Impact assessment

Opinion on the supervision of long-term risk assessment by IORPs providing defined contribution schemes

Policy Department
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CONTENTS

1. ANALYSIS OF COSTS AND BENEFITS

1.1. Procedure and consultation of stakeholders

According to Article 29 of the Regulation (EU) 1094/2010, EIOPA should, where appropriate, analyse the potential costs and benefits relating to opinions provided to CAs, proportionate to their scope, nature and impact.

In developing the opinion, EIOPA analysed current practices at national level through a survey completed by CAs and engaged with stakeholders including the Occupational Pensions Stakeholder Group, most notably through a workshop held on 22 January 2021.

A draft Opinion and its costs and benefit analysis have been subject to a public consultation, in line with Article 29 of the Regulation (EU) 1094/2010.

The analysis of costs and benefits is undertaken according to EIOPA's impact assessment methodology.

1.2. Problem definition

When analysing the impact from proposed policies, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional supervisory intervention

The IORP II Directive introduced new risk-management requirements. In particular, where members and beneficiaries bear risks, the risk-management system as set out in Article 25 thereof should also consider the risks from the perspective of members and beneficiaries. The ORA, set out in Article 28 of the IORP II Directive, should include an assessment of the risks to members and beneficiaries relating to the paying out of their retirement benefits. Recital 57 of the IORP II Directive explains that it is essential that IORPs improve their risk management while taking into account the aim of having an equitable spread of risks and benefits between generations in occupational retirement provision.

The IORPs' assets should be invested in accordance with the 'prudent person' rule and in particular in the best long-term interest of members and beneficiaries as a whole, in accordance with Article 19 of the IORP II Directive. Compliance with the prudent person therefore requires an investment policy geared to the membership structure of the individual IORP, as set out in recital 45 of the IORP II Directive.

The ORA should also include a qualitative assessment of operational risks. EIOPA issued an Opinion on the supervision of the management of operational risks faced by IORPs, offering supervisory guidance on reviewing the resilience of DC IORPs to operational risks, including outsourcing and cyber risk.

Member States may supplement the IORP II Directive through national regulation or supervisory guidance. The survey conducted by EIOPA demonstrated that only a handful of Member States' national measures specify how IORPs should conduct DC risk assessments from the perspective of members and beneficiaries relating to their future retirement income, also in relation to establishing their risk tolerance and designing and reviewing the investment strategy (see Annex 1). Even though a number of Member States had not yet decided to put in place supplementary measures, this implies that the provisions of the IORP II Directive may potentially not have been implemented consistently. In particular, DC IORPs' investment strategies may not be aligned with the risk tolerance of their membership, considering a long-term risk assessment using projections of future retirement income, jeopardising the protection of members and beneficiaries.

Similarly, the survey results showed that, in a few Member States, national regulation and/or supervisory guidance lay down specific quantitative measures for operational risk. Good qualitative management of the wide range of potential operational risks, in line with EIOPA's Opinion on operational risk management by IORPs, is essential. The quantification of operational risk exposures would allow DC IORPs to gain insight in the adequacy of means to cover for the impact of (severe) operational risk. Operational risk events may have an immediate impact on members and beneficiaries of DC schemes, as opposed to DB schemes, in terms of accumulated capital and projected future retirement income. Moreover, new for-profit, multi-sponsor IORP providers are emerging, increasing the need to clarify operational obligations and to assess operational viability.

1.3. Objective

The objective of this Opinion is to enhance supervisory convergence in the supervision of risk management by IORPs providing DC schemes, in particular with respect to operational risk assessment and long-term risk assessment from the perspective of members and beneficiaries, in order to foster the protection of members and beneficiaries and improve the functioning of the internal market.

The aim is to promote efficient and innovative occupational DC schemes with sound investment strategies and risk management that result in optimal long-term risk-return characteristics aligned with the membership structure of the IORP, taking into account the heterogeneity in occupational DC schemes across Europe.

1.4. Policy issue and options

EIOPA has identified as policy issue the inconsistent supervisory approaches to DC IORPs' use of quantitative elements in operational risk management and long-term risk assessment from the perspective of members and beneficiaries, also in relation to the establishment of their risk tolerance and the design and review of investment strategies.

A more consistent supervisory approach will not only enhance the protection of members and beneficiaries, but also contribute to improving international supervisory coordination, encouraging cross-border activity, as well as reducing regulatory arbitrage.

To meet the objectives set out in the previous section, EIOPA has analysed two policy options to address the identified policy issue, with the preferred option highlighted in bold:

1. **Principle-based approach to the use of quantitative measures for operational risk and the risk assessment from the perspective of members and beneficiaries using pension projections, also in interaction with the determination of their risk tolerance and the establishment of investment strategies;**
2. Uniform approach to the use of quantitative measures for operational risk and the risk assessment from the perspective of members and beneficiaries using pension projections, also in interaction with the determination of their risk tolerance and the establishment of investment strategies.

In both options, the expectations towards CAs would not only relate to IORPs providing DC schemes, but to all IORPs where members and beneficiaries bear material risks, where materiality is determined based on an analysis by the CA.

POLICY OPTION 1: PRINCIPLE-BASED APPROACH

Under the principle-based approach, CAs are expected to encourage DC IORPs to quantify operational risk exposures in terms of asset value losses, using their own risk estimates or the standard formulas based on EIOPA's common framework on risk assessment and transparency.

In addition, CAs should expect DC IORPs to use projections of future retirement income to assess the risks from the perspective of members and beneficiaries. The pension projections may be based on deterministic or stochastic scenario of asset returns. In the EEA's four largest IORP sectors (DE, IE, IT, NL) representing 90% of the total IORP sector in terms of assets, IORPs already conduct deterministic or stochastic projections for the purpose of risk assessment and/or information provision to plan members through the annual Pension Benefit Statement.

This option sets forth a number of high-level principles for conducting the pension projections, including on the consideration of the characteristics of the membership and the pension scheme. The assumptions underlying pension projections should be market-consistent and realistic to ensure that projected investment returns are not overstated nor understated. Moreover, appropriate risk and performance indicators have to be selected for the risk assessment, so that the indicators fit the national specificities.

CAs should expect DC IORPs to establish the risk tolerance of their membership to assess the outcomes of the risk assessment. This option prescribes that appropriate methodologies are used, at least distinguishing between different generations/cohorts, taking into account different national approaches and methods.

Lastly, CAs should expect DC IORPs to integrate the risk assessment from the perspective of members and beneficiaries - in conjunction with the established risk tolerance - in the design and review of DC IORPs' investment strategies.

Policy option 1: Principle-based approach		
Stakeholder groups	**Benefits**	**Costs**
IORPs	IORPs will benefit from more consistent approaches across the EEA, where relevant, fostering equal conditions of competition.	The investment and risk management functions, and potentially other functions, will require additional resources and/or more services will have to be sourced from external providers. In particular, this will be the case for IORPs not already doing similar risk assessments to inform the design and review of investment strategies. The fact that most IORPs already have experience with

		deterministic or stochastic projections limits these costs.
Members and beneficiaries	Enhanced protection of members and beneficiaries by ensuring a design of investment strategies that is aligned with the risk-return preferences of the membership, considering a risk assessment of future retirement income based on realistic assumptions. In particular, this will be the case for the membership in IORPs not already doing such an assessment.	The additional costs on IORPs may be shifted to members and beneficiaries (and also sponsoring undertakings).
Competent authorities	Convergence of supervisory approaches across the EEA will reduce regulatory arbitrage. It will also facilitate international supervisory coordination, thereby promoting cross-border activity.	CAs will have to bear the costs of implementing and supervising the expectations in national supervision.

POLICY OPTION 2: UNIFORM APPROACH

Under the uniform approach, CAs should expect DC IORPs to quantify operational risk exposures in terms of asset value losses using the standard formulas based on EIOPA's common framework on risk assessment and transparency.

In addition, CAs should expect DC IORPs to use projections of future retirement income to assess the risks from the perspective of members and beneficiaries, where he pension projections should be based on stochastic scenarios of asset returns.

This option puts forward principles for conducting the stochastic pension projections, such as the consideration of the characteristics of the membership and the pension scheme, but also specifies the term structure of risk-free interest rates and the maximum risk premiums to be assumed. Moreover, specific risk and performance indicators would be prescribed for the risk assessment, for example, similar to the requirements for the PEPP (Article 14 of the Commission Delegated Regulation (EU) 2021/473[1]):

- The risk defined as the shortfall between the projected sum of contributions and the accumulated assets at retirement in a 5th percentile adverse scenario;
- The return defined as the probability of outperforming the projected inflation rate during the accumulation phase.

The expectation of using stochastic scenarios, prescribing interest rate term structures and maximum risk premiums as well as specifying specific risk and performance indicators would admittedly result in strong supervisory convergence, as well as cross-sectoral consistency with PEPP. However, it will also imply that many IORPs would have to modify existing practices. For example, IORPs already tend to make scenario-based projections of future retirement, but often using deterministic scenarios and not stochastic scenarios. Moreover, the specific risk and performance indicators are likely to conflict with currently used indicators at the national level.

Under this option, CAs should also expect DC IORPs to establish the risk tolerance of their membership using surveys be completed by members and beneficiaries, in order to assess the outcomes of the risk assessment and to support the design and review of investment strategies. Such a uniform approach would results in higher supervisory consistency, but also increase the likelihood of clashing with existing national practices.

Policy option 2: Uniform approach		
Stakeholder groups	**Benefits**	**Costs**
IORPs	IORPs will benefit from uniform approaches across the EEA, where relevant, fostering equal conditions of competition. IORPs providing PEPPs will benefit from consistency with	The investment and risk management functions, and potentially other functions, will require additional resources and/or more services will have to be sourced from external providers. In particular, this

[1] Commission Delegated Regulation (EU) 2021/473 supplementing Regulation (EU) 2019/1238 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements on information documents, on the costs and fees included in the cost cap and on risk-mitigation techniques for the pan-European Personal Pension Product, OJ L 99, 22.3.2021, p. 1.

	Commission Delegated Regulation (EU) 2021/473.	will be the case for IORPs not already doing similar risk assessments to inform the design and review of investment strategies. A considerable group of IORPs will have to make stochastic projections, instead of the current practice of deterministic projections. Moreover, a substantial group of IORPs will have to adjust their approach to establishing the membership's risk tolerance.
Members and beneficiaries	Enhanced protection of members and beneficiaries by ensuring that IORPs are expected to quantify operational risk exposures and perform long-term risk assessment using stochastic pension based on realistic and uniform assumptions. In conjunction with the establishment of their risk tolerance, this ensures investment strategies are aligned with the risk-return preferences of the membership, especially where IORPs are not already considering such risk assessments in the design and review of investment strategies.	The additional costs on IORPs may be shifted to members and beneficiaries (and also sponsoring undertakings).

Competent authorities	Uniform supervisory approaches across the EEA will significantly reduce regulatory arbitrage. It will also facilitate international supervisory coordination, thereby promoting cross-border activity.	CAs will have to bear the costs of implementing and supervising the expectations in national supervision.

1.5. Conclusion

EIOPA considered two policy options to reach supervisory convergence with regard to the use of quantitative elements in operational risk management and long-term risk assessment from the perspective of members and beneficiaries: a principle-based (option 1) and a uniform approach (option 2). Policy option 1 is EIOPA's preferred option in terms of cost and benefits.

The principle-based approach strikes the best balance between enhancing protection of members and beneficiaries and limiting the costs for IORPs. This is in line with the aim to promote the provision of efficient occupational DC schemes with sound investment strategies and risk management that result in optimal long-term risk-return characteristics aligned with the membership structure of IORPs.

The uniform approach may deter the provision of occupational DC schemes by imposing risk assessment methods which result in considerable adjustment costs for IORPs and may even not fit national specificities. Even though some of the uniform methods, e.g. stochastic projections, may be technically superior, the potential discouragement of occupational pension provision would not be in the best interest of members and beneficiaries. These costs likely outweigh the potential benefits of a uniform approach in terms of the functioning of the internal market, e.g. preventing regulatory arbitrage and stimulating cross-border provision.

ANNEX: SUMMARY OUTCOMES OF SURVEY OF NATIONAL PRACTICES AND GAPS

RESPONSE

EIOPA conducted a survey among CAs in the third quarter of 2020 to map existing practices and gaps at national level relating to DC risk assessment.

All CAs responded to the survey. Twenty CAs responded to the specific questions on DC risk management, while ten CAs did not complete these questions because DC IORPs are largely absent (BE, DK, FI, LI, MT) or IORPs are largely non-existent (BG, CZ, EE, IS, LT).

Most CAs indicated that no further level 2 measures, e.g. regulations, (14 CAs) or level 3 measures, e.g. supervisory guidance, (12 CAs) supplementing the IORP II Directive were foreseen in the area of DC risk management. At the time, over one-third of CAs responded that further level 2 (CY, FR, HR, IE, LV, NO, PL, PT, SK) and/or level 3 measures (CY, FR, HR, IE, LU, NO, PL, PT, SK) have not yet been decided. In a few Member States further national regulations (GR, IT) and supervisory measures (DE, GR, IT, SK) in the area of DC risk assessment were still expected.

QUANTITATIVE MEASURES FOR OPERATIONAL RISK

In half of the Member States where the CA completed the survey (DE, FR, HR, HU, LU, NO, PT, RO, SE, SK) operational risks are borne by DC IORPs or their management companies through capital requirements (see Chart 1). Often these DC IORPs are subject to the regulatory own funds requirement of the IORP II Directive, which can be interpreted to contain an implicit allowance for operational risk. In other Member States, operational risks in DC schemes are borne by members and beneficiaries (AT CY, IT), the sponsoring undertaking (ES, LU) or by a combination of the IORP and members and beneficiaries (NL, SI) or the sponsor and members and beneficiaries (GR, PL). In IE, the party responsible for the operational failure would ultimately typically cover any loss e.g. investment manager, advisor, administrator, sponsor (on behalf of themselves or the trustees).

In three Member States (AT, NO, SE), national rules lay down specific quantitative risk measures for operational risk (see Chart 2), of which in two Member States derived from the operational risk module of the standard formula in Solvency II (NO, SE). In most Member States this is not the case or was not decided yet.

Chart 1: Operational risk bearers in IORPs providing DC schemes, number of CAs

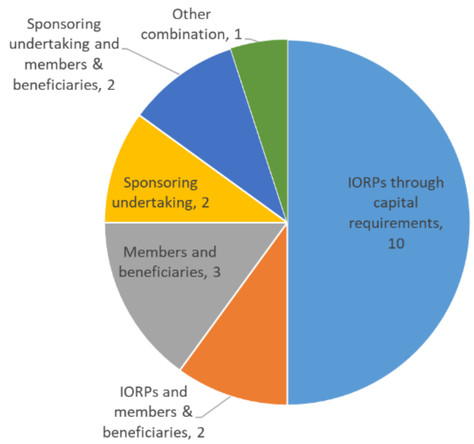
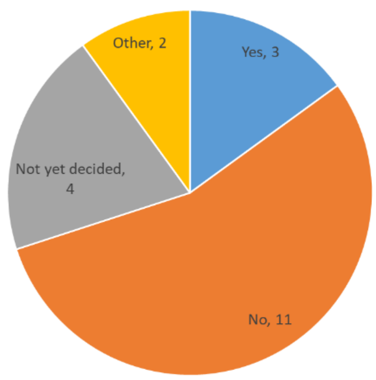


Chart 2: Quantitative measures for operational risk in national regulation and/or supervisory guidance, number of CAs



RISK ASSESSMENT FROM THE PERSPECTIVE OF MEMBERS AND BENEFICIARIES

Three out of 20 CAs (AT, DE, NL) indicated that national regulation and guidance specify how IORPs should implement DC risk assessment from the perspective of members and beneficiaries relating to their future retirement income (see Chart 3), as prescribed by Article 25 (Risk management) and Article 28 (Own-risk assessment) of the IORP II Directive. Still, in four Member States (AT, GR, LV, NL), CAs expect DC IORPs to assess – as part of their risk management - the risk from the perspective of members and beneficiaries using pension projections (see Chart 4).

Of the Member States where DC IORPs are expected to use pension projections as part of their DC risk management, only in NL, national regulation and supervisory guidance impose restrictions on the assumptions underlying the projections, like the type of scenarios and the return assumptions. The CA in NL provides IORPs with a pre-defined set of 10,000 stochastic scenarios containing trajectories for interest and inflation rates as well as asset returns.

Chart 3: National regulation and guidance supplementing the IORP II Directive with regard to risk assessment from the perspective of members and beneficiaries, number of CAs

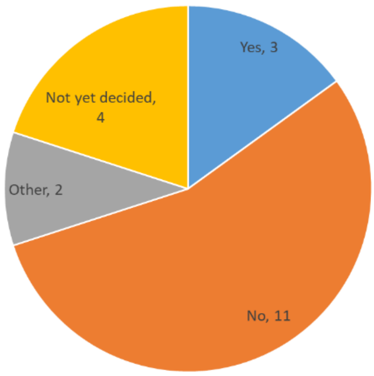
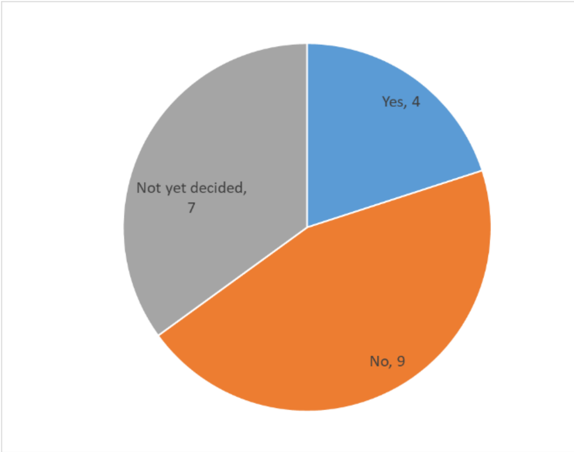


Chart 4: Expectation towards DC IORPs to assess within their risk management the risk from the perspective of members and beneficiaries using pension projections, number of CAs



In four Member States (AT, CY, IT, NL), national regulations and supervisory guidance contain provisions for DC IORPs to consider and/or establish the risk tolerance of members and beneficiaries (see Chart 5). In most other Member States, this is not the case or has not been decided yet. This does not necessarily mean that DC IORPs do not consider the risk tolerance. CAs were asked how DC IORPs established the risk tolerance of members and beneficiaries. While most CAs did not have experience in this regard, some provided examples. CAs explained that the DC IORP's investment portfolio considered the overall risk tolerance of the membership that life-cycling strategies reflected differences in risk aversion between younger and older plan members and/or that a choice of investment option aligns the risk-return characteristics with members' preferences. Methods to establish the (ex-ante) risk tolerance included member panels and surveys, including self-assessment questionnaires to assist prospective members in choosing an investment option, the use of member administration / socio-demographic data and the implicit or explicit establishment of the risk tolerance through social partners.

In five Member States (AT, CY, IT, LU, NL) national regulation or guidance contain provisions stipulating that the investment policy or strategy has to consider the interaction between the risk assessment from the perspective of members and beneficiaries and their risk tolerance (see Chart 6). In most other Member States, this is not the case or has not been decided yet. Still, nearly half of CAs (AT, CY, GR, HU, IT, LV, NL, NO, SE) indicate that DC IORPs typically determine the investment strategy taking into account the risk assessment from the perspective of members and beneficiaries and their risk tolerance, while the other half of CAs responded that this is usually not the case.

Chart 5: National regulation and guidance containing provisions to consider/establish the risk tolerance of DC members and beneficiaries, number of CAs

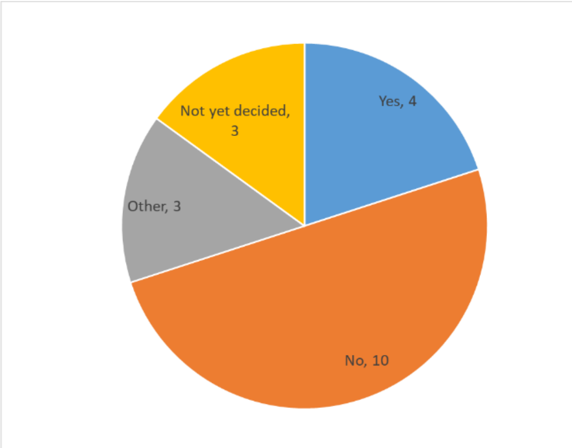
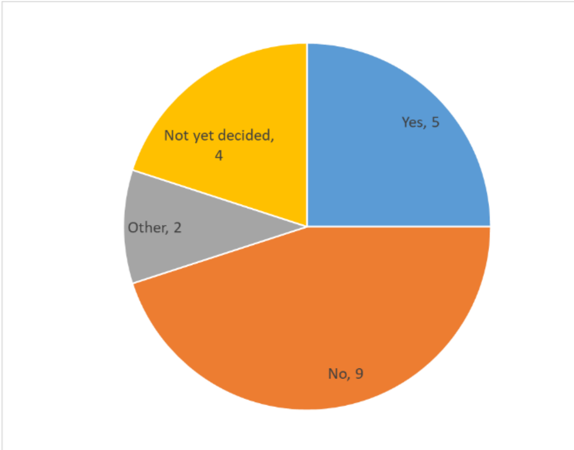


Chart 6: National regulation and guidance specifying the interaction between the risk assessment from the perspective of DC members and beneficiaries, their risk tolerance and investment strategy, number of CAs



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