Analysing risks

Laura Blows speaks to the IFoA's chair of its pensions board, Gareth Connolly, about the various risks pension schemes need to consider

The IFoA has recently stated that market conditions are a lot more challenging in 2015, compared to 2014. Please could you explain what was meant by that?

The market conditions for 2015 valuations are extremely challenging in comparison to 2014 because of the lower gilt yields. It's worth noting that the 2015 valuations, because of the typical triennial nature of the process, mean market conditions in 2012 are more relevant as a comparator. And certainly relative to 2012, deficits are likely to have remained stubbornly high, and as a result they are likely to place additional demand on sponsors. The concept of integrated risk management is something that The Pensions Regulator encourages and our members are very familiar with, so we look forward to making a significant contribution to this debate and hopefully leading the way in establishing risk management models.

There is a lot of uncertainty in the UK, with the possibility of an upcoming EU referendum and Scottish devolution. How concerned should pension schemes be about these issues?

Whether the UK decides to remain or leave the EU could have a significant impact on not just pensions, but insurance and investment as well. We are aware and we do accept that as part of the EU referendum there will be lots of rumour and rhetoric, and lots of emotion in terms of the pros and cons of the decision. What we would like to do is bring out key issues in a bit more of a dispassionate manner. We are looking at conducting some research into this area so we will be saying more about this in due course in the same way we said quite a bit about the subject of Scottish devolution.

On that subject, further Scottish devolution does raise a number of complex issues that will need to be thought through by policymakers, working in collaboration with industry. One such example is the potential for devolution to lead to different tax rates in Scotland versus the remainder of the UK. That will certainly increase complexity for tax relief on pensions savings. Any further changes will need to avoid the risk of unintended consequences, such as an individual claiming residency in one country and paying pensions contributions in another where this gives rise to advantageous tax treatment. The potential changes will inevitably lead to uncertainty and possibly market volatility but at this stage I suggest that trustees and sponsors might want to keep a watching brief on the issue rather than taking immediate action.

> **"To a certain extent there has been too much focus on the DC input stage rather than the likely outcome"**

The IFoA recently reviewed research exploring the link between environmental sustainability and the financial system. Should pension fund investors place more emphasis on responsible investment?

The research and environment board carried out this work and that's quite a newly founded board that came from a member interest group. They did find that the current research shows the general economic model reveals an increasingly fragile system. And the current system doesn't provide incentives to fully recognise natural and environment resource constraints. There is little analysis of the wider impact of the natural environment on the financial system and the economy. They also found that the solutions offered in the existing research are relatively limited and small scale in their outlook. So there is a vital need for further research, particularly for actuaries and others who are required to take a longer term outlook to ensure the financial system remains sustainable in the longer term.

In relation to trustees as pension fund investors, I would say that they need to balance the long-term viability of the scheme and the needs of the beneficiaries to ensure that they maximise returns.

It should be noted that the time horizons of investors can be different to the time horizon regarding the overall impact of resource constraints. Pension fund liabilities are long term in nature, but a lot of the DC investment funds are available in liquid daily tradable asset classes. So one could argue that DC scheme members are not benefitting, to the same extent as people in DB schemes, in terms of accessing additional returns on illiquid assets.

How should pension fund balance short-term risks, such as market conditions, with longer-term risks such as rising longevity?

What is important is that trustees and sponsors understand the risks they are running and ensure these are consistent with their overall risk appetite and the strength of the sponsor covenant. Within the risk framework that they establish, trustees and sponsors can then decide which risks to keep and which to pass on. Certainly a number of schemes have taken steps to manage their inflation and interest rate risk. We have also seen an increase in schemes managing longevity risk, whether that's by buying annuities or hedging the risk.

The size of the risk is important in deciding what ones to tackle first. Generally speaking, interest rate and inflation risk are considered to be bigger and easier to tackle for schemes of all sizes. This is why schemes are now moving beyond hedging these risks and are now looking at other risks such as longevity. Longevity hedging is becoming more affordable for smaller schemes, but are not yet on a par with larger schemes in terms of ease of implementation, compared to the more widespread availability of interest rate hedging.

There have been growing calls for an independent pensions commission to be established to avoid the risk of a disjointed approach to pension policy. What are your views on this?

We do understand the benefits if you are looking for a consensus approach. However a commission may end up delaying implementation. A commission would need to be careful to ensure that it isn't used as a means by a present government to stall what actually needs to be done. The key issue really is to what extent are any powers delegated by government. The issues affecting UK pensions are well known, such as with DC the need to increase contributions and member engagement. In DB it's about finding the right balance between risk and security so that benefits can be delivered at an affordable cost. There is a natural conflict between parliament's normal five year view of the world and the need of actuaries and others to take a longer-term view. So it would be helpful of the government to recognise this mismatch when formulating policy.

How should pension schemes manage member-bearing risks, such as lack of engagement (for DC) and pension scams?

In relation to DC there are many risks that can prevent a successful outcome for the member, and they include lack of engagement, pension scams and poor decision making generally. Members may suffer financial loss through poor financial decisions. Also, there is a risk that DB members may be targeted to transfer out of a DC fund to benefit from the new freedoms. Individuals need to understand the risk this sort of action involves and the need to take advice. There are many groups looking out for the member, such as The Pensions Regulator and the newly-created IGCs for contract-based schemes, but let's not forget the member; they play a vital role in all of this. Default investment strategies are not intended to suit everyone. And with the new freedoms meaning not everyone will purchase annuities, existing typical default designs will be suitable for even fewer individuals.

Gareth Connolly, FoA

The recently-available pension freedoms are already facing access issues – how should pension schemes respond to such changes and challenges?

There have been access issues for individuals reported in the press. Many pension schemes have been working flat-out to implement the changes that came into effect. It is worth remembering that trustees and sponsors have a choice as to the extent to which their own pension scheme should allow their members to benefit from the new flexibilities directly, rather than having to transfer the DC pot to a separate arrangement. There has been a significant amount of work done in a very short timeframe by both pension schemes and product providers, and there will inevitably be teething troubles.

Are there any risks you feel are not yet sufficiently on pension funds' agendas, and are set to increase in prominence?

I would like to see more time spent on the subject of DC insufficiency and the implications for members, sponsors and the working population as a whole. To a certain extent there has been too much focus on the DC input stage rather than the likely outcome. I think there is a long way to go until we solve the problems that are being stored at the moment. The freedoms are more about the flexibility of the existing pot rather than ensuring the pot is of appropriate size.

Written by Laura Blows