An tÚdarás Pinsean
The Pensions Authority

Presentation to IAPF Investment Conference

25 October 2022

Thanks to the IAPF for the invitation to address this investment conference today. It is especially useful to have the opportunity to speak at a time when there is so much going on.

Although I will address a number of investment issues, I think it would be useful if I put these into an overall context. As a result of the transposition of the IORP II Directive, Irish pensions are going through a period of change that is probably unprecedented. One of the most important aspects of this change is the increased emphasis on the responsibilities and obligations of trustees. Trustees must understand that all decisions taken in relation to their pension scheme, including investment decisions, are their responsibility.

Of course, trustees are not required to be professional investment managers. However, at least some of the trustees must have a reasonable knowledge and experience of investment matters. The investment decision process must be structured, thorough and well informed. The investment objectives must be clearly stated and measurable. Trustees must be able to understand the decisions that they make, to understand why they made them and, if called upon, to explain what alternatives they considered and why they made the decision that they made.

2022 so far

- Obviously 2022 has so far been a tough year for pensions investment – not just poor returns but challenging volatility. The re-emergence of significant inflation means that in real terms the returns have been even worse than they look.

- But over the course of a working lifetime and into retirement, there are going to be many years as unexpected and difficult as this year, and that is why long-term saving is so challenging. Pension schemes must make sure that their investment strategies are designed to cope with bad times as well as good times.

- Obviously many DC members will be concerned about recent investment returns, especially those who are close to their retirement. Trustees should be satisfied that their investment strategy for default funds takes account of short-term risks as members approach retirement and indeed of their members' likely risk appetite. Even where members are planning to invest in an ARF post retirement, it is more difficult to recover investment shortfalls once drawdown has begun.

- These recent losses will also be a concern for those with ARFs. The Pensions Authority supports proposals for more regulation of ARFs and for in-scheme drawdown. This is not intended to reduce the investment choices available, but to provide better structures and support for the many savers who have limited investment experience and confidence.

- It is likely that the solvency position of many DB schemes has improved this year – asset values fell but liabilities fell even more. But this does not simply mean that the members of those schemes are better off. We should remember that very few funded DB schemes provide post-retirement pension increases. DB solvency has improved as a result of higher interest rates, which are a consequence of higher inflation. The improved solvency has been achieved as a result of a reduction in the real value of retirement benefits.

Implementation of IORP II

- You are, I am sure, well aware of the deadline of 1 January 2023 for group schemes to comply with the obligations of IORP II. We in the Authority are very conscious that a great deal of work is going on to meet that deadline. We are, however, concerned that some schemes do not seem to have a sense of urgency.

- One of the most significant innovations of IORP II is the Own Risk Assessment obligation, the ORA. We know that risk assessment is already the practice for some schemes, but for many schemes, this is a new responsibility or one that needs to be significantly expanded.

- The ORA must be thorough, and where possible, and especially in relation to investment and solvency matters, it should be quantitative. But the most important aspect of the ORA is that it must be objective. The approach must be to assess all the risks facing the scheme and deciding how best to address those risks. What the ORA must not be is a rationalisation of the decisions previously made.

- The consideration of investment risk in the ORA should be no less thorough for DC schemes than for DB. The ORA process must look at the risks to DC member outcomes, and it should look at all investment options, not just the default investment strategy.

- The quality and integrity of the ORA are unambiguously the responsibility of the scheme trustees. But obviously the risk key function holder will play a vital role in the process. In particular, the risk KFH will use their knowledge and experience to support the trustees in ensuring that the ORA process is thorough and objective.

- However, it is important to be clear that trustees' obligations in relation to risk are not limited to completing a periodic ORA. Trustees must put in place a risk management system, which has an ongoing function within the management and governance of the scheme. Similarly, the role of the risk KFH is an ongoing responsibility, and is not limited to the task of supporting the ORA. We would therefore expect any newly appointed risk KFHs to be examining the risks and risk control processes of the scheme and not waiting for the formal ORA. Similarly, even if they have not yet completed a formal ORA, from 1 January next, the Pensions Authority will expect trustees to have a risk function in place and to have an understanding of the risk position of their scheme. And in due course, we will want to see that the results of the ORA have been incorporated into the strategic decisions of the trustees.

- Given the importance of risk for pension schemes, the Pensions Authority intends to hold a risk conference in the first half of 2023.

- There is no question but that the risk responsibilities are demanding, and they are by no means the only new tasks for trustees. In particular, DC schemes should consider whether they have the resources and can meet these responsibilities in a cost effective way. We in the Pensions Authority believe that considerable consolidation is necessary in Irish DC pensions, not least because of the need to ensure value for money for members.

Liability driven investment

- As you would expect, the Pensions Authority has been monitoring carefully the issues that have arisen with liability driven investment in the UK.

- Our cautious view is that there are a number of reasons why such a situation is less likely to arise in Ireland and if it did, why it would have less impact. However, we are not complacent.

- Proportionately speaking, LDI is much less common in Ireland than in the UK. Nonetheless, there is a significant amount. In coming weeks we will be making contact with the trustees of the largest defined benefit schemes in order to get more granular information about the extent of LDI and to deepen our understanding of LDI structures and practices in Ireland, conscious that there may be significant differences between schemes.

- This work by the Pensions Authority must not distract from the fact that it is of course the responsibility of the trustees to make investment decisions and to understand the functioning of their portfolio and the risks that arise. We expect trustees of all Irish schemes with LDI to be looking to see whether there are any lessons to be learned from the recent UK events particularly but not limited to liquidity.

- The Pensions Authority is definitely not against LDI.

  The objective of LDI is to identify the scheme liabilities and cashflows, identify the risks to them and minimise as many as possible of those risks. This approach cannot be criticised. Our concerns are about the implementation of LDI and at present specifically relate to liquidity, gearing and trustee understanding and decision making.

ESG

- I think that it is fair to say that in recent months, there is a growing awareness that ESG is neither as straightforward nor as objective a process as would have been a common view a couple of years ago. But this doesn't mean it is less important.

- We have to recognise that as a small country, Ireland is never going to be a standard setter in ESG. In order to implement ESG in pensions, we depend to a large extent on external actors to set definitions and to provide the necessary data. This is still a developing space.

- It also makes sense that as a small country we have consistency in our approach to ESG standards. We are consulting with our colleagues in the Central Bank and in the Department of Finance, to make sure that our approach for pensions is consistent with other sectors.

- We in the Pensions Authority are aware that guidance for pensions trustees about how to meet their ESG obligations would be welcome. However, because of ongoing international developments and because of other demands on the Authority's resources, we are not planning to issue any such guidance before the end of 2023 at the earliest. In the meantime, trustees should use their best efforts to comply with the relevant provisions of legislation and regulation.

Conclusion

- As I said, we are in a time of very significant change in the pensions landscape. The objective of these changes is to improve the outcomes for members. Members of pension schemes, whether DB or DC, are entitled to the same standards of governance and financial management as they would receive anywhere else.

- It is not our job in the Pensions Authority to tell trustees where to invest their members' funds. However, investment is one of the most important and challenging responsibilities of scheme trustees and it must be undertaken in a structured, objective and informed way. Furthermore, it will be trustees and not their advisers or investment managers who will be expected to explain their investment approach and the decisions that they have taken.

- This process and indeed all trustee responsibilities can be time-consuming and demanding. But it is what members are entitled to expect.