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IFoA NED Member Interest Group Seminar

"Actuaries as NEDs and the defined benefit pension scheme challenge".

Panel: Steve Webb, Charlotte Clarke, Rosalind O'Connor and Simon Willes

Transcript of talk by Simon Willes on "Why Actuaries NEDs should be concerned about how investment policy set."

Simon says “de-risk” investment policy.

Everyone’s doing it, everyone’s recommending it, taking less risk is good…who are we to question the crowd?

But in pensions we don’t rush into things – “Why is everyone busy doing it?”

That’s easy the employer and Trustee are being advised to do it…it’s a good thing to do. The advice comes with easy to understand “visuals”. We can see that investment de-risking reduces deficit volatility for employers and we can see that it reduces Value a Risk for scheme members.

This is good news and something the employer and Trustee can surely agree on.

But the employer has an actuary NED – we had better ask him or her whether this is just too good to be true….?

NED answers the phone, Hi NED ”what do you think?” NED replies: yes deficit volatility and VaR reduce but you have been told haven’t you? “What?” That the future investment returns the scheme is losing through transferring equities into gilts will need to be replaced by contributions. Your deficit will initially be higher until you have paid in more money.

Oh says the employer that sounds more like just swapping returns for contributions and I’m picking up the tab. Maybe we should go a bit easy on this de-risking – I can see it may have benefits but it also comes at a cost – why is no one showing me a visual of the longer-term cost of de-risking?

After some further deliberation the employer tables a neutral proposition: let’s allow de-risking but only if it is self-funding from excess returns then it can’t cost any more…alternatively lets tag it closely to increasing scheme maturity.

This is perhaps why a growing number of larger schemes now have funding or time based de-risking triggers.

But we are ignoring a very important risk. The employer may not be good for the additional contributions from employers needs to reflect payment risk which in all other areas of finance gets “royal treatment” and sits firmly centre stage…but not yet in pensions.

The payment risk on deficit repair contributions comes in two guises:

The normal credit risk that employers may become insolvent AND

Less than perfect affordability of contributions, with in extremis persistent underfunding and potential scheme wind-up

This really matters because members can only lose benefits where employers default or underfunded schemes wind-up.

(Better lead in? Make more interesting)

Poor employer affordability will slow down funding progress and if de-risking requires more contributions from an employer with constrained affordability there are going to be problems ahead.

If lower returns slow down the speed of funding progress – This exposes schemes to a longer periods of employer default risk. For example for a BB employer (tending to weak Covenant Group 3) the 10 year default rate is 18% but if de-risking stretches out achieving self-sufficiency to 20 years then your expected default experience is now 38%. Doesn't sound a good idea to me.

For the strongest schemes these factors are not prevailing ones so de-risking is still preferable. But otherwise it may well not be the clear-cut case that VaR-centric investment consultants would have us believe. In fact what investment consultants are prescribing as good medicine may be only an expensive placebo which weaker employers can ill afford.

So care must be taken to ensure that reducing investment risk is not just transferring risk on to the employer covenant – we are missing key relationships.

I have managed to get this far without saying "integrated risks" – the de-risking story is but one illustration of why integrating is so important.

The 2004 Pension Act introduced regulation which recognises employer covenant as a key risk to monitor. I do not believe we are yet at a point where integrating the employer covenant as payment risk equally alongside funding and investment risk is accepted by the industry.

The way forward is to integrate covenant into ALM and accept that advice supported by ALM on its own doesn't provide an adequate representation of pension risk. Some firms such as Punter Southall and LGIM have already spotted the opportunity for improving ALM technology – other firms are starting to worry that they should not be without integrated risk modelling if others have it. Worse case some clients may not have been getting the right advice using ALM alone.

Please actuary NEDs focus on integrated risks. Knowledge is power and the power to question. A good place to start is to read the PLSA DB Task Force reports.

The Task Force accepted that DB risk must be looked at in an integrated way across the UK DB sector as a whole. I undertook this modelling which supports the approach and conclusions of these reports.

The 1st report in 2016 identified very significant longer-term levels of risk to member benefits concentrated in tPR's CG3 and CG4 and that this risk, because it reflects less well funded schemes in combination with weaker employers, can be expected to be persistent.

The final Task Force report is out on Thursday and I believe is a very exciting paper. It provides fresh policy solutions to precisely target the DB risk diagnosis revealed by integrated risk modelling in the first Task Force report. The medicine is not going to be everybody's taste but it would, if implemented, improve benefit security for a very large number of "at risk" DB members and prevent DB risk becoming a very serious drain on the UK economy during the "run-off" period for close DB schemes.