PENSIONS EUROPE

20 March 2020

Subject: **CRISIS 2020 – UPDATE 1**

Impact on pension funds of current financial markets turmoil and challenges to Europe and global economy

Action required:
For information

We will closely follow the on-going economic and financial market crisis and its impact on issues relevant for funded pensions and our members. We will provide similar weekly updates and provide additional information if necessary. This first CRISIS 2020 UPDATE includes information of developments this far and of some of the measures that have already been taken.

We are at the moment mapping the situation and problems IORPs and other pension funds have experienced and expect and measures that can take place and what could helpful. We sent a questionnaire to our full and observer members on 17 March 2020 and asked for input by Monday 23 March. We will discuss the relevant issues in our working groups and take proper actions. We also aim to work in good co-operation on e.g. financial market regulatory and policy issues with other EU-level trade associations.

1. Introduction

a. What has happened this far challenges

COVID-19 Pandemic triggered a global capital market crises in early 2020 which exasperated in March 2020 as a result of never before seen measures by countries closing their borders and putting even nationwide lock downs in place. Supply and demand have been totally wiped out in many sectors and the impact will hit the whole economy at national and global level. There is a threat of drastically lower growth in EU and in the member states and recession is imminent. The stock markets have been volatile and uncertain than ever and also already now dropped more than ever since the 2008 – 2009 Great Financial Crisis and in some cases already even more. The room in the Europe for monetary policy and other central bank actions is very limited because of the vast amount of quantitative easing already taken place to deal with the previous crisis and the extremely low interest rates. These developments threaten the real economy and employment levels that have finally recovered or at least improved across Europe. The same development has taken place in different stages in the USA and Canada and in the end it is very likely that this will be the case globally. Many of the developed countries are struggling to cope with the pandemic and some already now have reached the limits of their capacity to treat people who have fallen ill. Less developed countries will have much less resources to deal with the health crisis There is uncertainty of how long the pandemic will last and when the economic activity and growth could start again. Meanwhile, many companies and even many sectors will struggle for survival and in many countries there will be a more rapid increase in unemployment that ever before. All of this poses severe challenges for pension systems. Central banks and governments and the EU institutions have taken actions and plan to do more and that is the case in other parts of the world and especially the USA. Information about these can be found below.

Europeans still mainly rely on PAYG social security pensions and low economic growth and lower employment levels together with aging of the population makes these pensions increasingly unsustainable and may well lead to decreasing replacement rates from public social security pensions. The EU policy to have adequate pensions in the future has been based on compensating lower social security pensions with funded workplace pensions or personal pensions. During and after the crisis of 2008 – 2009 it was difficult to support these types of supplementary pensions and some member states nationalised these pension assets. Crisis 2020 may pose similar challenges for funded pensions. The debt and deficit levels of many EU member states are on such a high level that their public finances don't have the capacity to maintain social security pensions on past levels. As a result of the crisis the EU economic framework has been relaxed and this will lead to higher deficit and debt levels for many countries.

The stressed financial markets pose major problems also for well-developed pension countries as the value of assets decreases drastically and even lower interest rates increase the value of liabilities further. Pension funds have benefited in the past from the decreasing interest rates in their fixed income investments as well as from the exceptional performance of the financial markets during the last decade. This market is now over and can't be assumed going forward in the near future. Thus, the funding levels and solvency of Defined Benefit pension funds will become an issue that the supervisors will scrutinise. In Defined Contribution pensions the market volatility will pose a challenge for especially voluntary schemes as people may find it too risky to save. The market risks will also materialise for individuals as members will increasingly enter the pay-out phase. The pay-out phase will continue to be very challenging as the low interest rate environment continues and also other options, such as life-cycling will not provide the same certainty as before as financial markets are stressed and pension funds experience losses and also yields are lower than before going forward.

b. Estimates going forward

The COVID-19 pandemic seems to ease in China but the fear is that there will be a second wave. Europe is at the moment the epicentre of the pandemic and Italy has the worst situation. Most European countries have closed their border for other than their own citizens and increasing number have limited all other than essential activities of the people. The USA is following same development and already California has ordered all citizens to stay at home. There are various estimates of how long the pandemic will last and they vary greatly. There is no vaccine for the COVID-19 virus and its development will take many months production and vaccination will take even much longer. Thus it seems very likely that the crisis will not be over any time soon, but it is not clear how long countries will have the present measures in place or whether they will need to resort to even stronger measures in order to protect public health. All travel between USA and Europe has been stopped and Americans have been advised not to travel anywhere. All of this will have severe impact on economy, growth and employment.

2. Assets and liabilities

a. Market developments and measures taken at EU and MS level

Fear surrounding the impact of COVID-19 on the global economy has hurt investor sentiment and brought down stock prices in major markets. The Eurostoxx 50 has dropped by 37,2% from 21 February to 18 March. Risk premiums on EU sovereign debts have also significantly increased and liquidity has continuously worsened in the bonds and interest rate swap markets, with higher transaction costs and declining interest rates.

Measures taken at EU level to stimulate the markets

On 18 March 2020, the European Central Bank announced its €750 billion Pandemic Emergency Purchase Programme (PEPP) (see section 4), a new asset purchase program of private and public sector securities which is expected to have positive effects on sovereign government bond yields and on the bond markets across the Eurozone.

Although it was initially expected that the European Central Bank would review its deposit rate downwards[1], it finally maintained its main reference rate at -0.5%. It is expected that the low interest rate environment will now be prolonged and that the ECB may even reduce its deposit rate in the future. In turn, both the Federal Reserve and the Bank of England already cut rates as ways to support their respective economies. The benchmark U.S. interest rate is now in a range of 0% to 0,25%, down from a range of 1% to 1,25%. In the U.K., the reference rates have been cut progressively from 0,75% to 0,25% and then from 0,25% to 0,1%.

b. Funding and solvency and measures taken at EU and MS level

As long-term investors, pension funds are able to mitigate financial shocks and work as a stabilising factor for the financial sector. Pension funds' long-term horizon and their ability to follow contrary investment strategies support the proposition that pension funds can act as shock absorbers in the

[1] Financial Times, "The ECB prepares to act as virus crisis escalates", 12 March 2020.

economy by providing liquidity and by not being forced to sell assets when asset prices are squeezed. Pension funds' investment strategies are very stable and many pension funds reinforced their long-term stances in the current context, including rebalancing to a strategic asset allocation that is focused on the long term and not largely impacted by intermediate market developments.

Despite the current concerns on economic growth and corporate earnings – especially equity markets, which have been falling since mid-February – some experts from the industry expect the downturn to be short-lived. The economic downturn would be temporary, with a recovery of the global economy in the second half of this year, according to Mark Fawcett, Nest CIO.

Notwithstanding this, the current situation in the financial markets will create new funding pressures and may have impacts on the solvency position of pension funds, affecting both their asset and liability sides. Even if pension funds often keep their strategic asset allocation constant, many of them may rebalance their investment strategies in the future which may remain challenging under current market conditions. Some experts are concerned that the current situation will take time to resolve and markets will take time to return to a semblance of normality. Investors would be currently struggling to determine the impact of the crisis on the earnings of companies are hit, supply chains are disrupted, and consumption patterns are affected. Market dislocations will have implications for pension funding levels and perhaps in due course in long-term investment strategies (letter from Liam Kennedy, editorial director, IPE).

Based on some estimates, the funding of Dutch pension schemes would have dropped by up to 11% on average in March. In the UK, the financial impact of the turmoil would have contributed to the rise of UK DB pension scheme deficits by around €110bn in the last week of February, taking solvency deficits to around £500bn.

Some national supervisors are considering the adoption of specific measures to closely monitor the solvency situation of pension funds and/or to alleviate their solvency requirements.

The Danish FSA (Finanstilsynet) is asking Danish pension funds to report solvency coverage on a weekly basis together with a simplified stress test. The FSA requires pension funds to report on market-rate pension plans, and the effect the downturn in the markets would have on customers saving with these products.

According to the Finnish Pension Alliance, strong solvency ratios of private sector pension insurers in Finland will make it easier to absorb the effects of the crisis. At the end of 2019, the average solvency ratio of private sector pension insurers was 128,3% and the solvency ratio of occupational pension companies was 127,7%, according to Finnish Financial Supervisory Authority figures (FIN-FSA). The FIN-FSA recognized that despite the strong solvency position of Finish Pension Funds, there could be a "rapid and significant decline" in average solvency. In this case, they will have to consider legislative or other measures. Finnish state of emergency legislation that has for the first time ever been taken in to use enable to change the solvency requirements of pension insurance companies.

3. Financial market measures

a. Short selling

The practice of short selling is often blamed for exacerbating volatility during times of stress. With the purpose to contain the volatility of the financial market, ESMA has decided to lower the threshold for the obligation to notify a short-sell position. Currently there is a requirement in Europe that net short-sell positions of more than 0.2 percent must be notified to the national market supervisor. It has now been decided at ESMA level that this notification threshold will be lowered to 0.1 percent. The measure takes immediate effect and applies for a term of three months, which may be extended if necessary.

In several EU countries, market authorities go even further and adopted a prohibition on short selling:

- In France, the AMF announced a short selling ban for one month until 16 April 2020.
- In Spain, the CNMV adopted a similar measure until 17 April 2020.
- In Italy, Consob adopted a ban on short-selling applicable until 17 June 2020. Consob also decided to introduce a temporary regime of enhanced transparency on the shares of the largest Italian companies.
- In Belgium, the FSMA announced a prohibition of short selling and similar transactions on the regulated market of Euronext Brussels until 17 April 2020.

b. Banking Sector

Companies remain heavily reliant on banks for funding purposes in the European Union and already face a severe shock both on the demand and the supply sides. Banks need to be in a position to continue financing households and corporates experiencing temporary difficulties and have already implemented measures to ensure business continuity and adequate service to their customers, but they are facing operational challenges, hence the need to focus on their core operations and critical functions. For this reason, European and national competent authorities have already adopted several measures to allow European banks to prioritize operational continuity and ensure that they can fulfil their role in funding the real economy. The European prudential framework already ensures that banks build up adequate capital and liquidity buffers which are designed to be used in order to absorb losses and ensure continued lending to the economy during a downturn.

The European Banking Authority postponed to 2021 the EU wide stress test exercise and recommends competent authorities should make full use, where appropriate, of flexibility embedded in existing prudential regulation. Banks should also follow prudent dividend and other distribution policies, including variable remuneration.

In this sense, the Single Supervisory Mechanism (SSM, ECB Banking Supervision) provides temporary capital and operational relief to directly supervised banks. More concretely, the SSM will allow banks under its direct supervision to operate temporarily below the level of capital and liquidity required in normal circumstances[2], adopted some flexibility in the composition of capital[3] and considers operational flexibility in the implementation of bank-specific supervisory measures.

Similarly, national competent authorities in many Member States have adopted specific measures to alleviate the solvency position of their banks and temporarily give them additional leeway to continue business lending and absorb potential losses. The Dutch National Bank lowered the systemic risk capital requirements for ING, Rabobank and ABN Amro and postponed the introduction of a floor for mortgage loan risk weighting. It is expected that these measures will free up EUR 8 billion in capital. As the total impact on lending could rise to a maximum of EUR 200 billion. The National Bank of Belgium welcomes the measures adopted by the SSM and will apply them in full to Belgian banks that fall under its direct supervision. The Federal Financial Supervisory Authority also intends to lower the countercyclical capital buffer from 0.25% to 0% as of 1 April 2020 in Germany. The buffer is to remain at 0% until at least 31 December 2020. In France, HCSF (High Council for Financial Stability) adopted a similar measure for an undefined period.

c. Insurers

EIOPA recognizes that insurers are likely to face progressively difficult conditions in the immediate future, both in terms of navigating challenging market conditions and in maintaining operations, while taking steps to protect employees and customers. In this sense, EIOPA calls national competent authorities to be flexible regarding the timing of 2019 supervisory reporting and public disclosure. In addition, EIOPA will limit its requests of information and the consultations to the industry to essential elements needed to assess and monitor the impact of the current situation in the market.
EIOPA is also extending the deadline of the Holistic Impact Assessment for the 2020 Solvency II Review by two months and considers the implementation of specific tools foreseen in the Solvency II framework to mitigate risks and impacts to the sector. Insurance companies are required to take measures to preserve their capital position following prudent dividend and other distribution policies, including variable remuneration.

d. Central clearing counterparties (CCPs) and Exchanges

The World Federation of Exchanges issued a statement recognizing that volatility has reached levels comparable with the Global Financial Crisis of 2008 and stressed the strong commitment of market infrastructures to support market participants in the face of the global economic shock

[2] Banks will be allowed to operate below the level of capital defined by the Pillar 2 Guidance, the capital conservation buffer and the liquidity coverage ratio.
[3] Banks will be allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements.

4. Wider economic impact and measures

a. Impact on growth and employment

The whole impact of the crisis on our economies is still unknown, but it is already known that it will be huge due to various extraordinary temporal measures already taken so far (it is unknown how long time those measures last), including closing borders and introducing (full) lockdowns. Possibly in the upcoming months there will be many bankruptcies meaning that many people will lose their job.

The estimates for global economic contraction are severe as well as for many EU economies. There is no consensus how severe the shock will be and how long it will last. Many member states are taking extreme measures to save companies from bankruptcy and e.g. France has said that it is ready to even nationalise big companies in order to save them. As both supply and demand are diminishing and in some sectors such as travel, hotels and restaurants almost completely, the layoffs and unemployment levels are increasing very rapidly. In the USA the estimates are that this increase this week may have been bigger than ever[4]. The US economy and financial markets are by far the most important for the global developments.

Equally there is no clarity or consensus of the impact of the crisis on financial markets going forward. There has been very little trust and the fear measure VIX index is record high, higher than even in 2008.[5]

b. Measures taken by EU, CBs and MSs

Central Banks:

On 18 March 2020, the ECB announced €750 billion Pandemic Emergency Purchase Programme (PEPP)[6].

- Economists have been calling for the ECB to increase its bond-buying programme, which has already collected €2.6tn of assets, particularly since the borrowing costs of southern eurozone countries — including Italy and Greece — began rising sharply to levels not seen for more than a year.
- The ECB opened the door to buy Greek sovereign bonds for the first time since the country's sovereign debt crisis by announcing a waiver for its debt under the new asset-purchase programme.
- Another option for the ECB to repair market confidence would be to lift its self-imposed limits to not buy more than a third of the eligible sovereign bonds of any single country and to purchase sovereign bonds in proportion to the weight of each country's investment in its capital.

[4] https://edition.cnn.com/2020/03/19/economy/unemployment-benefits-goldman-sachs/index.html

[5] https://www.cnbc.com/2020/03/16/wall-streets-fear-gauge-hits-highest-level-ever.html

[6] See the ECB press release "ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)".

- The ECB signalled this was under consideration, saying: "To the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the governing council will consider revising them to the extent necessary to make its action proportionate to the risks that we face."
- Divisions have again emerged between top European Central Bank officials after they disagreed over how far to take its new "no limits" policy to shield the eurozone from the economic and financial turmoil of the coronavirus pandemic[7].

On 15 March 2020, the ECB, the Bank of Canada, the Bank of England, the Bank of Japan, the Federal Reserve, and the Swiss National Bank have together agreed to lower the pricing on the standing US dollar liquidity swap arrangements to USD OIS plus 25 basis points and to offer weekly 84-day operations[8].

EU:

The EU is scrambling to find tools to offset the massive economic fallout of the coronavirus crisis - which could likely require a global effort. On 16 March 2020, Eurozone finance ministers tasked the EU's bailout fund, the European Stability Mechanism (ESM), set up after the 2008-09 financial crisis, to consider ways of tackling the economic fallout of the outbreak.

Italy's Prime Minister Giuseppe Conte urges Brussels to unleash €500bn rescue fund[9]:

Italy's prime minister has demanded the EU use "the full firepower" of its €500bn rescue fund to confront the continent's economic crisis, as he has warned against relying on monetary policy to counter a "global shock that has no precedents".

European Commission

On 19 March 2020, the European Commission has adopted a Temporary Framework to enable Member States to use the full flexibility foreseen under State aid rules to support their economies. Together with many other support measures that can be used by Member States under the existing State aid rules, the Temporary Framework enables Member States to ensure that sufficient liquidity remains available to businesses of all types and to preserve the continuity of economic activity during and after the outbreak. The Temporary Framework provides for five types of aid:

(i) Direct grants, selective tax advantages and advance payments: Member States will be able to set up schemes to grant up to €800,000 to a company to address its urgent liquidity needs.

(ii) State guarantees for loans taken by companies from banks: Member States will be able to provide State guarantees to ensure banks keep providing loans to the customers who need them.

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[7] See the FT Article "Top ECB officials divided over Christine Lagarde's bond-buying plan".
[8] See the ECB press release "Coordinated central bank action to enhance the provision of global US dollar liquidity".
[9] See the FT article "Italy's PM urges Brussels to unleash €500bn rescue fund".

(iii) Subsidised public loans to companies: Member States will be able to grant loans with favourable interest rates to companies. These loans can help businesses cover immediate working capital and investment needs.

(iv) Safeguards for banks that channel State aid to the real economy: Some Member States plan to build on banks' existing lending capacities, and use them as a channel for support to businesses – in particular to SMEs.

(v) Short-term export credit insurance: The Framework introduces additional flexibility on how to demonstrate that certain countries are not-marketable risks, thereby enabling short-term export credit insurance to be provided by the State where needed.

European Investment Bank:

- EIB Group offers support to European companies under strain from the coronavirus pandemic and its economic effects.
- Potential financing of up to EUR 40 billion can be mobilised at short notice, backed up by guarantees from the European Investment Bank Group and the European Union budget[10].
- Extra funding available for healthcare sector for emergency infrastructure and development of cures and vaccines.
- President Hoyer calls for significant, scalable additional guarantee from Member States to ensure access to finance for SMEs and midcaps.

World Bank:

On 17 March 2020, the World Bank approved an increased $14 billion package of fast-track financing to assist companies and countries in their efforts to prevent, detect and respond to the rapid spread of COVID-19. The package aims to strengthen national systems for public health preparedness, including for disease containment, diagnosis, and treatment, and support the private sector.[11]

5. Pension policy impact

a. EU pension policy

EU hasn't this far made new policy decisions in pensions as a consequence of the crisis.
However, EU has decided to relax the economic governance framework of stability and growth pack and thus member states will have more room in their public finances, in which first pillar social security PAYG pensions play a major part. This flexibility will ease the pressure on these pensions temporarily but in the longer term the problems for their financial sustainability will become even bigger.

[10] See the press release "EIB Group will rapidly mobilise up to EUR 40 billion to fight crisis caused by Covid-19 and calls on Member States to set up a further guarantee for SME and mid-cap support from EIB Group and national promotional banks".

[11] See the press release "World Bank Group Increases COVID-19 Response to $14 Billion To Help Sustain Economies, Protect Jobs".

b. MS pension policy

France

The French government is suspending all reforms already underway, "starting with the pension reform", President Emmanuel Macron said on 16 March 2020 in a speech about new measures to stem the spread of the coronavirus[12].

6. Recent/upcoming lobbying positions/actions by various industry representatives

American Benefits Council

On 18 March 2020, American Benefits Council **sent a letter[13] to both houses of the US Congress with issues for consideration in helping retirement plan participants, IRA owners, plans and plan sponsors address crisis-related challenges.** Many of the issues that the letter describes will be relevant in Europe as well and they cover both the DB and DC plans, such as:

- For retirement plan participants and IRA owners, the most pressing issues are (1) limitations on their access to their savings, which are needed to help them pay bills and provide for their families during 2020, and (2) avoiding unnecessary burdens and taxes.
- For retirement plan sponsors, the key issues are (1) helping their employees in the ways described above, and (2) relief from the pressures of large defined benefit plan funding obligations, some of which are generated by the economic crisis.
- For retirement plans, the key issues relate to notice and reporting obligations that will inevitably be delayed by the current state of disruption.

Invest Europe

Invest Europe which represents venture capital and private equity funds (and pension funds are the biggest investors in them) is very concerned of the situation as liquidity is drying out from the market. Many funds are already closet for redemptions.

Invest Europe has asked their members, which are the actual funds, what concerns they have and they are collecting this in a data base. Invest Europe wrote a letter 19 March 2020 [14]to the EC to ask for measures to help the situation. In their letter they said among other things that the establishment of a State aid Temporary Framework is a key move to allow Member States to grant aid to firms as they will likely face liquidity issues in the coming weeks and months and that these should also apply to companies backed by private equity and venture capital firms. They also asked

[12] See the IPE article "Macron suspends pension reform given coronavirus demands".
[13] You can read the letter here.
[14] Invest Europe letter 19.3.2020 to vice-president Dombrovskis

the European Commission to approve the full use of the **built-in** flexibility in the Stability and Growth Pact and supported the decision to reallocate some of the existing unused funds to support liquidity.
Invest Europe also suggested postponing the implementation of proposals that could make it harder for financial institutions to provide much needed liquidity to SMEs directly or indirectly, such as the ones envisaged by the implementation of the Basel III standards. While the implementation date is later, because market investors anticipate the impact on banks as soon as the draft legislative proposal is disclosed, it will reduce the finance capacity of banks in the same proportion as the capital requirements increase that the EBA estimated in 24%. Reversely, but with similar motivation, they urged work on the Solvency II review to continue rapidly, so that the framework can better reflect insurers' long-term business model and remove the disincentives that limit their natural capacity and interest to invest in SMEs.

We aim to work together with Invest Europe going forward, and they have also contacted other trade associations such as EFAMA, EBF and Insurance Europe.

EBF

The European Banking Federation, EBF, has sent a letter[15] to the ECB, EC, EBA, and the Single Resolution Board in which the EBF asks regulators and supervisors for assistance to be able to work constructively with borrowers and other customers in affected communities, which will require flexibility to stem the regulatory-enforced barriers to finance borrowers in temporary struggle.

In the opinion of the EBF, it is the joint responsibility of European authorities, regulators, supervisors and banks, to quickly adopt a series of measures needed to neutralize the effects of the COVID-19 on the economy. This should be addressed through a three-stage series of coordinated actions: Firstly, a set of immediate decisions to avoid adverse liquidity effects on European businesses and households during the coming weeks. Secondly, a set of medium-term actions to secure the continuation of credit transmission by banks which enables them to maintain their current prudential robustness over the next six months. Thirdly, other measures to smooth the prudential effects on banks in the next year.

[15] See the EBF letter "EBF call for European measures to face COVID-19 outbreak".