

OPSG

OCCUPATIONAL PENSIONS STAKEHOLDER GROUP

Position paper on IORP Governance and Risk
Assessment, Risk Assessment and Costs for
Defined Contributions Pension schemes

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INTRODUCTION

This position paper is prepared by EIOPA Occupational Pension Stakeholder Group (OPSG) as a general advice to EIOPA and National Competent Authorities (NCAs) of how IORPs can establish adequate and proportionate governance and risk assessment procedures. This question is especially discussed regarding risk assessment practices for DC pension schemes and regarding an objective, proportionate, transparent and comparable way of reporting and analyzing costs in this context.

This submission is prepared by a subgroup and has been approved by the OPSG on 16 March 2021.

BACKGROUND

Risk assessment (and management) is one key functionality for any IORP. As stated in the OPSG's position paper on Asset Liability Management (ALM) and Financial Instruments (2018) this holds as well for DB schemes AND for DC schemes. For both types of occupational pension plans the respective IORP should focus on providing an adequate pension (i.e. benefit) level while incurring an acceptable level of risk, in order to sustainably finance a certain guaranteed (in case of DB) or envisaged (resp. planned or targeted in case of DC) level of present and future benefit payments. In contrast to a DB pension scheme, an IORP providing a DC pension plan usually has much less risk out of that pension plan (if there is any risk at all for the IORP except for operational risk). But the risks have not vanished – they just have been shifted from the IORP and/or the sponsor to the beneficiaries and members. Hence, also and especially in case of DC schemes the general risk structure and especially the risk of not reaching an envisaged pension target for the beneficiary has to be properly assessed. In such an assessment many characteristics of the respective DC pension plan and of the respective IORP have to be taken into account including the demographic decomposition of the population of present and future beneficiaries (in case of collective DC pension plans), regulatory requirements (if any), the actual benefit level, which could be reached given the current state of the investment portfolio and its value, the type and specifications of the respective pension product (including payout options, benefits for widows resp. widowers and orphans, investment smoothing, guaranteed returns, solidarity between members, sponsor involvement, ...), the actual investment portfolio, eventually existing options for the member to select a specific investment strategy (and possibilities to switch between such strategies) etc.. Since the majority of all risks are carried by the beneficiaries, such risk assessments have to be at least as accurate as in the DB case. As a consequence, the OPSG very much appreciates EIOPA's initiative to work on risk management tools not only for DB but also for DC schemes.

However, the OPSG wants to stress, that this initiative can only be a concretization of existing rules and procedures under the current IORP II directive, in which, *inter alia*, some of the features of the proposed Opinion are already addressed (i.e. operational risks in the own risk assessment, national rules for pension projections under the Pension Benefit Statement). From the OPSG's point of view this proposal is clearly not meant to give any opinion with regard to the upcoming review of the IORP II directive (Directive (EU) 2016/2341). This would be far too early from the OPSG's point of view, since in many countries the current IORP II directive has been transformed into national law quite late or even maybe incorrect, so that there is currently not enough practical and meaningful experience available.

Furthermore, it has to be mentioned, that risk assessment as such is nothing new for DC pension plans. It is already today an integral part of any DC pension plan management and is a well exercised practice: there exists already a stress test also for DC pension plans on a pan-European level and also many kinds of own risk assessments are carried out by the IORPs already today, which give the IORP's management an absolutely necessary information for steering the pension product. Any additional guidance has to take into account current existing practices in Member States in this respect.

DC RISK ASSESSMENT

In many European countries a strong trend away from DB pension schemes towards DC pension schemes can be observed. If this trend continues, more and more European citizens will depend on an occupational pension of DC-type. Because in DC (as mentioned before) most of the risks are shifted from the IORP and/or the sponsor to the beneficiaries and members, a neglect or an inaccurate assessment or management of DC related risks can in extreme cases also cause social risks (in form of old age poverty) in the European member states and also economic risks on a national level, resulting out of the fact, that pensioners, which get a lower than expected pension payment, consume less. Hence also for DC systems a thorough, fair, comprehensive and comparable risk assessment should be performed.

Such DC risk assessment can never be seen on a stand-alone-basis. Instead, also the level of contribution or premium payments by the employer and employees and the general design of the plan have additionally to be taken into account.

The risk assessment should (at least) cover the full risk position from the beneficiaries' point of view and shall result out of following categories of risk, which contribute to the total risk position:

- Market risks for all the different asset classes (e.g. interest risk, equity risk, real estate risk, ...)
- Inflation risk
- Counterparty risk
- Operative (operational) risk (incl. outsourcing risk, IT-risk, Cyber-risk, leakage risk for sensitive data...)
- Cost risk (see also the paragraph regarding costs in this paper)
- Liquidity risk (if any)
- Biometrical risk (especially longevity risk, which in a DC case is usually the risk of outliving one's assets; this kind of risk might not be applicable for all DC pension plans)

Of course, market risks for different asset classes have to be properly transformed into a total investment risks for different strategies (where applicable, such as e.g. lifecycle models incl. glide paths, conservative strategies (high portion of fixed income), diversified (including a medium high portion of equity, minimum guarantee strategies, dynamic strategies etc.). Operative risk should also include outsourcing risk (if applicable).

Since the members and beneficiaries carry the whole (or at least a very significant part of the) investment risk, any kind of risk assessment for DC schemes has to assess risk from the point of view of the beneficiaries. Hence it is helpful, that the IORP develops a general feeling for the risk

tolerance of that population and takes this into account accordingly paying attention to the characteristics of the supplementary DC pension plan. This is especially true if the IORP defines a default investment strategy which will be applied for an individual member, if this member takes no active decision in favour of a certain different investment strategy offered by the IORP (if possible). However, it has to be clear that to a certain degree this may also depend on the “stomach feeling” of the IORP and/or NCAs, since an objective scientific methodology for measuring such risk tolerance of members is generally not available. Asking the individual members about their risk tolerance (e.g. how much pension cuts they are willing to accept, if things go bad) can be problematic, because many people may not be able really to understand this issue to an extent which would be necessary to take a really informed decision and to give a sound answer. This is even more the case in pension plans with compulsory affiliation. Also, the additional administration costs, which such a procedure can cause (and which in most cases would have to be paid by the beneficiaries), must be limited to an acceptable level. It also has to be mentioned, that a member’s risk tolerance may change during his/her lifetime, e.g. it may reduce if a person marries and gets children compared to the time when this person still was living on his/her own. Hence, the assessment of a member’s individual risk tolerance is not a one-time event - it would have to be updated regularly. If the risk appetite is only determined for a certain cohort, the investment risks which are accepted by the IORP may not be fitting with the specific risk tolerance of an individual and may hence result in an overall risk position, which this specific individual may not be willing or able to take. The sponsor can take this into account when designing his DC pension plan (including elements such as return smoothing, solidarity between members, investment guarantees, etc.). Hence, a DC risk assessment from a member’s point of view starts already with the design of the pension plan and is performed by the plan sponsor at that point in time. It is at that stage independent from the funding vehicle (IORPs, insurers, support funds, institutions operating social security schemes, ...). In this context a certain priority should be given to an adequate but also proportionate level of accuracy in member profiling that feeds into the design of the respective DC strategy.

Since market conditions and markets risks change over time – as well as other factors like e.g. life expectancy (which of course is relevant for the member regarding his/her planning for the retirement period) – EIOPA is right in requesting, that such risk assessment should be done on a regular basis. If risk parameters change, also different investment strategies than the ones currently used may become more “optimal” for reaching the targeted pension level for the respective beneficiaries. So, (similar to a classical ALM-procedure in case of a DB scheme) also the investment strategies would have to be adjusted in such a case. From that, it is more than justified, that EIOPA proposes to make it transparent in the statement of investment principles (SIPP), how the investment strategy is derived and determined on the basis of such risk assessment.

From the OPSG's point of view also biometrical risk, especially longevity risk, needs to be included into such a risk assessment from the beneficiaries' point of view, in the case of DC schemes offering protection against this type of risk. In such a case, the risk that the IORP would not manage to sufficiently protect members against the respective biometrical risks and the resulting consequences for them would have to be assessed. However, since in a DC scheme, which does not offer such protection, biometrical risks are not relevant for the IORP itself, but for the beneficiaries, who carry in the end the longevity risk completely in these circumstances. As a consequence, they should be well informed, what this risk really means from their point of view. However, in these cases (where usually only a certain amount depending especially on the IORP's investment results is paid out as a lump-sum to the respective beneficiary), the biometrical risk for the beneficiary (expressed e.g. as a potential reduction in percent of the expected average amount per year, which he/she can spend for living out of the received lump-sum payment until death) is not IORP-specific any more (and hence needs not to be calculated by the IORP). Therefore, the OPSG proposes, that the beneficiary might be informed about this kind of risk by another institution than the IORP. EIOPA or the relevant NCA could e.g. take over that task by publishing e.g. on their homepage this general (not IORP-specific) assessment for different age classes of beneficiaries in order to show, , what living longer than expected means for the beneficiaries' disposable money for covering costs of living. This would also be in line with article 28, (2), e) of the IORP II directive (Directive (EU) 2016/2341).

An inclusion of labour market risk however seems to be quite problematic, because this often depends heavily on the respective employer and/or the specific industry, in which the employer is active. Also, reliable data for calibrating suitable risk parameters seem to be not available. Additionally, an inclusion of behavioural elements seems to be quite problematic since this would be based on more or less speculative assumptions.

Since no objectively derived formula can cover the phenomenon of operational risk in a fully appropriate and exhaustive manner, EIOPA's suggestion that the (rough) standard approach from the Common Methodology may be used for this risk category could be a fair and pragmatic proposal, because operational risk (expressed as an amount of money) should be pretty much the same for DB and DC schemes (all else being equal). However, it is appreciated, that EIOPA thinks that also an IORP's own models may be used in order to best reflect the specificities of the operative sphere of that certain IORP. In general, the OPSG wants to give the hint, that certain parts of the operational risk (e.g. the risk for fraudulent actions of the IORP's employees) are nearly impossible to be properly quantified and that hence every quantitative assessment of operative risk has significant weaknesses. But this should not hinder the IORP to take some rough and cautiously derived risk amounts for operative risks into account. Although operational risk is consisting out of several sub-risks as mentioned above (in the list of risks), the OPSG believes for the aforementioned reasons

that it is appropriate to assess operational risk in one total figure, and not in calculating separate amounts for the separate sub-risks.

Furthermore, the IORP II does not set or suggest a specific methodology to quantitatively measure operational risk, as the co-legislator considered that there is not a one-size-fits-all approach able to capture the different kinds of DC arrangements across the EU. As reported by EIOPA, only three Member States already specify quantitative measures for operational risk. Encouraging all other NCAs to require IORPs to quantify operational risks would lead to increasing costs, which would in the end be transferred to members and beneficiaries with potentially limited additional benefits.

It is further highly appreciated, that EIOPA does not propose one single model but proposes more general principles instead. This is from the OPSG's point of view the most reasonable approach given the huge differences between the single IORP's, their setup and their legal framework in different European countries as well as the needed flexibility to propose innovative efficient DC plans in particular to address the long-standing on-going nearly zero interest rate environment. Given the many different type of DC pension plans a "one size fits all approach" can never work. Even if EIOPA has designed its own stochastic model for the PEPP, EIOPA must clearly remind that this model does not aim to become a "de-facto" standard for DC risk assessment and that each DC plan provider could use its own stochastic model. It is also adequate under aspects of proportionality, that IORPs (especially smaller ones) may use deterministic models working with some fixed pre-defined scenarios. However, EIOPA is right in saying, that in general stochastic models give a deeper insight into the risk situation, although their results may be much more difficult to understand and to interpret, especially for members and beneficiaries.

EIOPA proposes to use market data, which is of course reasonable. EIOPA also proposes not to use any kind of mean reversion assumptions in the stochastic (or deterministic) scenarios. However, the OPSG proposes that EIOPA should think about using some kind of reversion towards (national) economic long-term equilibrium risk free yields (e.g. from quantity theory) but not based on its Ultimate Forward Rate (UFR) as mentioned during the PEPP discussions. We have strong reservation on the use of the UFR (published at 3,6% for 2021) as a proxy of forward risk free rates for pension products and schemes. It is from the OPSG's point of view quite important to take also such longer-term convergency phenomena into account and not to focus only on actual market conditions or short-term developments. Depending on the respective market phase this would give either a too conservative or a too optimistic view on the risk situation, both of which is not desirable and would be misleading for plan members.

Of course, assumptions used in the (deterministic or stochastic) model must be realistic, just as EIOPA stated rightly. This is especially true for capital markets related data. However, since it is not reasonable to have only one single model (which is appreciated by the OPSG as said before), also

the type of assumptions and input parameters will be different in the different models applied. This will clearly make it more difficult to compare different outcomings and results stemming from the different models. However, in almost all models long-term return assumptions (stochastic expected values in case of stochastic models) for the different asset classes as well as for the risk of these asset classes and for the interdependency-relations between all of them will be needed. Regarding the last category of input data, stochastic models using a multivariate normal distribution assumption will have to use correlation assumptions between the returns (stochastic variables) of the different asset classes, whereas other stochastic models will work with certain assumed copulas describing such interdependencies. In case of deterministic models such assumptions regarding interdependencies might be used more implicitly when developing different deterministic scenarios to be applied. This makes it from the OPSG's point of view impossible for EIOPA to issue very concrete requirements regarding the assumptions to be used. However, also here EIOPA could think about issuing certain abstract principles ensuring some kind of "minimum quality" of the assumptions used. Such principles might be for example:

- Assumed risks for single asset classes should be based on statistical data derived from a long-term historic observation period (e.g. between 5 and 10 years)
- Assumptions regarding interdependencies should also be based on such long-term historic observations or should at least be consistent what could be observed in a longer historic period (backwards from now)
- Long term return assumptions should be in line with general market consensus
- etc.

NCA's could then supervise the respective IORPs in the single member states in order to make sure, that these abstract principles are obeyed to.

The OPSG stresses, that if an IORP fulfils such minimum quality criteria issued by EIOPA, the kind of risk assessment carried out by this IORP should as such not be seen as a reason to hinder cross border business by any national supervisory authority.

The main results of the risk assessment should be disclosed to the beneficiaries in a form, which is comprehensive and easy to understand. However, this has to be done very carefully, since it has to be avoided, that beneficiaries get a wrong understanding of their risks and may in consequence draw conclusions out of that, which are disadvantageous for them. The OPSG is very well aware of the fact, that it is a difficult balancing act to achieve simplicity to understand AND sufficiency of information at the same time and that a proper format for this in general is quite difficult to find. Since risk assessment results very much depend on the assumptions used in the assessment, some information regarding the underlying assumptions would in this case also have to be given to the beneficiaries in a simplified form. This information can e.g. be given in the context of the information given to the beneficiaries according to article 39, (1), d) (information on pension benefit projections) of the IORP II directive.

COSTS WITHIN THE DC RISK ASSESSMENT

Since the risk assessment should be done from a participant's point of view, all costs, which lower the resulting benefits for beneficiaries have to be taken into account also in the context of a DC risk assessment. Since in a risk assessment risks related to the potential level of benefits (e.g. investment risks) have a different nature than risks related to costs, any offsetting of costs against income positions should be avoided. For the same reason the OPSG supports EIOPA's point of view, that in this context a strict Look-Through-Approach including all costs and charges incurred at the level of investment funds and their managers should be followed. In this context also costs for investment management, which are not fixed, but depend on the performance of the investment manager (e.g. performance fees) should be properly included, if the influence of these costs on the overall result is not insignificant (otherwise these could be left out for reasons of proportionality, since the integration of such costs into the risk model can be quite cumbersome).

Since the assessment should cover the beneficiaries' point of view, any (administrative) costs which are directly paid by sponsoring companies should consequently be left out, because they do not at all influence the future pension result of the beneficiaries. Including such costs would also often not contribute to a higher degree of comparability and would often tell us nothing about the IORP's efficiency and/or the affordability of the IORP for sponsors. First, if an IORP has a sponsor company, to which a big part of its pension products can be assigned, and beside that only few sponsor companies having a relatively small share on the IORP's pension products, it is sometimes the case, that this "majority" sponsor companies pays certain costs. So, in such a case, strictly speaking, the cost level for different sponsor companies might be different. Often sponsor companies have also certain information requirements with regard to an IORP – and are willing to pay for that. In such a situation the cost level is influenced by these sponsor companies themselves and it would be misleading to compare the cost structure (including such costs paid by the sponsors) of that IORP with the cost structure of another IORP having sponsors with much less information requirements resulting in lower administrative costs. Also the argument, that reporting of these cost blocks may give additional insight with regard to the question, if – especially in the situation of a crisis – a sponsor company can still afford the pensions provided by this IORP, has to be questioned, because experience tells, that the size of such administrative costs is usually quite irrelevant for the respective employer.

Since costs are not constant over time, an increase of those costs, which are borne by the beneficiaries is also a risk from their point of view. Hence such costs should also be stressed in a DC risk assessment. In case of a deterministic model realistic cost stress parameters could be developed from analysing e.g. corresponding wage cost indices (which are often published by national statistic

bureaus) or consumer price indices. Here, it has to be decided in every single case, which publicly available cost index might be a good proxy for the development of these cost positions of the respective DC scheme. In case of a stochastic model one could look for a suitable probability distribution of the changes of such cost indices and use these changes as a stochastic variable in the model. Of course, correlation and dependencies to other stochastic variables in the model (one would e.g. expect a positive correlation between inflation and nominal fixed income yields) have to be taken into account properly. Having said that, the complexity of any modelling has to be proportionate to its needed accuracy because this additional modelling could imply additional costs for plan members.

Although taxes to be paid by the beneficiary lower his/her pension income, it is from the OPSG's point of view very problematic to include taxes into this risk assessment. The reason for this is, that in some countries taxes on pensions depend on the overall income situation of the individual pensioner (and may also depend on certain options, which he/she might have chosen in the past). Hence, they may differ from case to case significantly. This is e.g. the case in Germany. In such situations the IORP itself does not even know, how much taxes the respective (current or future pensioner) will have to pay. So, in these countries it is simply impossible to include taxes in manner, that the figure so produced still give a realistic and fair view. Hence, the OPSG advises EIOPA generally not to include taxes in this risk assessment, so that results (e.g. for different IORPs in different countries) remain comparable.