Munich, 15th October 2019

SUBJECT: Financial Study 2019 (Phase II) – Measures Assessment

SUBMITTED BY: Board of the EPO Pensioners Association

ADDRESSEES:
1. Budget and Finance Committee (for opinion)
2. Administrative Council (for opinion)

SUMMARY

This document contains a brief analysis by the Board of the EPO Pensioners Association of the financial coverage gap as calculated in the Financial Study (Phases I and II). For reasons presented in this document, the Association concludes that the negative size of the coverage gap is largely overestimated. The measures envisaged, which could have a serious financial impact on our present and future members are dependent on the size of the gap calculated. The Budget and Finance Committee and the Administrative Council are requested to ask the Office to make a more realistic calculation of the size of the gap before final presentation of measures to be taken are proposed to the Administrative Council in June 2020.

The two documents (Financial Study and the Financial Study (Phase II)) comprise close to 500 pages of complex and detailed material which need to be fully digested and comprehended. The calculations and proposals are summarised via a single table which presents the financial coverage gap as a single amount of 5.8 BN€. To close this gap a table of pick and choose measures, each given a monetary value, is presented.

The Association of EPO Pensioners, following its detailed analysis of the study, calls into question the financial coverage gap and the way it has been calculated.

The Financial Study dated May 2019 and presented to the Council in June 2019 concluded there was a coverage gap of 3.6 BN€ in the Base 2 scenario. This scenario has now been selected in the Financial Study Phase II as the most likely scenario, but with a recalculated and even higher coverage gap.

In calculating the original financial gap of 3.6 BN€ the consultants state that there is a structural operational gap with costs increasing faster than revenues. It is not surprising that the study reaches this conclusion, since it did not include some measures that should have been accounted for to give a true picture of the financial situation.

Two examples are particularly striking and obvious:

1. In the study, for a period of 20 years the general productivity is only supposed to increase by 3%.
2. The AC has adopted the principles of biennial inflation based fee adjustments to ensure stability and sustainability of the Office's finances, nevertheless only one single fee adjustment of 4% is calculated.

However, in the small print of the study, one finds that the consultants have, for the same 20 year period, calculated an inflation totalling 37%. With costs rising 30% above income it should not come as a surprise that the overall financial result is largely negative. In the table of possible measures presented in the Phase II document, biannual inflation based fee increases will reduce the gap by **<u>1.3 BN€</u>** and the digitization of PGP will bring a productivity increase valued at 1.2 BN€ and thus reduce the gap by **<u>1.2 BN€</u>**.

As third example, the consultants also calculate that the EPO will continue to create substantial cash surpluses. However, the consultants omitted to calculate the benefit of transferring parts of the surpluses to EPOTIF or RFPSS where a much higher return on investment would be achieved when compared to treating this cash as other financial assets earning a much lower interest. In the table of possible measures presented, a modest transfer of surplus to EPOTIF would reduce the gap with a further **<u>0.7BN€</u>**.

Had the above three measures been dealt with in a proper way in the Financial Study dated May 2019, the **resulting financial gap would have been reduced from <u>3.6 – (1.3+1.2+0.7) BN€ to 0.4 BN€</u>**. This amount of 0.4BN€ certainly looks much less frightening than the 3.6BN€ as presented in the study.

Furthermore, in the Phase II study, the Consultants have now not only recalculated the financial gap and increased it with 0.2 BN€, they have also built in a safety buffer of 1.9 BN€ rounded up to 2.0 BN€ in case the present low interest environment continues to exist for a long time. The total of all these consultant recalculations now result in a much higher financial gap presented in the Phase II study of **5.8 BN€**. Presenting the result as indicated in our analysis above, the gap would instead be **2,6BN€**.

In addition, the consultants have used the double safety principle of belt and braces. Not only have they added a 2.0 BN€ safety net but they have also reduced the expected return of investment (ROI) for the RFPSS to 2.1%. This is in contradiction to the Strategic Asset Allocation (SAA) agreed by the Supervisory Board of the RFPSS, which is expected to result in a ROI of 4.35%. It seems therefore surprising that the Office has agreed to this substantial reduction of expected return of invested Funds, since the Office representatives on the Supervisory Board also supported the proposed SAA. This lower percentage used as calculation by the consultants will now result in a 4 BN€ lower ROI than the SAA agreed by the Supervisory Board of the RFPSS. The consequence of this lower estimation used by the Consultants is also not clearly visible in financial terms in the Phase II document.

Conclusion

The possible measures could have a serious financial impact on our present and future members. Our analysis shows that it could be argued that there is no gap to be closed. The Association therefore requests that the Budget and Finance Committee and the Council mandates the Office to revisit and reanalyse the financial gap before returning in 2020 with a document containing final measurement proposals to be adopted by the Council.