Fostering Institutional Investment in Europe's Capital Markets

Reality vs. Expectations

2nd Interim Report of the

CEPS-ECMI Task Force on Asset Allocation in Europe

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1. Introduction

The Capital Markets Union (CMU) initiative has set out important priorities in the area of asset allocation, such as increasing retail participation, promoting sustainable investment, and removing barriers to cross-border activities. In Europe, capital markets have reached different stages of development, and activating savings and investment channels beyond national lines remains problematic. Capital markets are expected to enhance long-term value creation in the real economy, and institutional investors to play a more constructive role in achieving this overall objective.

Traditionally, insurance companies and pension funds (ICPF) have been considered providers of long-term capital aiming to match their assets and liabilities and exhibiting countercyclical investment behaviour. Their strategic/tactical asset allocation is influenced by multiple factors, resulting in portfolios that are built around two main asset classes, namely fixed income and equity. However, most institutional investors have started to shift their allocations further down the credit-risk spectrum, also venturing into assets with increasingly longer maturities and the alternatives space due the challenges posed by the low/negative interest rates environment in recent years. More holdings of equity, ideally cross-border, are needed in order to increase portfolio diversification, to isolate households and financial intermediaries from country specific shocks, and ultimately generate higher returns.

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This second Interim Report is based on the discussions among the experts present at the Task Force meeting held on 24 October 2017, additional secondary research and targeted bilateral consultations. The views expressed in this report are attributable solely to its author. The main ideas will be considered for the Final Task Force Report, which will put forward a series of policy recommendations supported by in-depth quantitative and qualitative analysis. More detailed and up-to-date information about the Task Force is available here.

2. Insurance companies

The insurance sector is the largest institutional investor group in Europe (with €10tn in assets) and remains highly concentrated in a small number of countries (United Kingdom, France, Germany, Italy). Despite a shift towards products featuring lower guarantees and a more flexible return structure, non-unit-linked still constitute the bulk of the policies. Insurers' portfolios are heavily invested in fixed income assets; an abrupt re-pricing in this segment could expose them to higher interest rate risk. The process of de-risking has come to a halt and has started to reverse in recent years primarily due to the low interest rate environment. Some insurers have been gradually increasing their investments in higher-yielding debt instruments but also in infrastructure, private equity and direct lending. On average, non-life insurers operate at higher shares of equity than life insurers.

- What are the most relevant constraints/opportunities on the balance sheets of insurers?
- Are the concerns about the increasing duration mismatch and re-investment risk warranted? What types of risk management strategies are currently being employed?
- What are the main drivers behind externalising portfolio management and other types of services (reporting, data analytics, etc.)?
- Should prudential regulation incentivise investment in certain asset classes? Is the current regulatory framework (Solvency 2) conducive to long-term investment?

Investment portfolios

Typically, investments are selected in order to allow the service of the payments ahead (coverage of liabilities) and optimise the performance for the policyholder and the insurer (given a number of constraints). Insurers' portfolios are dominated by fixed income assets (though to a lesser extent for non-life business). EIOPA data for Q2 2017 (sample based on 2027 solo insurance undertakings in EEA, asset-by-asset template, look through approach applied, participations included, unit linked excluded) shows that European insurers' portfolios were made up of government bonds (33%), corporate bonds (35%), equity (16%), cash and deposits (5%), mortgages and loans (5%), property (2%) and other assets (4%). ECB data shows that the percentage of investment funds units in the insurers' portfolios (including unit linked, only euro area) has been increasing steadily over the past four years to more than 25% by mid-2017, of which more than half were mixed and bond fund shares. Inflows into equity and mixed fund shares underpinned most of this growth in the last year and life insurers were the main contributors to this trend. The investment portfolios tend to vary substantially across Europe for multiple reasons. For example, in some countries (Germany, France, Italy and Spain) bond investments (government or credit) are dominating while in other countries (Denmark, Norway, Sweden, and United Kingdom), the proportion of equity and other assets is notably higher. There is also a certain home bias in sovereign debt, but credit and equity are also largely driven by the need to manage balance sheets locally. In its recent report on changes and trends in the investment behaviour of insurers, EIOPA indicated that the overall asset allocation (bonds, equity, others) in has remained broadly stable over 5 years across the examined sample (87 insurance groups and 4 solos, coverage: 72% of total investment assets in 2016). A small decrease in the debt portfolio is observable as against a small increase in other investments between 2015 and 2016. Equity allocation has remained unchanged. However, this does not necessarily imply that insurers have not altered their investment strategies. Most importantly, the analysis led to the identification of a number of trends that could be associated with search-for-yield behaviour by insurers (longer duration, lower credit quality, illiquid investments).

Direct equity holdings (excluding participations and collective investments undertakings) represented only around 4% of insurers' total investment portfolio in 2016. Life insurers are more focused on asset-liability matching than non-life insurers; as a consequence, their equity allocation is lower compared to non-life insurers. Equity has a specific risk and return profile compared to other asset classes. Data from the industry suggests that the share of equity compared to 10 years ago decreased mainly due to market/economic conditions, prudential and accounting rules. A few large players are currently operating at very low levels of equity (just above 3%). This is partly attributable to the portfolio de-risking undertaken to optimise the capital allocation in view of the introduction of the Solvency 2 regime in 2016; this came to a halt and tended to reverse in 2017. However, analysis by EIOPA indicates that the allocation to equities has been stable over the past 5 years and that the influence of Solvency 2 was neither so preponderant nor did it exacerbate pro-cyclicality. A shift from listed to non-listed equity has been identified, but there are no clear trends in the preferences for financial or non-financial companies. In aggregate terms, the share of equity investments seems to be higher in well capitalised insurance companies but this could also be attributed to other reasons such as the different business models.

The Commission has committed to investigating thoroughly what are the most relevant factors driving up or impeding investment in equity by EU insurance companies (listed vs. unlisted, directly vs. through funds, domestic vs. cross-border, characteristics of the issuers), including a ranking based on the degree of relevance of the identified drivers (liability structure, prudential and accounting rules etc.) and taking additional action if needed. A review of level 1 of Solvency 2 is due by the end of 2020 and this will look at the treatment of long-term business and investment. The potential shortfall in equity investments of insurance companies has been estimated at €350bn or 5% of their total investment portfolio (traditional business). Industry representatives argue that the current calibrations are based on the assumption that insurers invest like traders rather than long-term investors and are prone to liquidating their entire portfolio in worst case scenarios. Moreover, the current prudential framework does not reflect properly the predictable and long-term nature of their liabilities, as well as the flexibility they gain from sources of liquidity in deciding if, when and which assets to sell assets to meet claims. The risk of surrender tends to be isolated in nature, e.g. specific products. In their view, reducing the capital charge for listed equity (from 39% to 22%), provided that there is a long term approach, the risk is measured net of management actions and other mitigating tools are put in place, would significantly increase the target asset allocation in equity. Also mentioned: assessments of the potential capacity of dividends to offset potential capital losses over time and whether the accounting treatment in IFRS 9 (in conjunction with IFRS 17) is sufficiently conducive to long-term investment including equity investment.

At the end of 2016, the total value of strategic participations for insurers using the standard formula totalled €238bn (on average 3% of total investments). Most strategic investments are related to investments in financial and insurance activities, followed to a lesser extent by investments in real estate that are held for a period shorter than 10 years. Moreover, increasing portfolio diversification with more listed equity instead of strategic participations (in particular intra-group holdings or embedded in unlisted equity) could reduce idiosyncratic risks and even outperform within the overall portfolio.

With respect to other asset classes, most European companies have publicly expressed their intention to increase the average weight of infrastructure projects to as much as 5-10% compared to less than 2% at present. Even though prudential requirements have been calibrated more in line with the actual risk for insurers, additional concerns remain over insufficient pipelines throughout the EU, quality of the deals and price competition, but also the concentration risk to which insurers are exposed when investing in infrastructure projects.

When analysing the process of re-risking in the past years, it is worth distinguishing between an increased level of investments into illiquid asset as part of yield enhancement strategies (private equity/debt, hedge and absolute return funds, real estate, infrastructure, mortgages and other loans, direct lending) and re-risking in the traditional sense (e.g. buying more equities, which was not necessarily the case. Even though this approach supports portfolio diversification, such exposures should be complemented by enhanced risk management practices. At the same time, there are insurers that reported having shifted their investment allocation towards more liquid assets (in particular in the traditional business). As Solvency 2 was introduced, the buying of long dated exposures has increased substantively to counteract the duration mismatch in some cases. Insurers typically seek to match cash flows at portfolio level in order to minimise exposure to interest rate risk.

Financial conditions required companies to focus particularly on Asset Liability Management (ALM) positioning and screening their assets and liabilities in terms of common underlying factor exposures. The consequences of low interest rate environments vary widely across companies, largely depending on their business models, market specificities, and risk management strategies. The interest rate remains a heavy contributor to performance; the weak investment income in recent years reflects the difficulties in generating solid returns in the prolonged low yield environment and has led to a shift towards riskier assets. Regarding the latter, it is important to differentiate between taking more risk outright and investing in riskier assets based on liquidity considerations, i.e. insurers holding illiquid assets because the shape of their liabilities allows for it. A normalisation of interest rates is desirable provided that this would be triggered by an increase in 'risk-free' rates as opposed to an abrupt and sizeable repricing of risk or term premia.

Liabilities structure

The liability side features technical reserves, namely obligations to policyholders, and own funds. It is a reflection of the business models (life, non-life, composite), and the markets covered (national and/or cross-border). While traditional policies continue to dominate and the demand for guarantee products remains strong, insurers have been reducing the selling of financial guarantees or altering their features, but have also gradually have switched towards unit and index linked products (UL/IL). In 2016, the vast majority of the UL/IL business (80%) was managed by insurance groups in Germany, France, the Netherlands and the United Kingdom. In such cases, it is the policy holder rather than the insurer that bears the investment risk, and such shifting behaviour could raise financial stability concerns. Investor protection is a major issue at hand, in particular for those individuals who do not have large amounts savings and/or the financial knowledge to build a properly diversified portfolio and monitor it. When it comes to the risk of mass lapses of UL policy holders, it was argued that such sales are probably less likely (because of insurance wrappers) than similarly motivated sales by mutual funds.

Products with long-term guarantees (LTG) broadly using Solvency 2 LTG measures have slightly decreased across the EU given the low interest rates and the increasing cost of offering guarantees. Understanding insurance products, in particular their illiquidity, effective duration or short-term volatility, is essential for deriving the ALM spot and then taking active investment decisions. Sticky liabilities are underpinning the ability of insurers to harvest the liquidity premium of selected asset classes. The capacity to on-board long-term assets depends on the net position for each maturity bucket (how many claims to pay out compared to the cash flows generated by assets). A larger share of high-quality own funds (tier 1) could also be instrumental in stabilising the balance sheet and extending the time horizon in ALM and investment strategies.

Asset management

The European insurance market for asset managers (€3.6tn) is dominated by captive players (70% within insurance or banking groups), with portfolios largely biased towards fixed income strategies compared to alternatives and equities. However, there is an increasing demand for specialised services from independent third-party asset managers from, for example, mid-sized European insurers lacking access to non-traditional asset classes or preferring to start building relations with external asset managers that understand the reality/peculiarity of their business model. In general, there are clearly defined roles in strategic asset allocation (SAA), ALM, in(out)-sourcing (full or partial), asset classes (core or niche), and execution policies. The main services requested include portfolio construction (taking into account specific prudential, accounting, and tax rules) but also compliance reporting and data analytics. Being able to deliver higher returns in capital-adjusted and cost-effective terms is essential. Alternative fixed income will also be explored further (in particular investment grade and high yield corporate bonds, bank loans, infrastructure/real estate debt and multi-assets). Risk management and valuation capabilities will be particularly important for illiquid assets while Solvency Capital Requirement (SCR) optimisation strategies will be most common in the equity space. Insurers have also started to co-invest or enter other types of deal arrangements with originators and underwriters in such markets.

Regulatory developments

The Commission is due to review the standard formula for SCR by the end of 2018. Three priorities were identified for this review: enhancing proportionality for small and medium-sized insurers, removing undesired effects and inconsistencies with other financial legislation, and facilitating investment in growth-creating assets by looking at the balance between simplicity and risk sensitiveness, using market consistency and mitigating pro-cyclicality and volatility. The full review of the Solvency 2 Directive is scheduled after five years of implementation in 2021. While the new regime is generally praised, there are also calls for a comprehensive impact assessment on the cost, design and availability of certain insurance products and on insurers' investment decisions, in particular for long-term investments. The regime must remain fit for purpose, work for the insurance industry as a whole and, most importantly, deliver benefits for the consumers.

The current prudential framework prescribes how much capital should be put aside based on the one year Value-at-Risk (VaR) approach through the calibration of charges for investment risks, but also other important elements such as the discount rate or the risk margin. When it comes to recalibrations, amendments have already been adopted for infrastructure projects and corporates. This will be followed by investments in high-quality (STS) securitisation. EIOPA recommended objective criteria, such as financial ratios, in order for private equity and privately-placed debt to qualify for the same treatment as listed equity and corporate bonds. With respect to listed equity, Solvency 2 allows for a reduced capital charge when specific conditions are met (for example when they are held against certain pension products or qualify as strategic participation) and the use of transitional measures and symmetric adjustments modulating the 39% requirement according to market conditions. The industry representatives argue that the current calibrations are excessive when compared to the real economic risks; in their view, a reduced capital charge would be warranted provided that adequate safeguards are in place, e.g. calibrate more on historical rather than immediate volatility, catering for the illiquid part of the liabilities and identifying the equity that is really held long term. Notwithstanding the role of prudential rules, equity investments are in practice influenced my multiple factors and this is also reflected in the heterogeneity among insurers and specific markets. Recent analysis by EIOPA indicates that on average equity investments have been actually increasing since 2017. With the objective of incentivising long-term investment but also influencing underwriting practices of insurers, the Commission also considers incorporating sustainability/ESG factors into prudential rules and a separate request for advice will be sent out to EIOPA.

As part of the 2018 SCR Review, EIOPA provided information on the relative size of the risk margin in insurers' balance sheets and assessed if the methods and assumptions applied in the calculation of the risk margin continue to be appropriate in the current market environment. In particular, EIOPA was asked to review the cost-of-capital (CoC) rate. In view of the results of the CoC calculations in the range from 6.7% to 7.8%, EIOPA recommended that the currently applicable CoC rate of 6% should not be changed. The industry has highlighted that the CoC rate should be significantly lower than the current 6%, and that more than €200bn capital is currently locked on their balance sheets in the form of risk margin. They also emphasised the need to analyse the potential impact of the risk margin, not only on some long-term products, but also on the ability of insurers to invest long-term. Furthermore, EIOPA indicated that most of the proposals were not within the scope of the current review, which focuses on CoC parameters rather than on the risk margin formula. Such concerns might be tackled at a later stage, for example in the Review of the Solvency 2 regime due in 2021.

In the area of the calculation of interest rate risk, on its own initiative EIOPA recommended new calibrations on the basis of sufficient evidence of negative/low interest rates for 3 years straight. Under the current Solvency 2 regime, there are no capital requirements to cater for such volatile financial conditions. For example, for 5 YtM (years to maturity) shifts over 100% were registered with the shock being calibrated at 46%, for 10 YtM shifts in the range 70-80% shifts with the shock calibrated at 31% and for 20 YtM shifts of 50% with a calibrated shock of about 20%. However, the industry has questioned the need, timing and scope for the review of the interest rate module. In short, changes in the field of interest rates would heavily impact insurers' investment behaviour and the product mix, ideally long-term, profitable and capital efficient solutions. Insurers employing internal models have already adapted to the economic reality of a low and negative yield environment. Matching adjustments – duration and cash flow – also provided high level of immunisation against low/negative interest rates. The adjustment mechanisms allowed insurers to use the returns on slightly riskier assets to calculate their long term liabilities rather than 'risk-free rates', such as the return on government bonds. An isolated focus on interest rates was deemed inappropriate; instead the entire market risk module including correlations should be taken into account while more urgency has been identified in relation to credit spread volatility. In their view, sound risk management techniques, stress tests and other tools should be favoured over capital measures. On the timing, it was pointed out that the review of the interest rate risk module is interconnected with the RFR/UFR and LTG review scheduled for 2020. EIOPA's recommendation was to model interest rate risk in the standard formula with a relative shift approach and to phase-in/transition over the next 3 years. The proposed approach would be effective at both high and low levels of interest rates, and has already been adopted by internal model users.

FinTech

In recent years, the traditional insurance model has been challenged by InsurTech in terms of value proposition, operations and distribution. This translates into customer-centric, cost-efficient solutions, with more transparent, automated and faster processes. The incumbents seem to have fully embraced InsurTech either by changing certain parts of their businesses internally or by investing in, partnering with, and acquiring these highly innovative companies. In such cases, the focus is on simplifying and digitising parts of the insurance value chain as opposed to disruption and/or heavy disintermediation. Nonetheless, the number of InsurTech companies with separate digital brands and inherent competitive advantages are expected to increase. Although their initial focus has been on retail/household clients, in particular those that are digitally savvy, they have also started to move into the commercial segment. In general, big data should provide greater insights into the profile of the policy holders and their individual risks. This, in turn, is expected to improve underwriting decisions, pricing of policies and claims settlement. In the medium to long run, balance sheet management will also be impacted. Major insurers are also involved one way or another in blockchain initiatives. Such developments must be closely monitored, in particular the associated risks.

3. Pension funds

Europe's pension savings gap is projected at around €2tn a year for the period 2017 to 2057, equivalent to around 13% of the EU's GDP, and there is no one 'silver bullet' for solving this increasingly complex problem. Over the last ten years, European pension funds (defined benefit or defined contribution, occupational or personal, mandatory or voluntary plans) have experienced an increase in their investments (€4tn, >75% in the United Kingdom and the Netherlands). Traditionally pension funds have invested a lot in fixed income, but over the last decades they have started to shift towards equities and alternatives. At present, there is significant heterogeneity in the asset allocation among member states, with respect to direct or indirect holdings of equity in particular. When it comes to future challenges, the pension product mix (and underlying investment strategy) will have to accommodate the longevity 'risk' and deliver satisfactory and stable returns over time.

- What is the outlook for asset allocation (traditional vs alternatives) and investment strategies (active vs passive, cash flow vs liability driven) in the medium and long run?
- Do the main risks for pension funds appear to be on the return portfolio, or rather on the matching portfolio? Does the business model play a significant role?
- Are pension funds reconsidering their in(out)-sourcing of asset management or co-investment/partnerships with other institutional investors?
- Do the products and the regulation provide the appropriate framework for optimising the future purchasing power of pension savers?

Investment portfolios

Traditionally pension funds have invested more than 50% in fixed income assets (except for the Netherlands and the United Kingdom), but since 2008 they have started to shift towards more equities and alternatives. In the bonds category, they are generally more exposed to sovereign and financials compared to corporates (only 20%). The second largest category is represented by direct equity holdings (on average 30%), which is five times higher than insurance companies. Around 5-6% is invested in UCITS and 6-8% in real estate. The remainder is invested in other assets (loans, infrastructure, private equity/debt, hedge funds, alternative funds, etc.), a category that has been growing in recent years given the low yield environment. While changes have been clearly indicated at the level of individual firms, no clear conclusions can be drawn at this stage on the investment trends for the broader categories (fixed income, equity, other assets). The overall allocation in most of the countries seems to have remained almost unchanged in recent years (2013 to 2016). However, there a few caveats: data is not as granular as for the insurance sector and the overall comparability is also undermined by different national valuation methods for reporting on assets (market specificities, diversity in national pension systems and regulatory frameworks). Nonetheless, supervisors and market participants are making efforts in this respect in order to obtain a more comprehensive picture on the changes in investment behaviour (search for yield, flight to quality or herding behaviour). Generally, pension funds are not subject to investments quotas, but are encouraged to calibrate their exposure to alternative investments depending on the quality of their funding position and enhanced risk management capabilities.

There is quite some heterogeneity in the asset allocation across the EU. At the end of 2016, the UK pension funds showed almost equal exposures to equity and government bonds (30% and

35%, respectively) as a result of the de-risking process that started prior to the financial crisis. The share of direct equity holdings by Dutch pension funds has decreased in recent years, but this was compensated by a significant shift towards indirect holdings of equity via mutual funds (overall still more 40%). Pension funds in continental Europe tend to have asset allocation tilted towards fixed income. However, continental European corporate pensions (according to a survey ran by an asset manager) are planning to increase allocations to illiquid assets (real assets, real estate) and rotate out of fixed income and hedge funds. Within fixed income, continental European corporate pensions clients intend to shift into private credit, emerging market debt and unconstrained and out-of-core/ core plus and long-duration strategies. German pension funds appear to lie on the conservative side of the spectrum, but they have restructured their portfolios significantly in recent years, in particular towards more indirect holding holdings of equity and also corporate bonds. The largest shares in equity holdings (35%-50%) have been observed in Finland, Belgium, Ireland, Lithuania while in alternatives (20-25%) in Sweden, United Kingdom, Estonia, Portugal. In Poland, investments in governments bonds have been prohibited. In other CEE countries, more than 50% is invested in government bonds and quantitative restrictions on certain asset classes are in place. Portfolio allocations to infrastructure remain small (less than 1%); insufficient supply of viable projects is often mentioned as an impediment. Cross-border financial holdings have been increasing in the recent years, but the majority of assets remains invested in the domestic markets primarily due to balance-sheet constraints and home bias. The exception is the Netherlands, where 10% of assets are invested at national level, 40% in the rest of Europe and 50% outside Europe. A higher foreign exposure is associated with the search for new uncorrelated investments, currency and inflation hedging programmes and in-depth knowledge of the local market conditions.

The low interest rates environment is affecting both sides of the balance sheet to different degrees. In particular, countries that use discount rates directly related to market rates were confronted with insufficient returns on investment enough to compensate for the growth in liabilities. Liability-driven investment (LDI) will continue to be employed. The main objective is to lower funding level volatility over time and find the middle ground between matching and growth assets (i.e. higher yielding fixed-income assets and equities) that could outstrip liabilities. The need for more diversified and consistent flows of income might be translated into more incorporation of cash flow driven investing (CDI). The impact of unwinding the QE programme should also be monitored in the coming years. A repricing in the fixed income markets seems to be unavoidable. Nonetheless, the more volatile market environment could also bring more opportunities for alpha generation and sources of return with low correlation with mainstream asset classes. Pension funds are expected move from a fixed income portfolio consisting of government bonds, investment-grade and high-yield credits and emerging-market debt and continue to venture into illiquid and alternatives (private equity and debt, smart beta and multi-asset strategies, leveraged loans and direct lending, real estate and infrastructure, securitised finance).

Asset management

When it comes to asset management, large pension funds do almost everything internally while smaller and mid-sized funds need to outsource partially or completely. There are also cases in which smaller, specialised pension funds are owned by large pension funds. In the coming years, pension funds are not only expected to re-consider their strategies with respect to the in(out)-sourcing of asset management or co-investment/partnerships with other institutional investors, but also renegotiate the terms of their mandates, in particular as regards active vs. passive management. There is also pressure to consolidate in the pension sector and achieve more operational efficiencies (minimising the total costs of running the scheme and delivering better value and returns for members). Asset allocation will also have to accommodate changes in demographic trends, including intra-and inter-generational challenges. Lifecycle investment (in particular linked to DC plans), and more de-risking over the time may become in the norm in the coming years. The underlying idea is to expose participants to maximum market risk in the early stages of their life and minimise the risks progressively towards mid-career and ultimately retirement. This would allow for more flexibility depending on the risk profile of the savers and broadening the scope for multiple asset classes, strategies and specialised asset managers. This should be analysed in the broader context of risks being shifted onto the individuals and pension funds rethinking their optimum asset allocation in order to generate stable, real positive returns.

Shifts in pension plans

In Europe, more than 80% of pension assets pertain to pure defined benefit (DB) or hybrid schemes. Nonetheless, these have come under increased pressure in recent years – negative duration gaps, primarily due to the low interest rate environment but also operational inefficiencies. For example, the discount rates for the liabilities in Denmark, the Netherlands and Sweden are the closest to market rates. As a result, they started to lower or stop offering guarantees – benefit reductions, closing schemes to new members and/or replacement by defined contribution (DC) schemes for future accruals, transferred assets/liabilities in full or partially to another provider, or completely winding up. Moreover, the shift towards DC schemes (in terms of active members and total assets) is expected to continue. New pension designs incorporating features from both the DB and DC world may enter the market. The contributions to DC schemes (which tend to be lower than for DB schemes) are determined in advance and invested in a portfolio, and the members bears all the investment risk. The transfer of financial risks and costs from IORPs and sponsors to individual beneficiaries needs to be further monitored and investigated. The success of any pension plan is defined by the capacity of providing 'good value for money', namely setting a fair, affordable contribution levels for both employer and employee, designing investment strategies to reflect the risk and return characteristics, and ultimately delivering performance in cost-effective terms (better real returns). Other anticipated market developments include on the one hand more consolidation among various players and stagnation in cross-border activity, but on the other an increase in the number of multi-employer IORPs and expansion of multi-country cross-border IORPs.

Regulatory developments

At present, there is no harmonised prudential regime for pension funds. The IORP 2 Directive came into force in Jan 2017, and must be fully transposed into national law by Jan 2019. More broadly, a Solvency 2 type of regime was deemed unsuitable by the industry given the negative impact on sponsors, the need for protection schemes for members and also the changes in asset allocation and risks of pro-cyclical investment behaviour triggered by specific capital requirements. It was argued that a further development of solvency models at the EU level is neither realistic in practical terms nor effective in terms of costs and benefits, particularly given the diversity of IORPs within and across member states. Valuation methods are country specific: on national balance sheets, assets are valued either at market or book values while for liabilities the discount rates vary between risk-free rates and expected returns on assets. Also different national funding requirements coexist as well as different prudential/recovery mechanisms for dealing with funding shortfalls.

EIOPA's second EU-wide stress test ('double-hit' in risk-free interest rates and the asset prices) revealed that shortfalls for DB and hybrid schemes in their liabilities on the common, market-consistent balance sheet were €349bn and €702bn in the baseline and adverse scenario, respectively. According to the national balance sheet, the aggregated funding ratio declines from 97% in baseline to 79% in adverse scenario corresponding to 3% and 21% shortfalls (€49bn/€301bn). Shortfalls could be addressed through additional sponsor support, suspension of conditional or discretionary benefits and/or benefit reduction while reducing risk through changes in the asset allocation or derivative hedging. Additional strain on sponsor companies may have possible negative implications for economic growth and employment levels. As for DC schemes, the market value of investment assets will drop by 15% in the adverse scenario, reducing individual accounts. The impact on the real economy depends on whether members take into account lower projected retirement income in current consumption-saving decisions. IORPs are often subject to national recovery plans that allow sponsor support and benefit reductions to be spread over time, usually taking into account the future performance of investment assets. Typical recovery periods vary considerably between countries, ranging from less than 1 year in Denmark, Norway and Sweden, to 3 to 5 years in Belgium, Spain and Portugal and up to 10 years in Cyprus, Finland, Ireland, Italy, the Netherlands, and the United Kingdom. It is important to make sure the necessary adjustment to restore the sustainability of occupational pension schemes is not subject to too much delay.

The exercise aims to test the resilience of the sector rather than of individual funds and reveal risks and vulnerabilities and potential implications for the real economy and financial stability. It draws attention to existing and potential funding gaps, risk management practices and recovery mechanisms in place, while also taking into account that the sector is characterised by a high degree of heterogeneity across countries. Overall, 195 IORPs from 20 European countries participated in the exercise, representing a coverage rate of 39% of total assets. EIOPA's target coverage rate of 50% was not reached in some member states.

FinTech

Technological developments have the potential of transforming private pension design, management and delivery. Enhanced data collection and analysis tools are expected to lead to more tailored, personalised retirement solutions that will provide steady returns over time. Dedicated digital platforms are aiming to improve the accessibility to a broader consumer base. With respect to collective pension schemes, a greater use of fintech not only promises better engagement with individual members, but also operational efficiencies at the level of investment portfolios, transaction processing, risk management, cost disclosure, and regulatory compliance. In turn, this would translate into lower costs both for pension providers and for members. While the majority of robo-advisors target individual retail investors, an increasing number are also offering services (financial advice or active asset allocation) for pension funds. Although the application of Distributed Ledger Technology (DLT) to pensions has been so far limited, it is potentially applicable to a number of aspects of pensions, for example portfolio management, compliance and dashboards. The associated benefits should of course be assessed against the additional risks to be mitigated.

Pan-European Personal Pension Product

Some national pension markets are already very well supplied and have in place a multi-pillar structure, including collective and/or individual based pension schemes. Nonetheless, there are member states that remain heavily dependent on first pillar state pensions, which is socially and financially unsustainable in the long run. In Europe, the personal pension products market is underdeveloped and highly fragmented. On average, personal pension products represent 2.3% of the financial assets of European households. In only 5 member states (Austria, Germany, Spain, Sweden, Slovenia) has more than 15% of the population bought a personal pension product. The PEPP initiative has been described at the interface of pension/retirement policy and the CMU project, namely activating long-term savings and investment channels. PEPP is not meant to compete with the national systems but actually present the case for a product with a European added value. PEPP would create new opportunities not only for certain individuals (mobile workers, self-employed) and SMEs that cannot afford the costs of running an occupational scheme, but also enhance diversification in the funded pillars at country level. By 2030, the personal pension market is expected to reach €2.1tn in size, provided that national tax relief is granted to the PEPP. PEPP would need to encourage adequate savings for future retirement income and be sufficiently attractive for both savers and providers.

The PEPP proposal harmonises the core product features (authorisation, distribution, investment rules, portability, switching) and allows for flexibility in decumulation options. However, the conditions in the accumulation/decumulation phase are not prescribed in the EU regulation in order to allow providers to adapt to national laws and meet the criteria for tax relief in case of comparable products. It is open to many types of providers, if already authorised under EU rules (asset managers, insurers, banks, IORPs, investment firms). Distributors can be part of the PEPP provider, an agent of a PEPP provider, or a third party. There are no prescriptive rules with regard to the asset allocation, i.e. the prudent person principle will apply. PEPP is meant to be a long-term product, cost-effective and with positive real returns over time. While a central management of the investment is possible, providers must be able to offer compartments in all member states, as embedded in the different social and labour law (e.g. legal retirement age). When changing residence to another member state, the saver can decide to either keep multiple compartments or request asset transfer.

The Parliament and the Council are making good progress on this file. With respect to capital protection, some member states argue that life-cycle investment strategies may fall short of financial guarantees. Nonetheless, the proposal indicates that the qualifying risk mitigation techniques will have to be further specified at the level of implementing measures. It is crucial that competitive advantage for certain providers is not reinforced or created. Another issue relates to imposing or not a certain percentage in the form of annuity for the default investment option. It also appears that for many providers the natural market for a PEPP will be first their domestic market, perhaps then regional including several countries. Partnerships among potential providers in different member states instead of opening separate compartments might ease the burden of entering the PEPP market, but these are highly unlikely. Providers may also consider having administrators for the different national compartments, maybe externalising this to specialised companies – across the EU. The tax treatment is a crucial element for the success of PEPPs: they could receive the same treatment as for national products (contributions – returns – withdrawals, taxing upfront – TEE, in retirement – EET or hybrid regimes) or alternatively member states could agree on a specific 29th regime approach subject to unanimity (e.g. extending the EET tax system to all member states). The final parameters of the PEPP will be determined by the Parliament and Council (expected date is June 2018). The European Commission anticipates an EU-wide success of PEPP, resulting in a first product licensed by EIOPA and released on the market by 2020.

4. Conclusions

The capacity of insurance companies and pension funds to fulfil their financial obligations to policy holders and beneficiaries continues to be under scrutiny, with additional challenges posed by the prolonged low yield environment and the path towards normalisation of monetary policy in the near future. Starting from their specific business model, investment decisions are driven by multiple factors, such as assets and liabilities management, product design and mix, financial and economic conditions, risk-return performance, cost optimisation, prudential requirements, accounting rules, tax regimes and technological developments.

Notwithstanding the heterogeneity across companies and/or member states, the portfolios of insurance companies and pension funds remain heavily invested in fixed income, with increasing exposures to higher yielding instruments in recent years. The overall low level of equity must be addressed decisively. Given the specificity of their balance sheets, institutional investors are considered best suited to engage in long-term investment. With the growing importance of sustainability factors, significant changes in their asset allocation and risk-management practices are envisaged.

5. Next steps

The third meeting was held on 20 March 2018 and two remaining topics were covered: **asset allocation by/for retail investors** and **sustainable finance**. Discussions on these issues are briefly summarised below and will be presented in-depth in the 3rd Interim Report.

Retail investors

The European savers are and should remain at the core of the CMU project. To this end, a more balanced and diversified allocation of their financial assets is needed. Compared to the US, European households have more than double the amount of their savings in deposits, but only half as much in investment funds and shares. Moreover, due to a variety of reasons – savings rates/net financial wealth, investor preferences/behavioural aspects, market structure and access, regulatory/supervisory frameworks and tax regimes – the composition varies considerably across Europe. Retail capital markets services are also barely developed on a cross-border basis, and this translates into very limited cross-border holdings of financial assets. Against this background, the members of the Task Force explored the following questions:

- What are the main factors influencing demand for savings/investment products across Europe? How to foster (in)direct retail participation in capital markets?
- Is the current supply fit for purpose, i.e. products with a rewarding risk-return profile, transparent pricing and cost/fee structures?
- Are the developments in manufacturing, marketing, distribution and financial advice moving into the right direction? How to tackle the lack of financial literacy?
- How effectively are the ESAs and NCAs overseeing the interaction among the different sectoral EU rules affecting retail investors?

Sustainable finance

In Europe, the capital markets ecosystem is expected to continue to develop in line with the overall objective of enhancing long-term value creation in the real economy. Institutional investors and asset managers have a fiduciary duty to act in the best interest of their end investors, and therefore should be equipped to seize the opportunities and tackle the risks arising from materially relevant ESG factors. Retail investors have also been increasing their direct presence in this segment. With respect to non-financial data and integrated reporting, there seems to be a huge learning curve for companies, investors, service providers, policymakers and other stakeholders. Transparency, proportionality, the right incentives, and ultimately financial performance will allow the market to develop in size and maturity. Against this background, the members of the Task Force explored the following questions:

- Are investors mainstreaming the integration of sustainability factors? What are their approaches to ESG assessments, preferred asset classes and investment strategies?
- Is there a real 'scarcity' of sustainable assets/projects in Europe? Would fully-fledged taxonomies, labels and standards improve the conditions for investments?
- What drives the take-up of sustainability ratings/scoring, indices and benchmarks? How to ensure that SMEs are not underrepresented in investors' portfolios?
- How will the Commission's Action Plan for translate into practice? Should prudential regulation encourage such investments?

These post-meeting reports are a way of bringing more discipline and transparency into the general proceedings. The external experts joined the task force in their personal capacity and do not necessarily have to endorse the policy recommendations and/or overall conclusions.

ANNEX

Members of the CEPS-ECMI Task Force on Asset Allocation and Group of Experts

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