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Consultation paper on draft Opinion on the supervision of long-term risk assessment by IORPs providing DC schemes

Fields marked with * are mandatory.

Responding to the paper

EIOPA welcomes comments on the draft Opinion on the supervision of long-term risk assessment by IORPs providing DC schemes.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

Please send your comments to EIOPA using the EU Survey tool **by Thursday, 22 July 2021, 23:59 CET** by responding to the questions below.

Contributions not provided using the EU Survey tool or submitted after the deadline will not be processed.

Publication of responses
Contributions received will be published on EIOPA's public website unless you request otherwise in the respective field in the survey below. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.

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Contributions will be made available at the end of the public consultation period.

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[1] Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents (OJ L 145, 31.5.2001, p. 43).
[2] Public Access to Documents
[3] Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC (OJ L 295, 21.11.2018, p. 39).

About the respondent

* Please indicate the desired disclosure level of the responses you are submitting.

- (•) Public
- ( ) Confidential

* Stakeholder name

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Questions to Stakeholders

Q1: Do you agree with the focus of the draft Opinion on the quantitative elements in operational risk management and long-term risk assessment from the perspective of members and beneficiaries?

- (•) Yes
- ( ) No

Please explain and provide any suggestions for further aspects of DC risk management that need attention.

Considering that every Pension Plan is a long-term financial business it is necessary to be assessed and monitor from perspective of embedded risks. The quantitative assessment is important step for managing the risks.
For DC schemes some risks are usually borne by members of the plan - the investment risk, longevity risk, inflation risk, etc. The members of the DC plan are also exposed to the risk of insufficiency of the retirement benefits in long-term perspective. However, the standard definition for operational risk covers the risk of losses due to process failure or human mistakes or malpractices. Our understanding for OpR is that this one is borne by the managing company or shareholders of the plan, but should not be put on the account of members/ beneficiaries. For covering the Operational risk the IORPs usually are required to set aside additional capital. While the members of DC schemes usually are charged with particular fees – so they pay costs for administration and operation of the pension plan. Any capital or additional cost related to operational risk should be taken by the IORPs and/or their outsourcing partners . Furthermore, our understanding is that the consultation paper refers more to the risk of insufficiency of the amount of retirement benefits (time value of money) rather than to shifting operational risks themselves to members / beneficiaries. We consider the long-term projections as very important for every IORP and they should be done considering a lot of factors in case of DC plan – current level of income, size of contributions, charges, expected investment return, demographic factors, inflation, taxation and regulations.
Being actuaries and risk managers, we believe that Operational risk has to be assessed quantitatively but not to be transferred to members/ beneficiaries of the IORPs.

Q2: Do you agree that Annex 2 provides a balanced view of the costs and benefits of the draft Opinion?

- (●) Yes
- ( ) No

Please explain and provide any suggestions.

The IORP II Directive requires the risk management system of pension scheme to cover all risks from both perspectives – for Pension plan and for members. The regular ORA process should also include assessment of risks for members related to their retirement benefits. However, our understanding is that operational risk should NOT have immediate impact on members in terms of accumulated capital and future retirement income (opposite on the statement 2.2 of Annex 2).
As it is stated in the consultation in some members states the risk assessment for DC plan is already in place. Therefore, any new guidance should consider carefully the existing practices and the specifics of the DC schemes.
In addition, the risk assessment of the risks borne by members should take into account the risk tolerance defined by members/ beneficiaries. In all cases such assessment has to be done under aspects of proportionality, considering additional costs and specifics of the pension schemes.
Since in case of DC plans a majority of risks are borne by members, we appreciate the initiative to have a consistent approach in risk assessment process.

Q3: Do you agree with the scope of application of the Opinion, i.e. all IORPs providing schemes where members and beneficiaries bear material risks, or should the scope of the Opinion cover only IORPs providing schemes where members and beneficiaries bear all risks?

- (●) Yes, Opinion should apply to all IORPs where members and beneficiaries bear material risks
- ( ) No, Opinion should apply to IORPs where members and beneficiaries bear all risks

Please explain and provide any alternatives that EIOPA should consider.

In the set-up outlined in the consultation, member benefits will be determined by a combination of guarantees and investment performance, any projections should reflect these dual drivers of benefit levels. Main focus of risk management should be pure DC-parts of benefits as DB-parts are mainly determined by pension plan. The collective nature of DC-elements in some countries or pension plans should be reflected in the risk management of schemes.

Q4: Do you agree that the use of quantitative elements in operational risk assessment should be encouraged?

- (x) Yes
- ( ) No

Please explain how this could best be done in your view.

In many pension schemes, the operations are delegated to external providers and / or the scheme are run on a not-for-profit basis. As a consequence, 1) the scheme does not hold shareholder capital and 2) the operational risk is largely borne by the outsourced service provider rather than the scheme or the members. In many instances, these outsourced service providers must themselves hold capital to cover operational risks. The nature of pension scheme's and whether member's bear operational risks should be considered in determining if a particular scheme is required to quantify operational risks.
However, there is no universal formula that could reflect operational risk in appropriate and complete manner. We consider the suggested approach as commonly used and applicable. Relative measures (implementing detailed risk assessment process or introducing additional capital requirement) have to be considered only.

Q5: Are in your view the Value at Risk (VaR) formulas presented in Annex 3 helpful for better understanding the possible quantitative impact of operational risk exposures of DC IORPs?

- (x) Yes
- ( ) No

Please explain and provide any suggestions or alternatives that EIOPA should consider.

The presented formulas for VaR reflect the complexity and the size of the DC, therefore could be considered as sufficient approach for measuring the operational risk. Our understanding is that such quantitative metrics are useful for shareholders and regulation purposes but not for members of the pension plan.

Q6: Do you agree that the risk assessment from the perspective of members and beneficiaries should include a long-term assessment using projections of future retirement income?

- (x) Yes
- ( ) No

Please explain.

Members should be able to be aware of the potential risks surrounding their retirement benefits. How to show these projections is another subject for research in order to prevent information overload.
Itis important to balance the level of information provided with the clear communication of the benefits and risks of the investment strategy.
Long-term projections should be made considering different factors like investment risk, cost structure, amount of contributions, projection for inflation and demographic trends. For members of the DC plans it will be useful to know the ratio between contributions to be paid for the whole period of service and the expected amount of pension benefits. The other meaningful information can be the projected replacement ratio – based on the applied assumptions what be the amount of the retirement benefit in comparison with the last (expected) salary. Different DC plans could have one or more investment portfolios. Where applicable a dynamic strategy in modelling could apply. That could refer also to so called lifecycle services where the members are guided throughout the last stage of the accumulation phase to choose more conservative portfolios with well diversified investment strategy, or such with minimum guaranteed return.
Longevity risk is another very important factor to be considered. The members of DC schemes could be provided with the information regarding expected life time after retirement and how that period relates to the period of accumulation.
For the members and beneficiaries, the most important risk is the risk of poverty or risk of insufficient pension benefits after retirement. An assessment of value-for-money will provide useful additional insights.

Q7: In your view, what are the potential benefits and limitations of using pension projections for long-term risk assessment in the context of DC-based pension schemes that are prevalent in the EU Member States or your Member State? Please explain and provide any alternative methods that should be considered.

The purpose of providing such information to members is to give them a more or less reasonable assessment for the expected retirement benefit and to consider whether they should take actions like increasing contributions or seeking for supplementary sources for retirement benefits. That would help DC' members to reassess their risk appetite, to look for alternative (additional) tools for generating personal income after retirement or to increase the size of contributions.
At this stage DC plans are more popular in some CEE countries, rather than on a bigger market which has had a huge experience with DB schemes. In some countries the IORPs are obliged to provide annual statements to its members, presenting information for total accumulated amount, costs and investments. It is not a common practice to provide members with the projections for the retirement benefits since that could be considered as a promise.
In the same time providing members with more detailed and comprehensive projections could confuse them.
In some cases, the limitations are the willingness of the members to read the information. The challenge is therefore to include a purpose for the members to act upon the information that is provided.
We also see different parameters and techniques underlying the calculations of pension projections in PRIPPs and PEPP and the different techniques used for IORPs in different countries for example. Are these benefits addable in the end to have an overview of the projected benefits that are comparable?
Where members have a choice of providers, more optimistic projected returns from one provider or product over another could skew members decision making.
Where it is possible the introduction of a life-cycling approach could give the IORP a chance to adopt features of the pension plan to the current profile of its members, but for such approach there is no universal recipe. It is important though, that such life-cycle approach would align as good as possible with the preferred pay-out pattern as from retirement. The life-cycle will be different when the decumulation phase is a lumpsum, an annuity, a drawdown or a combinations of these.

Q8: Could you provide information on the use in practice of pension projections for the purpose of risk management and/or the design of investment strategies (e.g. in Europe, your country or within your IORP)?

- (•) Yes
- ( ) No

If yes, please provide this information.

In the Netherlands projections based on stochastic calculations are used, both for beneficiaries and investment strategies. More information can be found in the EIOPA paper on the pension benefit statement: https://www.eiopa.europa.eu/sites/default/files/publications/reports/eiopa_pbs_guidance_and_principles_0.pdf?source=search
In Ireland, deterministic projections of member retirement accounts and projected income in retirement are provided annually to members. More detailed or sophisticated projections are often provided to trustees in designing investment strategies and default investment glide paths..

Q9: Do the principles for conducting projections of future retirement income strike the right balance between setting sensible minimum standards and recognising the specificities of DC schemes in the various Member States?

- (•) Yes
- ( ) No

If not, please explain your suggestions to make the principles more or less specific and/or to add or remove principles.

• Stochastic analysis may assist fiduciaries in designing investment strategies, but the benefits in terms of member engagement and understanding would need to be considered more fully. Would the additional information be accessible to the majority of members and would it add member understanding and decision making?
• Lump sum amounts can seem large, but must be spread over an extended retirement period, projections should consider projected income
• Other risks should only be included to the extent that the member bears this risk (e.g. if operational risks are borne by the scheme or service providers, these should be excluded from the analysis)
• Projections should be wary of the impact of understating potential returns (as well as of overstating) in terms of encouraging savings and design of investment strategies
• Considering the different types of DC pension plans there cannot be found an universal approach that does reflect every specific plan.

Q10: Do you agree with the content of the below principles, as put forward in paragraphs 3.14-3.28 of the draft Opinion:

	Yes	No
Stochastic scenarios of asset returns	(•)	( )
Market-sensitive and realistic assumptions	(•)	( )
Characteristics of members and beneficiaries	(•)	( )
Pension scheme characteristics	(•)	( )

Target variables and risk & performance indicators	(selected)	( )

If not, please provide your suggestions to improve the principles.

Recognising that pensions are long-term investments, the use of market sensitive assumptions should not lead to changes in investment strategy (or other decisions) resulting from short-term market events or adverse conditions and some element of medium term smoothing may be appropriate .
For long term projections of future retirement income provided by DC plans, the investment return is very important. That leads to a conclusion that the stochastic scenarios on the return is good to be applied. However, we should note that stochastic calculations are more costly than deterministic ones, either in perspective of resources and of complexity. The IORPs would need to have in-house expertise on stochastic modelling. Therefore, we consider usage of stochastic approach reasonable only on the basis of proportionality. In all other cases a deterministic scenario with adequate assumptions could be applied for long-term projections of the retirement income.
We also consider as very important all main characteristics of the DC plan to be covered appropriately by the projections.
To be able to assess the results of the projections the IORP need to define relevant indicators in advance. They could be used to assess both the current performance and the risk to deviate from the long-term targets.

Q11: The supervisory expectations recognise and allow different methods to establish the risk tolerance of DC members and beneficiaries. Do you agree or would you propose more specific guidance?

- (selected) Yes, agree to recognise and allow different methods
- ( ) No, would propose more specific guidance

Please explain and provide any suggestion.

Since there are so many different characteristics of DC plans it is not possible to have one benchmark that fits all. In the same time having the major risk borne by members, we expect that the risk tolerance level (on individual base) may change during the lifetime. The risk tolerance level also depends on the design and characteristics of IORP.

Q12: Do you agree that the design and the periodical review of the investment strategy, or investment strategies in case of multiple investment options, should consider the long-term risk assessment using projections of future retirement income, taking into account their risk tolerance?

- (selected) Yes
- ( ) No

Please explain and provide any suggestions.

Our understanding is that the Investment strategy is not the starting point for DC scheme but rather an instrument to support achieving the main targets. The Investment strategy should reflect the design of the DC scheme, its characteristics, targets, size in terms of AuM and the number of members, projected dynamics in both perspective, liquidity issue and so on. Hence, the investment strategy should be assessed periodically considering the recent results from long-term risk assessment.

Q13: What should in your view be the frequency of conducting the risk assessment using pension projections? Is at least every three years sufficient, unless there is a significant change in the risk profile, as provided by Article 28 (ORA) and Article 30 (SIPP) of the IORP II Directive. Or should DC IORPs conduct these projections more regularly, as suggested by Article 25 (Risk-management system).

- (x) At least every three years, unless there is a significant change in the risk profile
- ( ) More regularly

Please explain.

Three years seems to be appropriate. Some periodic monitoring of KPIs / market conditions which could trigger an acceleration of the next review may be appropriate.
Every three years is a reasonable term that gives enough time to get results / observations from investment strategy, market dynamics, demographic trends and other factors.

Q14: Do the expectations put forward in the draft Opinion achieve a proportionate approach to DC risk management, fitting small-, medium- and large-sized IORPs?

- ( ) Yes
- (x) No

If not, please provide your suggestions to improve proportionality of the draft Opinion.

Not completely. As a next step the specificities of DC schemes in the various Member States should be further recognised and analysed. Only after that a segregation approach based on proportionality could be discussed.

* Q15: Do you have any other comments on the draft Opinion?

- (x) Yes
- ( ) No

If yes, please provide these other comments.

A simple communication with deterministic approach in an equation with the level of financial literacy of plan members is better than a sophisticated one with stochastic approach that members do not understand what mathematically they mean.
We also consider the choice of the default option/fund selected in case of no answer from the plan member in DC schemes as an important issue that is not enough put forward in the questionnaire.

Contact

Contact Form