An tÚdarás Pinsean
The Pensions Authority

Risk management for defined benefit pensions

Presentation by Brendan Kennedy, Pensions Regulator to the Society of Actuaries in Ireland Annual Convention on 8 December 2020

- Thanks to the Society for the invitation to speak at the Annual Convention. My objective today is to give you an insight into the Pensions Authority's thinking on the supervision of defined benefit scheme's risk management and our expectations of trustees, after the transposition of IORP II. I am not making any announcements in this presentation, but in any case, we will make the text of the presentation available shortly.

- Before I talk specifically about DB risk, I first want to make a few remarks about the future oversight of pensions:

  - The most important aspect of the transposition of IORP II into Irish pensions law will be the introduction of forward looking risk based supervision. Simply put, what this means is that the Pensions Authority will not limit its supervision to seeing whether there have been any past breaches of the Pensions Act. In future we will also be looking at the trustees' management and governance of their scheme to see whether there are any weaknesses or shortcomings that present a future threat to the interests of members and beneficiaries. Clearly, this means a fundamental change in how the Authority interacts with trustees.

  - Central to our oversight of schemes will be the culture of the trustees. By culture I mean the set of attitudes, values, expectations, and practices that determine the activity of the trustees. We will be as much interested in how trustees approach their responsibilities as we will be in what they actually do.

  - The topic of this talk today is risk, but this does not affect the central importance of solvency in the assessment of DB schemes.

- So let me turn to risk, and I will start with a definition. The objective of a defined benefit scheme is to pay the benefits set out in the scheme rules. By risk I mean any possible future event that might be a threat to those benefits. What follows from this is that risk should not be just a single standalone item on the trustees' long agenda: risk awareness and management must be central to everything that trustees do.

- Most of the people listening to me are actuaries, and are most familiar with longevity and investment risk. But you should bear in mind that there are many potential risks to a scheme, including operational ones. Although much of what I am talking about is indeed related to longevity and investment risk, those other risks must not be forgotten.

- The Pensions Authority's views of the standards of defined benefit risk management are formed from a number of sources – discussions with trustees and actuaries, our experience of funding proposals, and our recent programme of engagement with some large defined benefit schemes.

- There is certainly not a long history of widespread risk awareness and management in Irish defined benefit schemes. We have come across some schemes where there clearly has been very little consideration of risk, and it seems to be simply accepted as a fact of life, without any consideration of the options available to the trustees.

- Overall, our view is that the current defined benefit risk culture and awareness is very mixed. Some scheme trustees have a very strong risk management culture and very good practices. In some other schemes, however, risk awareness and process seem to be almost non-existent. Our objective is therefore twofold: to develop a risk awareness and management culture among all DB trustees, and to introduce a structured way of measuring risk for our supervisory purposes.

- Post transposition there will be two separate processes addressing a scheme's risk management. The first will be the trustees' Own Risk Assessment – ORA – and the second will be the Authority's own supervisory review processes. It is important to distinguish between these two separate processes: we will make our own assessment of a scheme's risk and risk management, but the trustees have their own separate responsibility. This ORA is my main subject today.

- The ORA is the trustees own independent take on their scheme's risk. The amended Pensions Act will specify a number of minimum areas to be covered, and the Authority is likely to issue supplementary guidance. But the trustees retain responsibility for ensuring that they have included all relevant risks and considered them properly.

- Obviously, the ORA must be comprehensive: it must address all significant risks to the members' interest. For each risk, the trustees must ensure that they have gathered whatever information is available to help them understand the extent of the risk and their possible responses. For defined benefit schemes, this must include quantitative analysis where possible of relevant risks and their potential impact.

- The purpose of an ORA is not and must not unconsciously become a demonstration that the scheme is OK. The purpose is to look at all significant risks, assess the vulnerability of the scheme and consider mitigating actions if appropriate. This analysis must be objective and must not be simply a rationalisation of the status quo.

- Although the ORA is the trustees' responsibility, the Pensions Authority will look at it as part of our supervisory work. It will provide us with an important insight into the trustees' approach to scheme governance. The questions we would ask would include whether the ORA is comprehensive, is it informed, and is it objective.

- We expect the risk manager to play an important role in achieving a good ORA. In particular, the risk manager should help to ensure objectivity and make sure that the ORA is thorough. It is worth noting in passing that although we expect that many risk managers for DB schemes will be actuaries, we do not see an actuarial qualification as automatically certifying the holder as qualified to be a risk manager and it will not be necessary to be an actuary to be a DB scheme risk manager: relevant experience is very important.

- As part of our own supervisory risk process, the Pensions Authority is developing a standard quantitative measure of investment and longevity risk for all DB schemes, and we will have more to say about this in the new year.

- As we are all aware, the strength and commitment of the sponsoring employer is probably the single biggest determinant of a scheme's ability to bear investment risk. However, given that in most cases, the sponsoring employer has no legal obligation to support a scheme, there is no useful way to quantify the value of this employer support. We are very unlikely to expect trustees to commission a formal covenant assessment. However, we will expect the trustees to have had a thorough informed conversation with the employer. This should include sharing risk information and exploring different scenarios and possible responses. The result should be an objective and rational analysis by trustees of the strength of the employer commitment, albeit qualitative rather than quantitative.

- We do not want to have an adversarial relationship with trustees. Running a DB scheme is extremely complex and demanding. Ideally we want to be happy that the trustees understand their scheme, have a realistic view of the challenges and risks, are thinking about the effect of those risks on the different categories of members, and are taking steps to address them.

- So what happens next?

    - We are obviously awaiting transposition of the Directive. I do not have anything to say about when that might be.

    - Nonetheless, I strongly believe that trustees should conduct an honest self assessment relating to the major provisions of IORP II. For defined benefit schemes, trustee risk awareness, process, data and management should be looked at.

    - We intend to publish our framework for DB scheme financial assessment, including risk, in Spring 2021.

- Before I finish, I want to say a few words about the actuary/trustee relationship. Although what I have covered is relevant to you, actuaries are not my real target audience. It is obviously important that you know of our intentions and scheme actuaries have a role to play in the risk measurement and management process. But one of our most important goals is to get to the point where all DB trustees understand their schemes in all their complexity and understand and have ownership of and responsibility for the decisions that they make. This means that the quality of the communication between trustees and actuaries is vital.

- Thanks for your attention. I am happy to take questions.