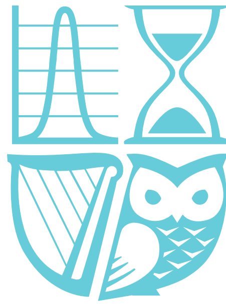

Society of Actuaries in Ireland

Response to the Pensions Authority consultation on financial management guidelines for defined benefit schemes

30 September 2014

Introduction

1. The Society of Actuaries in Ireland ("Society") is the professional body representing the actuarial profession in Ireland. Risk Management is a key area of practice for actuaries. We therefore welcome the invitation of the Pensions Authority to provide feedback on the recently published financial management guidelines for defined benefit schemes.

2. The following sets out our general response to the issues raised in the consultation.

3. We welcome the publication of these guidelines which we see as a positive development. Defined benefit (DB) pension schemes have experienced a tumultuous time over the last decade or so and many lessons have been learnt. The publication of these guidelines will greatly assist those schemes that have survived in putting measures in place that will enable trustees to better understand the risks to which their schemes are exposed to and to better manage those risks.

4. In recognition of the importance of this topic to ensuring the continued sustainability of defined benefit schemes, the Society recently established a "Risk Management in Pensions" working party to help actuaries increase their understanding of risk management as it applies to pension funds so that they are well positioned to help their clients and to serve the public interest. Indeed the Society is holding a Pension Risk Management Forum on 23 October where members of this working party will present their findings - we invite representatives of the Pensions Authority to attend this event to learn more about the Society's activity in this area as a further input into its guidelines. The Pensions Authority provided some input into the initial discussions of this group and the Society would be happy to participate in a Pensions Authority working group in developing tools in this important area.

5. In some areas the proposed guidance is necessarily high level and principle based. In other areas trustees might benefit from greater direction and detail. In relation to investment governance, for example, we would refer the Authority to the IAPF Investment Guidelines for Defined Benefit schemes. These set out seven guidelines and there is also a more detailed booklet setting guidance on compliance with the guidelines. We suggest that the Authority consider either endorsing the IAPF Investment Guidelines directly, or, using a similar approach and perhaps based on the existing IAPF guidelines, draft a revised version that gives a similar level of detail and direction to trustees. We also suggest that the disclosure regulations require trustee annual reports to contain a statement that the Trustees have access to "Investment Guidelines" literature to match the requirement to have access to the Trustee Handbook.

6. We suggest that the trustee training regime could be adapted to encourage trustees to adopt a more proactive approach to risk management e.g. by developing an advanced trustee training module on risk management, for trustees who have already completed the core training requirements.

7. We have addressed each section of the guidelines in the order they were set out in the Pensions Authority document, and added a summary of some of the main points at the end.

Financial management guidelines for defined benefit schemes

8. We feel that it would be useful to expand this section to make it clear to trustees that the purpose of the guidelines is to improve risk management and encourage strategic thinking, rather than to produce paperwork and increase the cost of compliance.

9. We think it would be useful to have a 2 or 3 layered approach to risk management i.e. a base line of the minimum requirements, a middle layer of what would be good practice and possibly a top layer of an ideal approach.

10. This layered approach would not necessarily correspond to scheme size – a small scheme can be exposed to significant concentrations of risk, for example one member can represent a disproportionate percentage of the liabilities – but rather recognise the proposed voluntary nature of the code and the need for all schemes to at least have a base level approach to risk management.

11. We also note the Pensions Authority's opening comments that, where the Authority has occasion to become involved with a scheme, it will assume that the trustees will have the information and understanding set out in the guidelines. We believe it would be appropriate for the Authority to further clarify its expectations of trustees in this regard and be forthright with trustees as to how a scheme's approach to risk management could be a consideration if that scheme has to review a funding proposal and apply to the Pensions Authority for an extended funding period or Section 50 order.

12. The guidelines state that trustees should have access to adequate actuarial and investment advice. Legal advice may also be needed, particularly in relation to trustees' powers in setting the contribution rate and to demand a final contribution in the event of the wind up of the scheme. Perhaps there is some merit in encouraging trustees to prepare a balance of powers document in conjunction with their legal advisors.

13. IORPS I (as codified in the investment regulations) requires trustees to invest assets held to cover technical provisions in a manner appropriate to the nature and duration of the liabilities. We believe the guidelines should stress that the trustees ensure that the investment adviser has sufficient expertise and practical experience to advise in the context of DB and has sufficient knowledge of DB liabilities, the funding standard and interaction of investment and funding policies.

14. The draft guidelines require trustees to ensure that they have access to adequate actuarial and investment advice. We note that trustees are legally required to obtain

actuarial advice, but that there is no legal requirement to obtain investment advice. In this regard we make the following observations:

- We would suggest that at the very least it is recommended as good practice that independent investment advice is sought. We note that in the UK trustees are required to seek written advice from a suitably qualified person before preparing or revising a statement of investment principles
- Actuarial funding advice often employs prudence margins in assumptions. For this reason, provision of investment advice can be conflicted to some degree with provision of actuarial funding advice, as lower than best estimate assumptions about long term returns can require that higher levels of investment risk be taken than might be needed if no margins were employed. Trustees should be encouraged (as per the Myners report in the UK) to see actuarial and investment advisors as two separate appointments (although not necessarily requiring separate firms).

Data

15. The specified timeframes for the provision of basic asset and liability data are generally not unreasonable. The investment-related timeframes could be compressed, but it may not be possible to provide liability information in such a short timeframe, and we think that trustees should review the assets and liabilities at the same time. (See also paragraph 17.) It may be useful to summarise the related compliance deadlines for items such as trustee annual reports, actuarial statements/certificate, annual actuarial data returns, valuation reports, etc. in a separate appendix. However the emphasis on reviewing this information should be on strategic thinking rather than a compliance-based approach.

16. Scheme liabilities can be calculated on a range of bases and therefore the Authority should clarify what liability bases would be included in its view of the minimum information that should be available – presumably the funding standard and possibly the ongoing valuation basis. Trustees (and sponsors) should be aware that the funding standard measure may not represent the cost of settling liabilities in the event of an actual wind-up. Trustees should also be aware that generally there is no portfolio of assets that will match a scheme's funding standard liabilities, so some volatility in the funding level is inevitable.

17. We suggest that the guidelines should specify that an *estimate* of the liabilities is required. Providing accurate figures will involve more time and expense, and on balance we think that an estimate is more efficient. A more detailed figure can be prepared if required or will be prepared in any case to meet the compliance requirements and the associated deadline.

18. We welcome the suggestion that operational costs should be monitored against budget, as this is an area that is often not monitored very closely.

Governance

19. It is useful to have a modus operandi for how trustee meetings are run e.g. appointment of chairperson/secretary, procedures around circulation of papers/minutes, sample agenda, etc. (We note that some of this is covered in the Trustee Handbook but it is worth repeating here). We feel that each year a substantial amount of time should be spent on financial management and risk management issues e.g. appraisal of the scheme risk matrix (discussed in paragraphs 35-36).

20. We also believe that the operation of an investment sub-committee can have benefits in allowing for detailed consideration of financial management issues and efficient decision-making. The statement that "All decisions about financial management should be taken at formal trustee meetings" should be modified to allow for the operation of an investment sub-committee (and sub-committees generally). It is reasonable (and sometimes essential) for sub-committees or other parties (e.g. fiduciary management) to have decision making powers provided the power has been appropriately delegated and an effective reporting and monitoring regime is in place.

21. A more detailed discussion of conflicts of interests would be useful, although this topic may require its own separate set of guidelines. In general, it is not possible for an adviser to definitively state that there is no conflict of interest; rather there should be an agreed framework or protocol for dealing with any conflict of interest that may arise. Such a framework is already mandatory for actuaries who advise both the trustees and the sponsoring employer of a pension scheme in relation to funding and investment matters. While we appreciate the intent of the statement that "the trustees should be the primary client of the advisor", the Authority should note that in certain circumstances this may not always be possible, for example, statutory schemes where the strict role of the trustee may be more limited and the Board of the Company is the recipient of most of the advice.

22. We also feel that trustees should be encouraged to consider and discuss their own conflicts of interest. Consideration could also be given to requiring that a Register of Interests be prepared (i.e. declaration by each trustee of any interests in the scheme as a beneficiary or the employer, as an employee/shareholder, etc.) – this might form part of the 'top layer' of risk management as mentioned in paragraph 9.

23. A written agreement with the employer, setting out the trustees' power to incur costs, is a good idea but great care should be taken to ensure this does not restrict the trustees in carrying out their duties under the trust deed.

24. We agree that all trustees should be encouraged to prepare a Statement of Investment Policy Principles (SIPP) even where the scheme is exempt from the legal requirement to

prepare one, but we would stress that the important work is setting the investment strategy, and the SIPP only documents the outcome of that work.

Processes

25. Attention should be paid to the interaction between funding policy, investment policy, sponsor covenant and the scheme benefits (in particular, discretionary benefits).

26. We agree that a triennial review of investment strategy is required, but feel that an annual review (perhaps less detailed) is also useful. This might be considered in the context of the layered approach mentioned in paragraph 9.

27. It would be useful to mention some of the other circumstances that might prompt a review of investment strategy e.g. changes in market conditions, regulatory change, a change in the scheme's demographics, a change in the scheme's status (from 'active' to 'frozen') or a deterioration in the employer covenant.

28. It is important to remember that the performance of the investment manager relative to the benchmark is likely to be a second order issue compared to the asset allocation decision. However, we agree that at a minimum the performance of the investment manager should be reviewed every three years. Ideally the investment manager review would be conducted annually and cover performance and other issues such as changes in key personnel, style/approach, service, etc.

Analysis

Contributions

29. The guidelines strongly encourage trustees to discuss the sustainability of the existing contribution rate with the employer, and to identify the scope for future increases in the contribution rate and the ability of the sponsor to meet such an increase. We believe that this type of conversation is very useful, but we feel that trustees should also be encouraged to consider undertaking an independent assessment of the sponsor covenant. Guidance or a case study from the Authority setting out a methodology to follow would be useful. Such a framework might include detail on the types of questions that the trustees should ask of a sponsor, the main risk factors to focus on and what key performance indicators should be monitored.

30. We agree that both long- and short-term contribution rates should be assessed, for example trustees of schemes with a funding proposal in place should consider what the long-term contribution rate is likely to be after the funding proposal has run its course

and taking into account the risk reserve requirements applicable from 2016 and the impact of future retirements on the funding standard liability.

31. Many of the suggested scenarios highlighted by the Authority are already quantified in the triennial actuarial valuation report, for example, the requirement to set out the contribution rate if the scheme was fully invested in bonds and the requirement to illustrate the impact on the funding standard position under varying investment strategies or economic scenarios. A recent change to ASP PEN-1[1] which stipulates the minimum content of a valuation report is the requirement to comment on non-investment risks that are significant to the likely future development of the scheme. Trustees can extract better value from a valuation report by continually referring back to it. A similar point can be made about a formal investment review.

32. The suggestion that trustees should ask "Given the current contribution rates by members and employers, what rate of long-term investment return will be required to pay benefits?" should be treated with some care. There is a danger that this could lead trustees to consider contributions as fixed, and investment return as the variable factor that can be adjusted in order to maintain the fund. This is not an appropriate approach for the vast majority of Irish pension schemes. While the calculation may be useful (particularly if the required return is expressed as a margin over bond yields) in highlighting whether the benefit scale under the existing contribution structure is sustainable, it should be stressed that the primary question is what level of contribution is required, based on a reasonable set of assumptions. We also note that the investment strategy of the scheme is likely to change over time as the scheme matures, so it is potentially misleading to calculate the *long-term* investment return and assess this by reference to the *current* investment strategy.

33. A key point in any discussion about the sustainability of a contribution structure is the distinction between the ability of a sponsor to *afford* an increase in contributions and *willingness* to pay a higher contribution. An assessment of the employer covenant as discussed in paragraph 29 above is useful in assisting the trustees' understanding of the ability of a sponsor to pay a higher contribution – this, in turn, will input into deliberations in setting the level of investment risk and funding considerations such as the general pace of funding/deficit spread periods. However, a major risk to trustees in Ireland is that a sponsor may be unwilling to pay a higher (or even the existing) contribution and instead choose to terminate the scheme. At a macro level this risk is exacerbated by a wide variation between schemes in terms of the powers available to trustees to influence this decision. While the preparation of a balance of powers document (as referred to in paragraph 12) would assist trustee groups in understanding their particular circumstances (i.e. the relevance of the contribution rule wording and the existence (or not) of a notice period in the wind-up clause), it would require a policy decision by government to introduce overriding legislation that would level the playing pitch between schemes in this area.

[1] ASP Pen-1: Funding defined benefits – Actuarial reports. An Actuarial Standard of Practice issued by the Society of Actuaries in Ireland

34. To encourage trustees and sponsors to have frank and open discussions about contribution rate sustainability and funding generally, the Authority could promote the concept of a Statement of Funding Principles (SFP) that would formally document items such as the scheme's funding target, surplus/deficit spreading policy, discretionary benefits policy, assessment of employer covenant, etc. Again, it would be useful if the Authority prepared a specimen copy and/or published an FAQ on the type of information that would be contained in such a SFP.

Risk Management

35. We agree that a framework of identifying and ranking risks is useful and that a matrix identifying the most significant risks, their likelihood, their impact and mitigation actions is an appropriate format. To translate this academic treatment into practice, we encourage the Authority to follow through on its aspiration to prepare and publish sample risk matrices.

36. We agree with the suggestion of an annual risk assessment but also think it would be useful to consider a more thorough risk review exercise every three years. This could be integrated with a triennial cycle of investment review and actuarial valuation.

37. The guidelines identify what would generally be accepted to be the most significant risks i.e. investment volatility, interest rates falling, increasing longevity, sponsor risk (i.e. ability or willingness to make contributions) and higher than assumed earnings growth. However, we believe it would be useful to include a more comprehensive list of risks in the guidelines. Other risks that could be mentioned (or identified risks that could be expanded upon) include the following (in no particular order):
    - inflation risk,
    - currency risk,
    - default risk,
    - concentration of assets / self-investment risks,
    - legislative or other regulatory risk (e.g. increase in risk reserve level, pensions levy),
    - scheme administration such as inaccurate member data/calculation errors/failure to underwrite protection benefits,
    - demographic risk e.g. reduction in number of active members due to employer restructuring,
    - inappropriate insurance arrangements in respect of protection benefits,
    - concentration risk i.e. a small number of members have a disproportionate impact on the liabilities,
    - options risk i.e. the risk that members exercise options that result in unanticipated liabilities (or fail to exercise certain options e.g. commutation).

38. We agree that the high/medium/low assessment is an appropriate starting point. We do not necessarily agree with the statement that “it is rarely possible to put a meaningful

numerical value on any risk." Techniques such as scenario analysis and value at risk (VAR) calculations can be used to put numerical values on risks. These calculations, while they may not be particularly meaningful in isolation, can be very useful in comparing risks and allowing a more detailed quantitative assessment than the more qualitative high/medium/low approach.

39. This will be a challenging area for trustees and the provision of additional guidance is likely to have a significant impact on the quality of risk management following publication of the guidelines. As noted above, a sample of a risk matrix and some examples of risk mitigation techniques would be very useful. Some detailed case studies would also be useful and could illustrate risk management techniques such as the growing trend of DB schemes to put in place investment flight paths and the use of 'trigger points' to assist in their investment de-risking objectives.

40. It should be remembered that it is not possible to eliminate risk entirely, and that a policy of minimising risk is not always appropriate. Trustees should apply a cost/benefit analysis to decide how to allocate their risk budget and whether to retain, reduce or minimise a particular risk. Another way to approach this idea is to consider whether risks are adequately rewarded. For example, trustees might decide that a certain level of equity investment is adequately rewarded, whereas the currency risk from holding non-Euro equities is not adequately rewarded, in which case it could be reduced using a currency hedge.

Summary

41. The foregoing sets out our response to the issues raised in the consultation. In summary, we feel that the most important points to make are as follows:

    (i) There should be a holistic approach to financial management of defined benefit pension schemes, encompassing (among other things) funding, investment, sponsor covenant, insurance arrangements and operational risk.
    (ii) Risk management tools such as the risk matrix should be part of a triennial cycle of financial management including actuarial funding reports and investment reviews.
    (iii) The strategic asset allocation is possibly the most important investment-related decision and should be allocated a corresponding amount of time and attention.
    (iv) Proper risk management will require legal and investment advice in addition to actuarial funding advice.
    (v) Trustees will need guidance in improving their level of risk management and the more supporting material is available from the Pensions Authority, the better the outcomes are likely to be.

We hope the Authority finds our response useful in finalising its guidelines. We have identified a number of tools/documents that could be prepared to assist trustees in carrying out effective financial management and, as mentioned, we would be happy to assist the Authority in developing these.

If you have any questions, please contact Tracy Gilbert, Actuarial Manager, at tracy.gilbert@actuaries.ie or 01 6340036.

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