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Consultation paper on draft opinion on supervision of liquidity risk management of IORPs

Fields marked with * are mandatory.

Responding to the paper

EIOPA welcomes comments on the Consultation Paper on the draft Opinion on the Supervision of Liquidity Risk Management of IORPs.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

Please send your comments to EIOPA using the EU Survey tool **by Friday, 20 December 2024, 23:59 CET** by responding to the questions below.

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Publication of responses
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It is also recommended that you select the “Send this Link as Email” icon to send a copy of the weblink to your email - please take care of typing in your email address correctly. This procedure does not, however, guarantee that your answers will be successfully saved.

You will have the possibility to print a pdf version of the final responses to the survey after submitting it by clicking on "Download PDF". You will automatically receive an email with the pdf file. Do not forget to check your junk / spam mailbox.

About the respondent

* Please indicate the desired disclosure level of the responses you are submitting.

- (●) Public
- ( ) Confidential
- ( ) Partly confidential

* Stakeholder name

Dutch Federation of Pension Funds

* Contact person (name and surname)

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Questions to stakeholders

Q1: The draft Opinion aims to be consistent with the FSB's proposed policy recommendations to enhance the liquidity preparedness of non-bank market participants. However, the draft Opinion covers all sources of liquidity risks within its scope rather than only liquidity risk relating to margin and collateral calls. Do you agree that the draft Opinion takes a comprehensive approach to liquidity risk of IORPs?

- (x) Yes
- ( ) No

Please explain.

Pension funds need to consider, and do consider, all sources of liquidity risk. Therefore, we agree with the fact that the Opinion takes a comprehensive approach.

At the same time, we do want to emphasize the very different nature of the examples cited beyond margin calls. Withdrawals from IORPs are currently not possible in the Netherlands. Even though it is likely that plan members will obtain the right to withdraw a lump sum of 10% of the accumulated capital attributed to him/her on retirement, this will only be possible at a single specific point in time (at retirement) and therefore not at the same time for all plan members. In any case, the cumulative amount of such lump-sum withdrawals will be much smaller than collateral calls on interest rate derivatives during large interest rate hikes. In the Netherlands, individual transfers are rare. Collective transfers will often also transfer ownership of the assets, instead of liquidating all assets and reinvesting them.

More importantly, all these scenarios have much longer time horizons than variation margin calls, which have to be settled on the next day or even on an intraday basis. It takes a long time to get a value transfer approved and lump sums will need to be requested ahead of time, so the IORP will be well aware in time of future cash withdrawals.

Q2: Do you agree with the definitions of 'liquidity risk' and 'material liquidity risks' in paragraphs 3.1 and 3.2?

- (x) Yes
- ( ) No

Please explain your answer and provide any suggestions to improve the definitions.

Q3: The draft Opinion specifies that NCAs should gather relevant derivative data to assess liquidity risk exposures of IORPs. Are you aware of any issues or obstacles for IORPs:

	Yes	No
- in collecting derivative data from asset managers to monitor and assess liquidity risks in relation to margin and collateral calls?	( )	(x)
- in reporting relevant derivative data to NCAs?	( )	(x)

Q4: The draft Opinion envisages a two-step approach. IORPs should first assess whether they are exposed to material liquidity risk and, if so, integrate liquidity risk in their system of governance and risk-management system, including an assessment in their own-risk assessment (ORA). Do you agree with this two-step approach?

- (●) Yes
- ( ) No

Please explain.

Q5: The draft Opinion provides in paragraph 3.6 suggestions for possible sources of liquidity risk that IORPs are exposed to. Are you aware of any other sources of liquidity risk that should in your view be explicitly addressed?

- ( ) Yes
- (●) No

Please explain your answer.

Q6: Do you agree that IORPs with material liquidity risk exposures should establish a contingency plan to deal with liquidity stress, as expected in paragraphs 3.8-3.10?

- (●) Yes
- ( ) No

Q7: The draft Opinion provides in paragraph 3.12 that IORPs should define their own liquidity risk indicators for day-to-day risk management. Subsequently two examples of commonly used risk indicators (liquidity coverage ratio & excess liquidity indicator) are suggested. Are you aware of any other liquidity risk indicators that are commonly used by IORPs?

- ( ) Yes
- (●) No

Q8: Do you agree that IORPs with material liquidity risk exposures should establish and maintain a clearly defined liquidity risk tolerance statement approved by the management or supervisory body of the IORP, as expected in paragraph 3.14?

- (●) Yes
- ( ) No

Q9: The draft Opinion prescribes in paragraph 3.15-3.16 that IORPs should regularly review and update their liquidity risk-management system. What would in your view be appropriate triggers and minimum requirements for such a review?

We believe that the wording of paragraphs 3.15 and 3.16 is sufficiently broad to capture all relevant scenarios. Pension funds should regularly review the liquidity management system. We do not think that the Opinion should a priori define scenarios that would trigger a review, as this could be interpreted as an exhaustive list of events.

The liquidity risk monitoring is not a one-off measure. It is a process of continuous (daily) monitoring. Any adjustments made in the portfolio (in real assets or derivatives) should automatically translate in liquidity measures being adjusted. As such there is no need for additional triggers.

Q10: Do you agree that IORPs should perform stress tests and scenario analysis covering all material sources of liquidity risk, and assess the impact of a range of severe, but plausible liquidity stresses, as expected in paragraphs 3.17-3.20?

- (x) Yes
- ( ) No

Please explain and provide any suggestions on the proposed minimum requirements for the stress tests and scenario analysis.

It is currently practice that pension funds or their fiduciary managers (to whom treasury and asset management is outsourced) conduct these types of exercises, next to stress test conducted by our supervisors. These internal and supervisory stress tests show that Dutch pension funds are able to withstand significant interest rate and currency shocks. As such we agree with the current wording of paragraphs 3.17 – 3.20.

While we agree with the fact that IORPs should perform stress test and scenario analysis, we would disagree with specifications of these measures at the European level. If scenarios are provided by a supervisor, it should be the NCA.

Q11: Do you agree that IORPs should maintain an adequate buffer of liquid assets to cover any shortfall of incoming relative to outgoing cash flows, also under severe but plausible stress conditions, as expected in paragraphs 3.21-3.23?

- (x) Yes
- ( ) No

Please explain and provide any suggestions on the conditions imposed on the liquid assets in paragraph 3.22 and 3.23.

First, the “buffer” should not only consist of assets, but should also take into account the availability of short-term borrowing facilities, most importantly repo. Primary liquid assets will need to be transformed into cash through sale or repo, and pension funds will often use the latter, in particular to meet collateral calls. Therefore, we would add to the first sentence of paragraph 3.22 that assets should be readily marketable “or transformable”.

Second, we believe that the list of primary liquid assets is too restrictive and should be expanded. Even if paragraph 3.22 does not appear to limit the assets eligible for the buffer of liquid assets to just those included in the list of primary liquid assets in the Annex, the Annex could be interpreted as an exhaustive list by NCAs or for other regulatory initiatives in the future. It is therefore important that, for example, money market funds and other money market instruments are considered. MMFs are a key asset for IORPs' liquidity risk management. Also, the sale of reverse repos is a key source of liquidity for IORPs and essential for being able to cover shortfalls and these facilities should be taken into consideration as such.

In this context, we would also like to stress that for IORPs, and large IORPs in particular, cash basically does not exist. On the one hand, cash at a bank account results in (100%) counterparty credit risk exposure. On the other hand, our members indicate that no bank is willing to have IORPs leaving large amounts of cash at bank accounts at all time as this is just too costly to the banks. Any cash will be invested in money market instruments and is being considered as part of the buffer. It should be taken into account that a cash buffer will come with transformation risk.

Third, we consider that equities could also be included as liquid assets with an appropriate haircut, also considering that equity markets have better liquidity that, e.g., credit markets.

Fourth, we note that liquidity buffers always come with opportunity costs; therefore they should be kept at a proportionate level. We believe that even when there might be liquidity risk under “severe but plausible risk conditions”, the risk management function of the IORP should be allowed to cover this by non-liquid assets that could be sold with a haircut if the necessity emerges.

Considering the above, we believe it is important that the assets and facilities eligible to be taken into account for the liquidity buffer are defined sufficiently broad to allow IORPs the necessary discretion and flexibility to manage liquidity risks appropriately, or rather not specify any types of liquid assets and facilities in the Opinion and leave it to NCAs to oversee that liquidity needs can be met.

Q12: Do you agree that IORPs with material liquidity risk exposures should periodically test their liquidity contingency plan through simulation exercises in order to ensure operational readiness, as expected in paragraphs 3.24-3.26?

- (●) Yes
- ( ) No

Please explain and provide any suggestions on the conditions imposed on the periodical testing.

Although periodically testing should form part of an effective liquidity contingency plan, proportionality should be a key factor (such as risks and costs of testing) in determining the manner in which this should take form. It would be too costly to conduct actual trades, but appropriate to hold so-called fire drills during which operational processes are tested. It could be verified, for example, whether processes are in place to port positions, in case of a default of a clearing member. It should be acknowledged that there is a wide spectrum of market conditions that can occur during an actual liquidity squeeze and it impossible simulate all.

Q13: To prevent operational lags in fulfilling margin requirements, do you agree that IORPs should ensure that investment funds to which IORPs have outsourced the management of derivative instruments should hold sufficient buffers of liquid assets to cover margin calls in times of market stress?

- (x) Yes
- ( ) No

Should this apply to all outsourced derivative arrangements or only a specific subset, considering for example segregated accounts/mandates versus multi-client/pooled funds and AIF versus UCITS funds?

- (x) all outsourced derivative arrangements
- ( ) only a specific subset

Please explain.

> In the Netherlands, pension funds often appoint asset managers or fiduciary managers to act on their behalf including in relation to their treasury functions. The discretionary management agreements between pension funds and asset manager/fiduciary manager are subject to strict regulatory requirements, such as outsourcing rules. The Dutch pension sector therefore would not be subject to the same operational challenges as was the case in the UK LDI crisis, as a single actor is responsible for meeting variation margin calls. Nevertheless, we do think that investment funds should be subject to the same level of supervisory expectations.

Q14: Do the expectations put forward in the draft Opinion achieve a proportionate approach to liquidity risk management of IORPs?

- (x) Yes
- ( ) No

Q15: Do you agree that the Impact Assessment in Annex I provides a balanced view of the costs and benefits of the relevant policy issues in the draft Opinion?

- ( ) Yes
- (x) No

Please explain and provide any suggestions.

No, the IA in Annex I does not provide a balanced view, as;

(i) The Impact Assessment misses the most important cost factor under policy options A1 and A2: the opportunity costs of holding a liquidity buffer. Cash and cash-like assets deliver a low return compared to the rest of the portfolio. Consider the hypothetical situation where European pension funds hold a liquidity buffer of 67bn euros to protect against a 1%-point interest rate shock. Assuming an average annual return of 6% on the broad portfolio and €STR (currently 3,1%) on a liquidity buffer of cash and near-cash instruments, holding the liquidity buffer would entail an annual opportunity cost of 1.9bn euros annually. This is just a theoretical example, but it shows that a pension fund must balance liquidity risks with the interest of its participants in obtaining decent returns. A requirement to hold an excessive buffer would be incorporated into the ALM process and subsequently lead to lower levels of interest rate hedge, leaving participants more exposed. It is important to keep in mind that both interest and currency derivatives are entered into in order to reduce risk in the balance sheet, on behalf of participants;

(ii) The impact assessment also misses a qualitative or quantitative assessment of the financial stability risks. These relate to two elements: the ramifications of closing out the position of an IORP at a CCP and the potential to create a negative feedback loop as witnessed in the UK. It is, of course, undesirable that an IORP has to be closed out of a position at the CCP, but the impact on the pension fund or the CCP is not really covered. The Impact Assessment could describe in more detail in ramifications and costs of being closed out. It is important to note, however, that this would occur during a scenario where the interest rate is rising. As Dutch pension funds are typically not fully hedged against interest rate risk, the coverage ratio of the pension funds is improving during this scenario. While the pension fund would default due to liquidity, the solvency position would be improving. The pension fund therefore would not default on other obligations and the expected pensions of its participants would rise. The main issue would be that the participants would lose a part of their interest rate hedge. If rates would fall, this would lead to losses. If rates would continue to rise, this would lead to larger than previous gains.

The reason EIOPA wants to publish this Opinion clearly are the events in the UK in 2022. LDI strategies of pensions caused a negative feedback loop that pushed interest rates up sharply, as they were selling government bonds in order to meet variation margin calls, gravely undermining financial stability and leading to BoE intervention. In order to provide insights into the benefits of this Opinion, it would be useful to quantify the risks of the European pension sector having a similar role in continental European bond markets. We strongly believe that these risks are a lot smaller than in the UK, for various reasons. First, only a few countries have large IORPs with derivative portfolios, with the Netherlands dominating the landscape. For this analysis the holdings of insurers should also be considered, but to the best of our knowledge these mainly exist in Denmark. The role of pension funds and pension insurance companies in euro bond markets is much smaller than the British pension funds in the gilt markets. Their role was further exacerbated by the fact that many DB funds have derisked, completely hedging the interest rate risk. Average hedges have increased in the Netherlands due to derisking as pension funds are preparing to convert their liabilities from DB to DC, as well as dynamic hedging policies, but currently stand at 64% (DNB: https://www.dnb.nl/media/jb5djjc0/ofs-najaar-2024.pdf). The level of the hedge is expected to fall, particularly for the longer maturities that swaps are used for, once the conversion has been completed and pension funds no longer use a coverage ratio.

Q16: Do you have any other comments on the draft Opinion / consultation paper?

- (x) Yes
- ( ) No

Please provide these other comments.

We welcome the fact that EIOPA has decided to publish an Own Opinion, rather than proposing an amendment of the IORP2 Directive. As derivative exposures are concentrated in the Netherlands, we believe a legislative approach would not meet the subsidiarity principle.

We note that the Opinion addresses IORPs directly. Previously published Opinions addressed NCAs. This seems more appropriate for this type of regulatory tool, as it is essentially EIOPA's opinion on how NCAs should conduct the supervision of liquidity risk management.

Finally, and most importantly, we remain concerned that in times of stress, the repo market does not work efficiently enough to prevent systemic risks occurring as a result of liquidity challenges. While it is right to expect that risk management and governance of pension funds are adequate, pension funds rely on intermediaries and other actors to access cash to meet margin calls, as pension funds cannot hold sufficient cash to meet calls that occur under adverse market conditions. A cash buffer is costly and cash will need to be invested in money market instruments. IORPs will need to rely on liquidity facilities and asset transformation and, therefore, a well-functioning market at all times.

Prior to central clearing, these liquidity risks did not exist to the same extent for pension funds, as pension funds could use government bonds as collateral in bilateral derivatives trades. While the back book still is significantly bilateral, all new trades must be cleared centrally, with cash currently being the only way to meet variation margin calls. Pension funds were given a 10-year exemption from the clearing obligation under EMIR, while the European Commission and market participants sought a solution to this problem, but the exemption expired without a solution.

In other jurisdictions a solution was found. Central banks in the United Kingdom, the United States, and Canada have recognized this issue. They put in place, or are in the process of doing so, liquidity facilities to prop up the resilience of repo markets or to provide a backstop repo facility directly to pension funds and insurance companies, as is the case in the UK. Unfortunately, the ECB has refused to consider similar arrangements, thereby exposing EU pension funds to risks that are beyond the scope of their own policies and governance structures. We believe supervisors must recognise these limitations when communicating their expectations, while weighing all risks, costs and benefits of interventions.

Further comments on Q6:

Dutch IORPs and fiduciary managers to which treasury functions are outsourced have written policies in place that meet the requirements of paragraphs 3.8 to 3.10. However, on paragraph 3.9, we do not believe that forcing pension funds to make exact estimates on amounts that can be raised through various liquidity sources, and at what cost, will result in better contingency plans. It is just not possible to assess exactly what the market circumstances will be during a liquidity squeeze and what the impact of these circumstances would have on generating additional liquidity. Instead, IORPs and fiduciary managers should have wide a set of instruments in place in order to be able to adapt to then prevailing market circumstances. Importantly, the contingency plan should address governance issues, so that the IORP, or the fiduciary managers acting on its behalf, are operationally prepared to act within the necessary timeframes.

Further comments on Q7:

Dutch pension funds define tailor-made indicators based on these ratios, adapted to the risk tolerance and specific risk profile of the IORP. We believe the wording of draft Own Opinion is sufficiently broad to allow this tailoring. If ratios are ever more narrowly defined in the future, it is important that the sector can provide input what is exactly measured. Our members have seen LCR ratios for pension funds being calculated incorrectly recently (for example value change buffer not taken into account, value change posted bond collateral not taken into account, no correction made for received cash collateral).

Further comments on Q14:

The expectations broadly reflect the current practice of liquidity risk management and supervision thereof in the Netherlands. Notwithstanding specific comments to improve the text, the draft Own Opinion generally is sufficiently flexible to avoid a disproportionate burden.

However, it is necessary to formally recognise the opportunity costs of holding a buffer. See answer to question 15.

Contact

Contact Form