PENSIONS EUROPE

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PensionsEurope Newsletter 2022/05

1. Challenge of high margin calls due to historically rapid interest rate hikes

Over the past weeks, we have discussed with senior managers of the ECB, DG FISMA, and EIOPA on the impact of the market turmoil (see also the recent ESRB warning) and rising interest rates on pension funds. Particularly, we have exchanged views on the use of derivatives, pension funds' clearing, and a long-term solution.

When pension funds use derivatives, such as interest rate swaps, to match the interest rate sensitivity of their assets more closely with that of their liabilities, counterparties with which these contracts are concluded require a margin in the form of a ringfenced bank account. When interest rates go up and these contracts increase in value, also the margin requirement increases accordingly. With the recent historically rapid interest rate hikes, pension funds have been obliged to significantly contribute to margin accounts.

Following Commissioner McGuinness' announcement in PensionsEurope 2022 Conference, on 9 June 2022 the European Commission published a delegated regulation on the final one-year extension of Pension Scheme Arrangements' (PSAs) exemption from clearing obligation and the report assessing whether viable technical solutions have been developed for the transfer by PSAs of cash and non-cash collateral as variation margins and the need for any measures to facilitate those viable technical solutions. The European Parliament and Council did not object the above-mentioned Commission delegated regulation, and on 30 September 2022 the regulation was published on the Official Journal of the European Union, entering into force on the following day.

To start applying the clearing obligation on 19 June 2023, the key challenge for pension funds remains the need to post variation margin in cash in case of market stress when they may be required by Central Counterparties (CCPs) to post significant amounts of variation margin. We have found that the best way forward would be a structural solution, involving central bank liquidity, as central clearing houses in Europe would suffice to provide (indirect) central bank liquidity utilizing their cleared repo platform. Therefore, we have proposed that the solution would be that the European central clearing houses could provide central bank liquidity to pension funds in times of stress to convert high quality government bonds into cash.

Alternatively, the ECB could guarantee the reliability of repo markets, like the U.S. Fed and the Bank of Canada do, as for instance proposed by Jan Mark van Mill, Head of Treasury & Trading at APG, on the recent APG article. As stressed by van Mill, currently pension funds do not have a guarantee that a repo market functions under all circumstances, and they remain dependent on the willingness of banks to accept bonds as collateral.

2. Finax launches the first PEPP on the market

The Regulation 2019/1238/EU (the PEPP Regulation), including the Commission Delegated Regulation (EU) 2021/473 started to apply as from 22 March 2022. Although the potential providers' appetite has not been as high as EIOPA and the EC were expecting, in September 2022 the first PEPP has finally been introduced in the market and officially registered in EIOPA's PEPP central register. Finax, a Slovak investment management platform operating also in Poland, Croatia, the Czech Republic, and Hungary, launched the first PEPP. Finax offers a Basic PEPP and an alternative investment option which use passively managed index ETFs to invest and provides no guarantees on the returns. There are still no sub-accounts opened. EIOPA's register includes plenty of information, including the PEPP KID and all the information required by the PEPP Regulation.

PensionsEurope keeps supporting the development of PEPP. EIOPA and the EC seem to be waiting for the market response and are not planning to take any specific regulatory action on the matter in the near future. While the EC is investigating the Member States' decisions on PEPP tax treatment, in 2023 EIOPA will coordinate supervisory activities in relation to PEPP, focusing on supervisory approaches, coordination of supervisory plans, and monitoring the market, using – among other data sources –the first PEPP prudential data and data on the register of PEPP. More specifically, aside from monitoring and other continuous actions, EIOPA plans for 2023 to set up the processes for product intervention powers (Q1) and to publish a report on the PEPP market development (Q4).

3. IORP II evaluation and review – updates

EIOPA will have 3 additional months to answer the call for technical advice on the evaluation and review of the IORP II Directive sent by the European Commission in June this year. The deadline is now 1 October 2023. This will allow EIOPA to run a 3-months public consultation on the draft advice, which we expect to open in March 2023. The extension period is also allowing EIOPA extra time to collect information and preliminary views from the national competent authorities and stakeholders on the six areas of focus: adequacy and proportionality, cross-border activities, pension information, ESG issues, DB/DC shift, and diversity&inclusion policy. EIOPA could also take this occasion to explore some additional arising areas, such as potential new prudential requirements on liquidity risk management, or additional provisions for multi-employer IORPs, or on the non-financial misconduct of members of the management board.

In October, PensionsEurope provided EIOPA with informal preliminary views on the IORP II evaluation and review. We are having a constant and open dialogue with them, and we will continue discussing the IORP II internally with our members to best prepare for the public consultation that will open next year.

4. Corporate sustainability due diligence directive

On 23 February 2022, the European Commission adopted a proposal for a Directive on corporate sustainability due diligence. It aims to foster sustainable and responsible corporate behaviour throughout global value chains. In May 2022, PensionsEurope prepared and sent a feedback statement on the proposal of the CSDDD to the EC. In that document we identified the key issues of the proposal which were briefly the following:

- In article 3, the proposal brings into the scope the entire financial sector irrespective of legal personality, including pension funds/IORPS. Moreover, the scope of the original proposal includes companies which had more than 500 employees on average and had a net worldwide turnover of more than EUR 150 million.
- Pension funds/IORPs should conduct due diligence on investments in the secondary markets.
- In article 8 bringing the actual adverse impact to the end, financial undertakings would not be required to terminate credit, loan or other financial service contracts, when this can be reasonably expected to cause substantial prejudice. We said that this would need further clarification.
- In article 8, the reporting that companies must provide, will be based on KPIs based on delegated acts developed by the EC. There is a potential danger of double reporting.
- In article 15, companies, under the relevant thresholds and sectors, must adopt a plan for transition to meeting the objectives of the Paris Agreement. In that part, there is a need for further clarification.
- In article 22, the proposal imposes serious consequences when companies fail to fulfil their due diligence obligations. This failure may lead to civil liability, as well as a breach of the directors' duty of care.
- In Articles 17 to 21, each Member State shall designate one or more supervisory authorities to supervise compliance. We saw no need for creating a new NCA but rather using the existing ones.

In October 2022, the Presidency of the council's compromising text and the amendments by the ECON committee were circulated. The Presidency of the council's compromising text proposes that :

- Article 3 -Scope: IORPs are remaining under the scope like other financial undertakings. The Presidency has not been included under the scope the AIF and UCITS. The main alternative that the Council encourages is to increase the threshold to 1000 employees and a worldwide turnover of EUR 300 million.
- Article 8: a new proposed recital mentions that substantial prejudice should be interpreted as a negative and significant effect on the company's legal, financial or economic situation or its production capacity, including in the long-term perspective, such as an effect giving rise to the likelihood of insolvency
- Article 22- civil liability: the new text tries to clarify that the right to full compensation of a potential victim should not lead in any way to overcompensation whether by means of punitive, multiple or other types of damages

The amendments by the ECON committee mention that:

- In its draft opinion, the main rapporteur supports that the new threshold should be 50 employees on average or a net worldwide turnover of more than EUR 10 million or a total balance sheet of more than EUR 10 million in the last financial year. Moreover, changes in Article 8 are much more restrictive for the companies to continue the relationship.
- The shadow rapporteurs and other MEPs of the ECON committee introduced hundreds of amendments. It should be noted that the shadow rapporteur MEP SØGAARD-LIDELL from Renew Europe introduced some amendments which could be evaluated positively by pension funds, especially on the Civil liability issue.

Now, 3 shadow meetings in the ECON are envisaged in November, December, and January. JURI committee members will introduce their amendments by the end of November.

5. Deforestation

The ENVI Committee of the European Parliament (EP) voted to include the financial sector in the Deforestation Regulation. We had supported a joint letter requesting to exclude the financial sector from the Deforestation regulation which was prepared in collaboration with 7 other financial services associations (EBF, EFAMA, Insurance Europe etc.) and was sent to the EP. On 13 September 2022, the European Parliament, despite our efforts, voted to include the financial sector in the Deforestation Regulation.

Financial institutions would only be allowed to provide financial services to customers in case it is established that there is no more than a negligible risk that the customers' products or services cause or are linked to deforestation. This lack of more than negligible risk seems a very low and unclear threshold. The lack of more than negligible risk must also be demonstrated through documentation, so it seems that the burden of proof is on the financial service provider to demonstrate the customers do not cause or are linked to deforestation. Inclusion of the financial sector would lead to a significant administrative burden for all types of financial entities, it is particularly cumbersome for institutional investors and asset managers who hold portfolios with securities of hundreds or thousands of companies. Moreover, in contrast with CSDDD, this current regulation has no employee threshold, so even small IORPs are likely to fall into the scope

In collaboration with other financial services associations (EBF, EFAMA, Insurance Europe etc.) we decided to start our advocacy to the Council via the permanent representatives of the member states. In Octoebr, we prepared a position paper against the amendments 40, 87, 105, 127, 130, 148, 149 and 158 that we circulated to the permanent representatives.

6. TR usability report

In October, the Platform on Sustainable Finance published its final report on Data and Usability as part of Taxonomy reporting.

The summary of recommendations has been prioritised high, medium and low based on the urgency with which they are addressed to support upcoming and implemented Sustainable Finance reporting obligations. This summary can be found in Table 2 on p 9. These recommendations are not prioritised based on importance or impact. According to the report, all recommendations should be considered valuable in the usability and application of the Taxonomy Regulation. This report does not address the application of the EU Taxonomy to Small and Medium-sized Enterprises (SMEs) or the treatment of SMEs within financial institutions reporting obligations be it at entity-level or at financial product level. This is because the Platform is preparing a separate report on SMEs as part of its work on data and usability.

The report will be carefully analysed by the Commission, but it does not bind the Commission to any decision on the matter.

7. Final report on minimum safeguards

In October 2022, the Platform on Sustainable Finance published its final report on minimum safeguards. The minimum safeguards set out in Article 18 of the Taxonomy Regulation require that companies implement procedures to comply with OECD Guidelines for multinational enterprises and the UN guiding principles on business and human rights. PensionsEurope provided an answer in the relevant consultation in early September.

The report identifies four core topics for which compliance with minimum safeguards should be defined. These are:

- Human rights, including workers' rights
- Bribery/corruption
- Taxation
- Fair competition

The advice on these four topics is aligned with the standards referenced in Article 18, as well as upcoming EU regulation, which is built on these same standards. As regulation of human rights due diligence (CSDDD) and sustainability reporting (CSRD) is not yet fully finalised, there remains some uncertainty surrounding their implementation. In this situation, the solution developed in this report is to:

a) build the requirements for MS compliance on the international standards referenced in Article 18 - especially on the six steps of the UNGPs/ OECD guidelines,
b) point to upcoming regulations and disclosure requirements that build on these standards,
c) provide independent sources of information on particular aspects of their implementation for external performance checks and
d) illustrate potential non-compliance with minimum safeguards, with the help of examples.

The report recommends that the following should be considered:

1. inadequate or non-existent corporate due diligence processes on human rights, including labour rights, bribery, taxation, and fair competition as a sign of non-compliance with MS.
2. final liability of companies in respect for breaches of any of these topics as a sign of non-compliance with MS.
3. The lack of collaboration with a National Contact Point (NCP) , and an assessment of non-compliance with OECD guidelines by an OECD NCP as a sign of non-compliance.
4. non-response to allegations by the Business and Human Rights Resource Centre as a sign of non-compliance.

Additionally, the report gives advice on project finance, SME financing, and green bonds. Finally some advice is given on how to assess sub-sovereign compliance with MS. An overview of the recommendations is presented at the end of the document.

The report will be carefully analysed by the Commission, but it does not bind the Commission to any decision on the matter.

8. Sustainability reporting standards

At the global level, the International Sustainability Standards Board (ISSB) decided in October to continue the development of the Sustainability Standard-setting projects:

- Climate-related disclosures — The next step in this project is now the issuance of a final IFRS Sustainability Disclosure Standard (no date given)
- General sustainability-related disclosures — The next step in this project is now the issuance of a final IFRS Sustainability Disclosure Standard (no date given)

At the European level, the EFRAG will now focus on the second set of European Sustainability Reporting Standards (ESRS) upon delivering their technical advice to the EC on the first set of ESRS. This second set includes:

- sector-specific standards
- non-EU company standard
- standard for listed SMEs
- voluntary guidance for non-listed SMEs
- amendments to the first set of ESRS