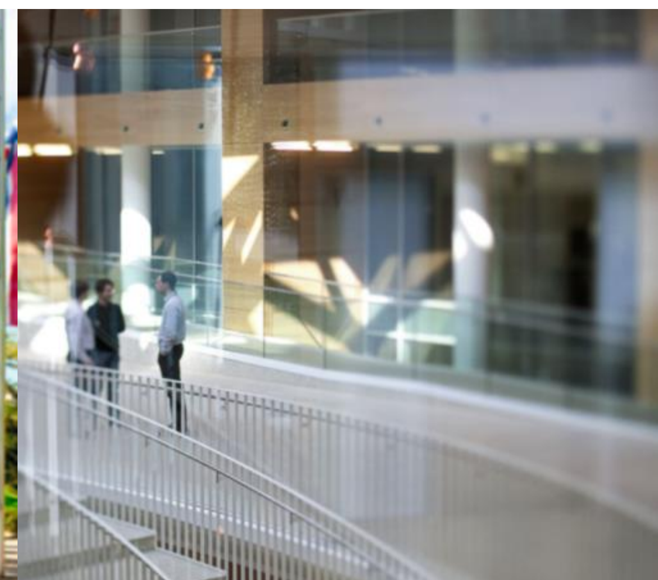
Europäisches Patentamt
European Patent Office
Office européen des brevets

THE 2019 FINANCIAL STUDY

The need for a follow-up and a new approach after the 2016 Deloitte Financial Study





Vincent Kos CFO May 2019

Purpose of the presentation – Need for a new Financial Study

The need for a new study on the long term financial sustainability of the EPO – three years after the 2016 Study – comes out of the following reasons:

A. Change in exogenous and other factors:
    - A1. Persisting low IFRS Discount Rate (DR)
    - A2. Stronger demand for patent services in recent years
    - A3. Change in relation between production / pending stocks
    - A4. Approaching crossing point between contributions and benefit payments
    - A5. Change in retirement behaviours of employees

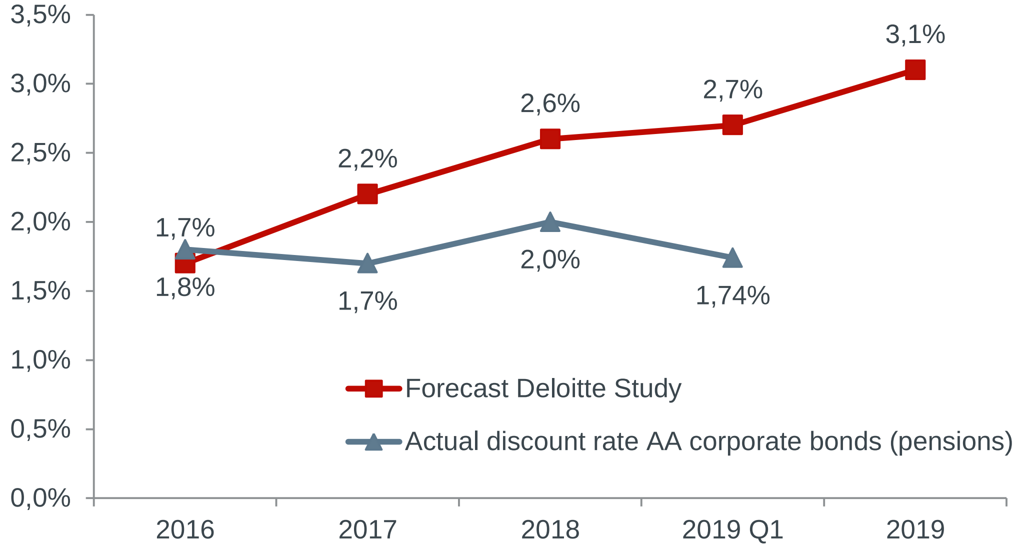
B. Management actions taken following the recommendations of the 2016 Study

C. Need for an extension in scope and methodology via a new Study

A. Change in exogenous and other factors

- Five main factors assumed in the 2016 Deloitte Study have evolved differently than expected:

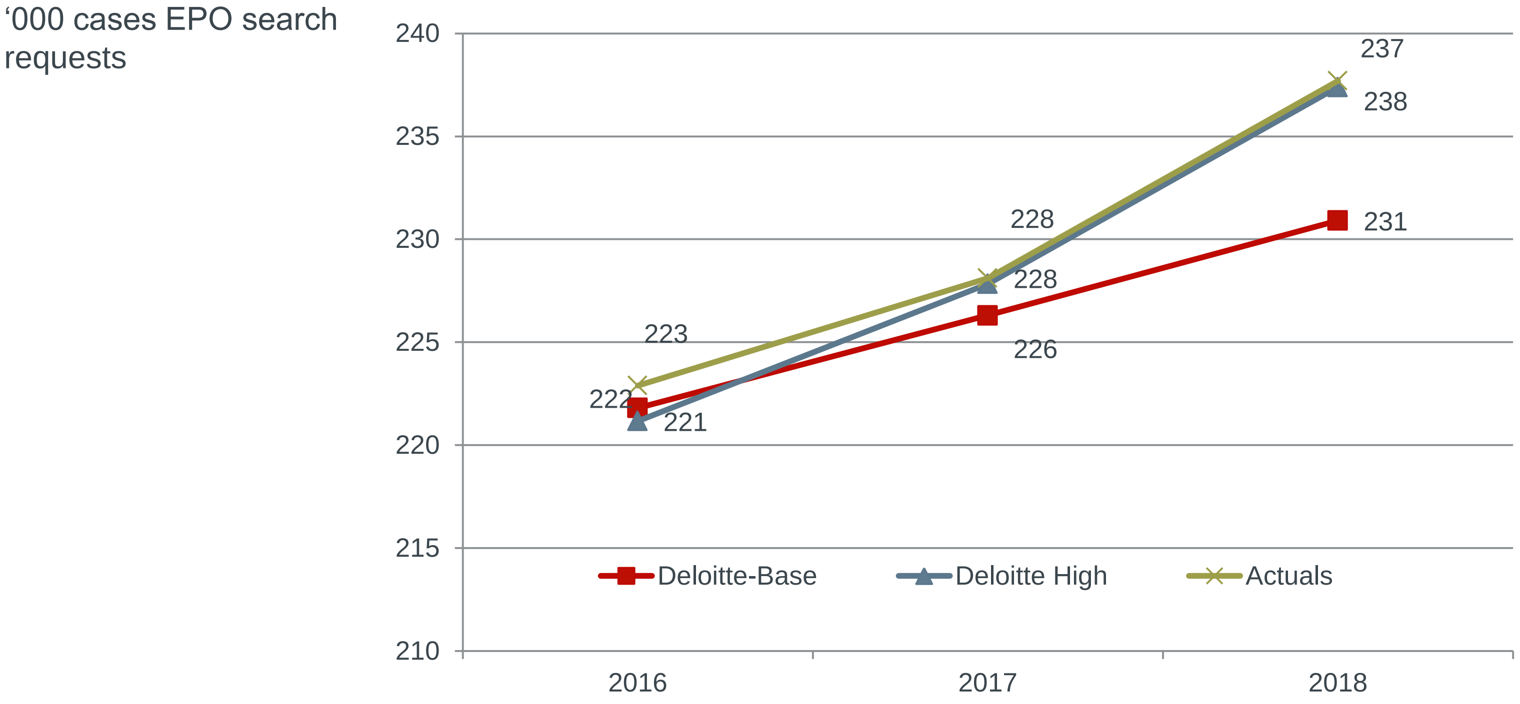
A1. The IFRS DR has not recovered as predicted - we still witness a low interest rate environment, induced by European Central Bank policies:



Note: a reduction of 1% in the DR increases the pension liability by €4,8bn (see Audited financial Statements, CA/60/2019)

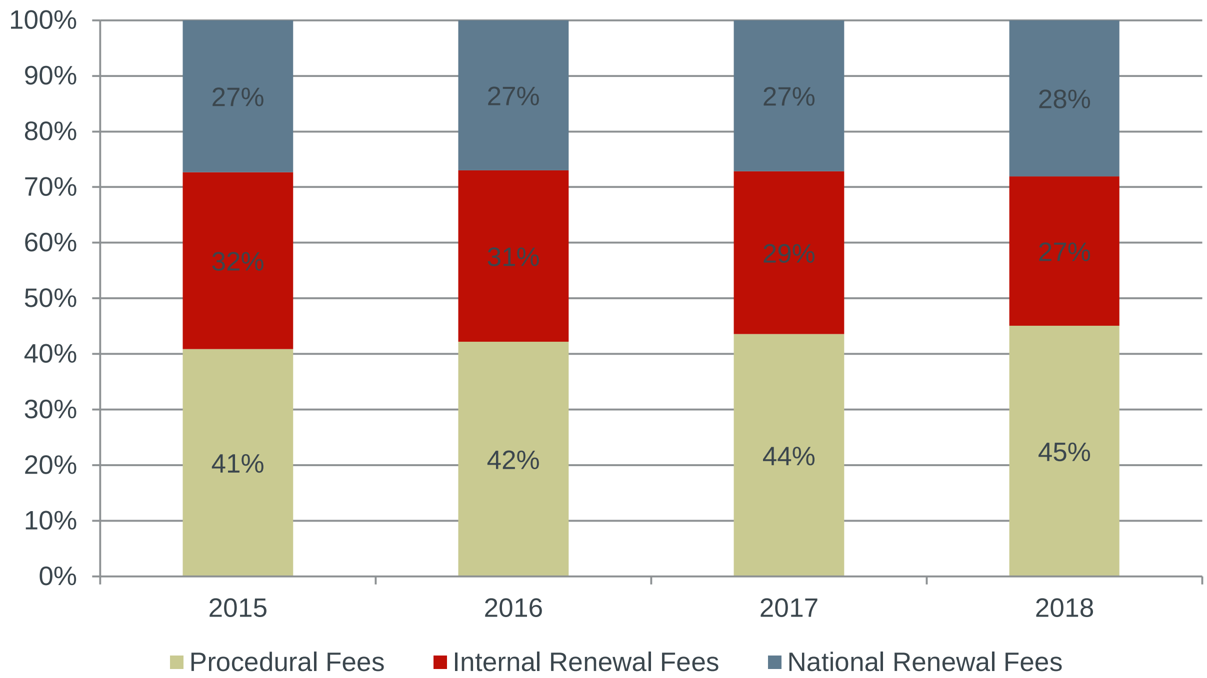
A. Change in exogenous and other factors

A2. The demand for patent services- here expressed in incoming search workload for the EPO - has evolved above the expectations of the Base Case in 2016, coming close to the High Case for 2017 and 2018:



A. Change in exogenous and other factors

A3. The structure in the revenues is evolving rapidly, more specifically as regards Internal vs. external renewal fees :



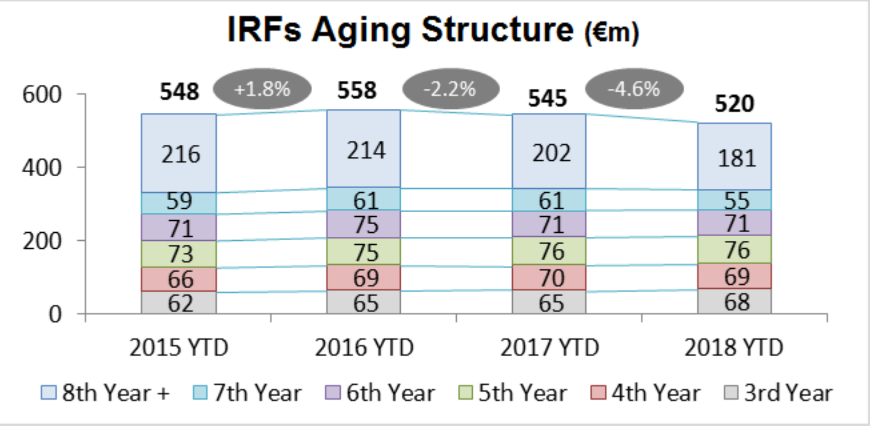
The above change in paradigm raises challenges in matters of financing mechanism, with a higher dependence on external renewal fees, which are beyond EPO control (applicant’s maintenance practice, Fee Policy of MS).

A. Change in exogenous and other factors

A3 (continued). Deep-dive Internal Renewal Fees : pending stocks is changing quickly as regards aging structure :

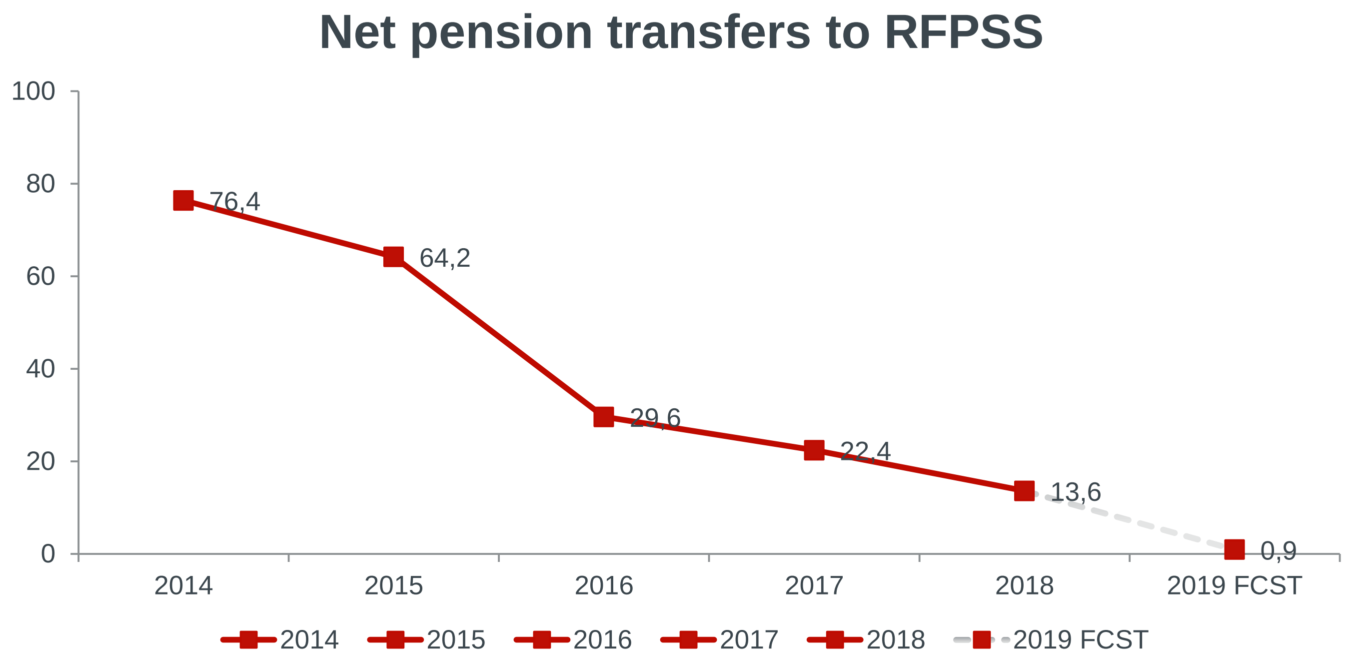
Revenue from IRF declining as a result of sustained production

- In 2018 revenue from IRF 4.6% below the comparison period, mostly due to lower income from applications older than seven years.
- This outcome was the result of Early Certainty initiatives and the decline is expected to continue into 2019.



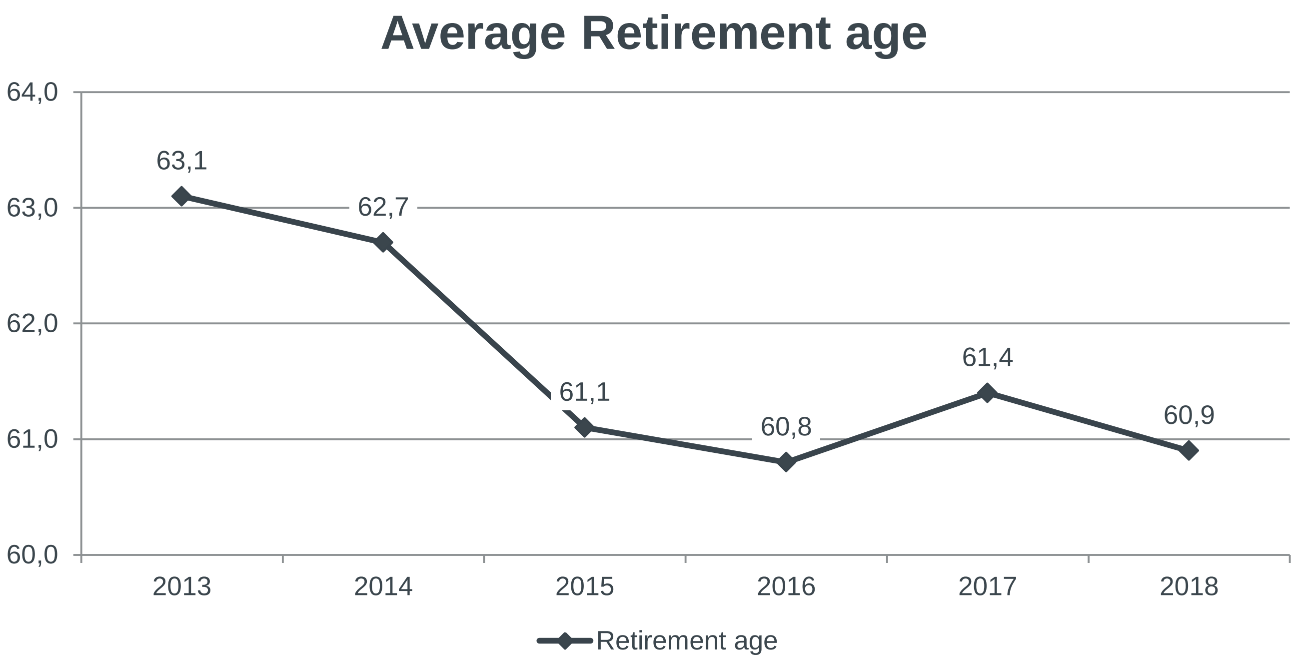
A. Change in exogenous and other factors

A4. The difference between the contributions (EPO and Staff) to the RFPSS and the payments of post employment benefits (mainly pensions) is expected to turn negative sooner as initially anticipated :



A. Change in exogenous and other factors

A5. Trend in the average retirement age (staff retires earlier) :



Earlier retirement means a reduction in contributions for pension and increase in pension payments and for salary a higher turnover and reduction of salary mass.

B. Management actions taken following the recommendations of the 2016 Deloitte Study (1/4)

Recommendation:
PROTECT:

- Strive to protect **high levels of standardised operating performance** required to reduce negative equity
- Secure / further develop productivity gains in order to achieve productivity levels of **90-100 PpH**
- Continuous generation of operating surplus in order to maintain financial independence – standardised operating result of approx. €300m-350m needed to overcome structural deficit in the long run (15-20 years)

Action / outcome:

- *Standardised Operating result 2017: **€366m**; 2018: **€390m***
- *Productivity (Products per Examiner): 2017: 95,5 PPH ; 2018: **99,8 PPH***

B. Management actions taken following the recommendations of the 2016 Deloitte Study (2/4)

Recommendation:
REVIEW funding policy:

- Possible creation of TA/FA (tax adjustment/ family allowance) and “risk reserve” managed by the EPO (Office Treasury / RFPSS)
- Consider pre-funding of the TA/FA fund and the risk reserve in order to reduce future balance sheet risks - estimated between €180m - €250m p.a. (DBO risk) and €90m-€130m p.a. (TA/FA) to cover all liabilities as of 2036

Action / outcome:

- *Additional cash injections into the RFPSS : 2016* ***€200m****, 2017* ***€200m****, 2018 :* ***€200m***
- *Repatriation of the ex IIB insurance fund : 2018* ***€60m***

B. Management actions taken following the recommendations of the 2016 Deloitte Study (3/4)

Recommendation:
DECIDE on liquidity / treasury management:

- Funds for the future DBO for TA/FA and the potential DBO risk could be established
- Both type of funds could be managed by EPO treasury, by the RFPSS administration or a combination thereof
- Deciding on the management of those funds by the EPO treasury management or the RFPSS requires in both cases a careful review of investment mandates, objectives and resources first

Action / outcome:

- *EPO Treasury Investment Fund (EPOTIF) established and activated in 2018 under external asset management construct: €2,4bn*

B. Management actions taken following the recommendations of the 2016 Deloitte Study (4/4)

Recommendation:
MANAGE :

- HR reforms enable flexible control over total salary mass and future evolution of DBO
- New Career/Performance System has the potential to contribute positively to the future overall liquidity situation
- Flexibility introduced by the HR reforms should be managed in line with the overall financial performance of the EPO

Action / outcome:

- *New Employment Framework introduced in April 2018 (five-year employment contracts with options for permanent employment)*
- *The yearly reward envelope (pensionable and non pensionable rewards) are decentralised management decision*

C. New Mandate: extension in scope and methodology (1/2)

- The mandate of the Consultant has been completed and extended in 4 areas :

C1. The incoming demand has been evaluated on the basis of a dedicated demand model elaborated by the Consultant taking into account correlations between GDP evolution, patenting practice per country and expected demand.

C2. Asset Returns have been evaluated in their model on a year-on-year basis with the help of stochastic scenarios (i.e. factoring into the calculations the probability distribution capital market returns) - rather than “betting” on one flat figure scenario;

C. New Mandate: extension in scope and in methodology (2/2)

C3. Volatility of the expected return on pension assets has been thus taken into account ; a more prudent approach has been chosen, reflected in a higher targeted probability for the return objective to be met (66% vs. 40% or 50% probability up to now)

C4. Besides the IFRS view on the long term assets and liabilities, an actuarial, funding view has been applied in the study; the latter is the one driving the expected management of the long term assets and liabilities of the EPO