An tÚdarás Pinsean
The Pensions Authority

Presentation to Society of Actuaries in Ireland Pensions Forum

24 February 2022

Defined benefit risk management

- Thanks to Paul Torsney and the Society for offering me the opportunity to speak at this event, which is much appreciated.

- My theme this afternoon is defined benefit risk and risk management. Much of what I say will be familiar, or I certainly hope that it is: the issues facing defined benefit schemes do not change much over the course of a few months or years.

- But what I will do is take advantage of the Society's announcement that this event would be particularly suitable for pension scheme trustees; my presentation therefore is mainly aimed at trustees of defined benefit schemes, though I have no doubt that pensions actuaries will also want to hear it.

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- As you are well aware, the transposition of IORP II into Irish legislation last year imposed many new obligations on scheme trustees. As a result, the list of trustee tasks is long and demanding. But pension provision is not a mechanical process: there is no fixed set of tasks or actions which, if undertaken, will make it certain that the benefits can and will be paid.

- Longer term saving, including for retirement, is inherently uncertain. This is especially true for defined benefit provision, where the rules of the scheme promise a specified benefit to members in spite of the challenges of providing it. This uncertainty is why mechanical administration of defined benefit is not enough. Above and beyond the very necessary day to day tasks, the trustees must have active strategies which they pursue in order to meet their goal which is to pay member benefits as they fall due.

- In setting their strategies, trustees must recognise the inevitability of uncertainty, and they must put it at the centre of all their work. They must also recognise that their responsibility is dynamic: they will have to respond to changing circumstances throughout the lifetime of their scheme.

- Uncertainty creates risks, and the Own Risk Assessment, ORA, must therefore be at the centre of trustees' consideration. My own view is that it is possibly the most important responsibility of trustees and if it is done properly, many of the other aspects of trustee responsibilities will fall into place.

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- But to achieve its objectives, the ORA must be done properly. I think there are four ways in which an ORA can fall short:

  (a) The ORA isn't comprehensive enough

  (b) There isn't enough information to support it

  (c) The trustees may not be objective enough

  (d) The ORAs conclusions are not implemented

  Comprehensiveness

- When I talk about risks, I mean issues that may threaten the ability of the scheme to pay benefits. The main threats can be categorised as operational, financial and employer related, though obviously there is going to be overlap between them.

- I want to talk about each of these matters, but what I do not want you to do is to copy down the list and replicate it for your own scheme. There may be particular issues with your own scheme that I do not mention. Of all tasks, the ORA must not be a form filling exercise, but a genuine open-minded assessment.

- In the past, operational risk was not a topic that traditionally got a lot of attention from scheme trustees, though this is changing. Among the questions that trustees must ask themselves are:

  - How accurate is our member and financial data?

  - How robust is our administration? How good is the system?

  - How good are our defences against cyber-attack?

  - How good are our financial controls?

  These questions apply just as much to trustees who have outsourced their administration: in fact, they should have been asked when the outsourcing decision was made.

  And it is not enough to come up with answers. We in the Pensions Authority will want to see the evidence on which those assessments were based.

- By financial risk I mean the external factors that are relevant to the scheme's financial health – the most significant are future investment returns, longevity and salary increases. There is a feedback loop: the trustees' assessment of the financial risks dictates their investment strategy and contribution rate, but these in turn affect the financial risk to the scheme.

Again, the question is whether the risk is acceptable, and whether the evidence on which that assessment is made is robust.

- By employer risk I mean the risk that the employer will not or cannot continue to support the scheme. It is worth considering as a standalone category because for most DB schemes it is the single biggest risk to the ability of the scheme to meet its obligations.

  The risk, simply put, is that the trustees are overestimating the ability or willingness of the employer to support the scheme. I am not at all underestimating the difficulty of evaluating the employer support. It is unavoidably a matter of judgment both in terms of assessing the employer's capacity and the employer's willingness. The necessary conversation with the employer is a challenging one: it may be particularly difficult for employee trustees to state a view that the employer support cannot be relied on. And I do not want to impugn anyone's good faith but trustees who are also senior managers may well have an unavoidable conflict of interest which, at a minimum, may cloud their judgement.

Information

- As far as possible, the ORA must be supported by data, and as far as possible, that data should be quantitative.

- For operational risk, the internal audit function is both useful and important. Furthermore, for outsourced services, trustees should be regularly seeking information from the service providers about risks, and about the evidence for the answers that the service providers are giving.

- For financial risk, the trustees must ensure that, with their advisers, especially their actuaries, they have enough information to understand the solvency, risk, and sustainability of their scheme.

  Given the fundamental uncertainty of defined benefit provision, there is no single number that can summarise the position of the scheme. We are long past the time when a funding standard and a long-term valuation were believed to be enough between them to manage the finances of a defined benefit scheme. Trustees must therefore ensure that they can see the range of possible outcomes and their effect on the scheme's finances. To be clear, I am not saying that this additional information will reduce the risk: it will contribute to a better understanding of that risk.

Objectivity

- An ORA will fail if it is not objective. Trustees must beware of producing an ORA that, even inadvertently, is geared to a preferred outcome or that justifies decisions that have already been taken. The risk Key Function

Holder will have a very important role in contributing to this objectivity, and trustees must be prepared to hear things that that they may not like.

- Trustees must also examine the assumptions that underlie their own thinking. Defined benefit schemes have changed a lot over the last 20-30 years.

  - The membership of the typical scheme has changed – the average pension scheme's liabilities are now almost two thirds comprised of retired members;

  - the average time in retirement has increased considerably;

  - the investment markets – equities and bonds – have changed almost unrecognisably

  What was once a not too expensive entity with very long term very uncertain liabilities matched by (what were thought to be) reliably high yielding investments is now a very expensive entity with quite predictable short to medium term liabilities matched by low-yielding volatile investments. Trustees must satisfy themselves that their understanding of their scheme and their approach to managing it has similarly changed.

  Implementation

- But an ORA is not just a process of identifying risks; it is just as much about deciding how to control them and to respond to them. Trustees have a legal obligation to take account of the results of their risk assessment in making strategic decisions.

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- Before I finish, I want to make some additional points about financial risk. For these financial risks, the task for trustees is to

  (a) identify and quantify the risks

  (b) reduce that risk to an acceptable level

  (c) decide how the remaining risk will be managed – in other words, who will carry any losses that might arise.

- Financial risk is not a theoretical actuarial measure: it is addressing the question of how likely is the scheme to suffer losses and what happens if it does. In a defined benefit scheme, there are only three things you can do with financial losses:

  1. If the scheme has built up a surplus, this is available to absorb the losses.

2. If the sponsoring employer is willing and able, they will make good the losses through additional contributions.

3. If neither of the first two are enough, then the members will suffer the losses, in particular those members who have not yet retired.

- I think it is not just useful but important that trustees think about financial risk not just in abstract terms but in terms of possible losses and who will bear them.

- I do not think that it is good practice for a scheme to rely permanently on the unretired members to provide risk capital for the scheme and to be the risk buffer for the other members. This practice has little or no potential upside for those members but exposes them to the real possibility of suffering losses on behalf of all scheme members.

- To finish up, I want to reemphasise the importance of the ORA for the management of defined benefit schemes. I also want to emphasise the importance of the risk KFH role. This risk manager role is separate to and different from that of the scheme actuary, and their role is to ensure that the risk management process and specifically the ORA is comprehensive and objective. I suggest that any newly appointed risk manager should work with the trustees to immediately undertake an ORA, even if it is informal and if the process can be improved over time.

- I am happy to take questions

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24 February 2022