Presentation to Society of Actuaries in Ireland annual convention

14 November 2022

Thanks to the Society of Actuaries in Ireland for the opportunity to speak here today.

My objective is to address a number of current issues, but not to make any significant new announcements. The issues I will cover will be mostly but not wholly DB.

The issues are:

- Recent market events
- LDI
- IORP II compliance
- Longer term planning for DB schemes
- The role of the actuary

Recent market events

2022 has seen a great deal of market volatility, including significant losses in some sectors of the equity markets. We have also seen a big jump in inflation and increases in bond yields.

Despite the market losses, it is probable that the solvency situation of most DB schemes has improved, sometimes significantly, since the beginning of the year. This is in contrast to the situation of most members of DC schemes, who are probably worse off. However, if we compare the situation of the members of DB and DC, we will see much less difference. Very few funded defined benefit schemes now provide post retirement increases and as a result, the real value of defined benefit pensions is lower than it was at the beginning of 2022. Essentially, the financial situation of DB schemes has improved because the real value of member benefits has fallen.

But the most important lesson to draw from these market events is the unpredictability of longer-term investment. No-one in 2021 predicted a scenario such as 2022 has turned out to be. This is a reminder that in the investment and financial management of pensions, whether DB or DC, trustees and their advisers must avoid the temptation of managing their scheme based on a single long- or medium-term narrative. The reality is that the narrative, if there is one at all, keeps changing.

The objective in running a scheme must be resilience in the face of a wide range of possible outcomes. I certainly do not mean that schemes must avoid risk: in most cases, this would be inappropriate and unrealistic. But the economic and investment environment will always be changeable and unpredictable, and this must be recognised by trustees and their advisors.

Among other things, this emphasises the importance of trustees having a comprehensive understanding of the financial situation and dynamics of their scheme. We have emphasised before that there is no single number that can capture the complexity of the defined benefit scheme, and in particular, the need to monitor solvency, risk and sustainability measures.

LDI

Obviously, we in the Authority have been carefully following the recent issues with liability driven investment in the UK. Although our view is that such a situation is less likely to arise for Irish DB schemes, it would make no sense to be complacent.

In the last 10 days, we have written to the trustees of the largest 30 DB schemes seeking information about any LDI arrangements that they may have, and we have already received some responses.

Our objectives are to understand better the extent of LDI among Irish pension schemes and get an understanding of the nature of what LDI there is. It is far too early to draw any conclusions, but the specific topics we will want to address are trustee understanding and decision making, liquidity, and gearing.

(a) We want to know that, where schemes decide to implement LDI, the trustees are making an informed decision, i.e. that they and not just their advisers, understand the decision that they are making, how LDI will work, and what the risks are. Hence we are addressing our questions to trustees and not to their advisers.

(b) As we know, the proximate cause of the LDI crisis in the UK was a liquidity issue, caused by a sudden significant fall in UK gilt prices. We are seeking information about the liquidity tolerance of Irish LDI arrangements.

(c) LDI gearing seems to have been a contributory factor in the UK situation, and we need to understand the role of gearing in Irish LDI. It is too soon for the Pensions Authority to form a view on this, but I would say that gearing is a potential concern. In the normal course of pension investing, gearing (i.e. long term borrowing) is not permitted and obviously we would have concerns about any derivative structures which may replicate the economic effect of borrowing.

IORP II

There is a great deal of work underway to bring schemes into compliance with IORP II. I want to address a few specific items.

- Although a number of schemes have already had in place a risk management process, especially DB schemes, the appointment of a risk management key function holder is an innovation for almost all schemes. We have been asked a number of times what is the Pensions Authority's view of the scheme actuary holding the role of risk KFH.

  Our position is firstly that it is permissible.

  However, this is only permissible where the actuary has the necessary experience to discharge the risk role: an actuarial qualification is not automatically enough to meet the KFH requirements. It is the responsibility of the trustees to satisfy themselves that the risk KFH is appropriately experienced, but I would imagine that this would also by an issue for the appointee's own judgement: it is also something that the Pensions Authority may interrogate.

That said, the Authority's view is that it would be preferable were the actuary and the risk KFH separate. They are distinct roles with different responsibilities. There would be an obvious advantage in having the perspectives of two separate people in addressing risk issues.

- The Pensions Authority has emphasised the importance of the own risk assessment (ORA) in the management of a pension scheme. In any supervisory assessment of a scheme by the Authority, the ORA will be one of our most important sources. It is a fundamental requirement that this be thorough and objective.

  But the ORA is certainly not the only task of the risk KFH. Trustees are obliged by the Pensions Act to have a risk management function in place at all times, and this function must be well integrated into the decision-making processes of the scheme. Therefore, the role of the risk KFH must be understood as an ongoing responsibility, not as a task or series of tasks: this is a significant difference between this role and the scheme actuary.

  We therefore expect any newly appointed risk KFHs to be immediately examining the risks and risk control processes of the scheme and not waiting for the formal ORA. From 1 January next, when we in the Authority engage with any pension scheme, we will expect trustees to have a full understanding of the risk position of their scheme, even where they have not yet completed a formal ORA.

- There are very many small DB schemes in Ireland: half of all DB schemes have assets of less than €17 million. Clearly compliance with IORP II is going to be difficult for these schemes: the greatest challenges are likely to be compliance with the requirements for the trustee board to have the necessary qualifications and experience, and the costs of compliance with the risk KFH and other obligations.

  But small DB schemes are inherently more risky than larger schemes: it is harder to pool risks if the pool is smaller. Many small Irish DB schemes have significant risk related to a specific individual. Not alone must these smaller schemes comply with the requirements of IORP II, they must ensure that their risk function identifies all risks and that their decision making addresses them.

Defined benefit longer term

The Irish pensions sector is in a process of significant transition. The current priority is for all schemes to become compliant with the obligations of IORP II – such matters as appointing key function holders, making sure that trustees have the appropriate qualifications and experience, having the necessary processes and governance in place, and meeting new obligations such as the ORA.

However, this compliance is not an end in itself. The objective is that the trustees will have the necessary knowledge, skills, and experience to identify and address the most important issues facing their schemes, and to make decisions in the best interests of the scheme members.

One of the most important decisions facing many funded DB schemes is their endgame. Almost all such schemes are closed to new entrants. For many of them, the liabilities of retired members and those close to retirement represent over three quarters of the total and it will not be long before this number gets close to 100%.

At some point, trustees have to engage with the question of whether it is still appropriate to carry all of the investment and longevity risk within the pension scheme, or whether it would be more appropriate to buy out the pensioners liabilities. Certainly, in some cases, it is a lot easier to understand the downside risk of the status quo than the potential benefits for members.

This is a topic that the Authority may raise in our future engagement with such schemes.

The role of the actuary

At the heart of the Pensions Authority's implementation of IORP II is the principle that the responsibility for running a pension scheme lies unambiguously with the scheme's trustees. Although they can and usually should seek actuarial and other professional advice, and usually outsource almost all of the administrative work and investment management of their scheme, what they cannot do is outsource or alienate their responsibility.

For example, if there are administration errors, we will want to know how and why the trustees chose that administrator and how they monitored their performance. Where the trustees have received advice, they will have to be able to demonstrate to the Authority that they understood the questions being addressed, the implications of the options considered and the reasons why they took the decision that they did.

In practice, this means that the Authority's substantive conversations will always take place with the trustees, not with their advisors or service providers – usually without them present, though we may deal directly with the latter by agreement when gathering data or specific scheme information.

This does not change the role of the actuary: indeed, given what I have said about the need for trustees to understand the financial dynamics of their scheme, IORP II may in many cases increase the need for actuarial input and advice. However, it is important to understand the respective roles of the trustees and the actuary, and the importance of clear communication between them.

Brendan Kennedy 14 November 2022