Pension
Protection
Fund

Dear Natasha

"Joint Forum on Actuarial Regulation: A risk perspective"

In November 2014 the Financial Reporting Council (FRC) published a discussion paper "Joint Forum on Actuarial Regulation: A risk perspective". The Pension Protection Fund welcomes the opportunity to provide feedback on the contents of the paper.

The Pension Protection Fund (PPF) was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.

The PPF is a statutory fund run by the Board of the Pension Protection Fund, a statutory corporation established under the provisions of the Pensions Act 2004. The PPF became operational on 6 April 2005.

On 10 July 2009 the Board of the PPF was also given the responsibility of being the scheme manager for the Financial Assistance Scheme (FAS). FAS provides assistance to members of eligible under-funded defined benefit schemes that started to wind up between 1 January 1997 and 5 April 2005, where an employer insolvency event occurred between 1 January 2005 and 22 December 2008.

PPF Response - "Joint Forum on Actuarial Regulation: A risk perspective"

We welcome the broad approach taken to defining the public interest in section 1.5 and would agree with the split and the individuals and entities included. We strongly believe it would be helpful to explicitly include 'Compensation arrangements' among those included in 'The Financial System'. This would include the PPF, Fraud Compensation Fund, Financial Services Compensation Scheme, Equitable Life Payment Scheme and any future such arrangements. While the costs arising from such arrangements will fall across the groups identified (whether through explicit levies or taxation) we believe that these would fall within the public interest definition.

We agree that the twelve high-level risks identified in section 3.1 of the discussion paper are a reasonable set of priority risks for JFAR's consideration. We would suggest some further thought about the relationship between 3.5.4 and 3.6.3, so that activities which may result in changes to scheme funding more broadly are reflected. The split between liability management exercises and economic outlook may miss some of these, such as advice to employers.

We have provided comments on some of these risks below. We use the same numbering as the discussion paper.

3.4.1 Modelling

It seems right that the internal model for any financial organisation should be owned by the board of that organisation. It is likely, however, that not all board members will have an in-depth understanding of the model. There may well be instances where some board members rely on the views of one or two other board members, or employees, who have a much fuller understanding of the model. It is unrealistic, we think, to expect all board members to have an in-depth understanding of the model and its assumptions. Actuaries who are board members or senior employees have an important role to play in driving up board knowledge, but in the end boards have at certain times to make decisions based, in part, on such collective knowledge of their internal model as they have at the time. Knowledge gaps at board level increase the risk of poor decision-making; actuaries may not always be able to prevent this.

At the PPF we have recognised these challenges in the governance around our Long Term Risk Model. The PPF Board is responsible for the model and the assumptions that underpin it. As with most boards, the PPF Board has a broad range of skills with only some members having an actuarial background. We have therefore worked to develop board knowledge and, through development sessions, give all board members comfort and confidence in the collective knowledge of the Board around our internal model.

Models have serious limitations; however models are useful tools to inform and aid decision-making. Even if a model appears reasonable, it is likely that a new model set up independently and run in parallel would give different results due to differences in the methodology and assumptions used. In unrealistically ideal circumstances, several different models would be created and run independently to indicate a range of possible outcomes. In practice the main need is that users recognise that actual outcomes can be very different to the central outcome produced by the model. Thus in relation to the second hot spot (internal capital models) we would comment that model methodology, to the extent that it is different from expert judgement, also generates uncertainty around results. We would also comment that much of the uncertainty of results is intrinsic; i.e. even with the best methodology and expert judgement there will still be considerable residual uncertainty. Boards need to make their decisions being fully aware of this overarching limitation.

The first hot spot refers to the insufficient use of stress-testing and scenario analysis. It is stated that some financial institutions and pension schemes have limited ability to quantify risk and may therefore be under informed in their response to those risks. Our comment here is that actuaries may not be able to help much unless these organisations are willing to develop appropriate actuarial capabilities or pay for good quality external actuarial advice. Our work on our stochastic model, deterministic scenario model runs and reverse stress testing has illustrated the importance of sufficient activity in these areas to guide strategic decision making.

3.4.2 'Group think'

'Group think' in itself may be appropriate where it can be evidenced and justified.

In other contexts, where expert judgement is required due to a lack of data or inherent uncertainty, for example in setting a long-term longevity improvement assumption in the context of the CMI longevity model, 'group think' can also arise.

We recognise that there are areas where 'group think' might be of concern. Individuals might follow what others are doing as there is safety in numbers, particularly when there is a wide range of plausible assumptions.

Linked to this, regulatory bodies could unintentionally encourage herding by criticising those who adopt views they consider to be too far away from their peers and which turn out to be wrong. Why, regulators may well say, did the individual who turned out to have held an extreme but (as it turned out) incorrect view, think he or she knew better than all his / her fellow actuaries? The PPF supports regulation that is robust and questioning where appropriate but recognises that specific circumstances, where evidenced, may justify atypical behaviours.

We also believe 'group think' can arise in situations where there are one or two powerful and forceful individuals in an organisation who strongly articulate their views on a particular matter; their views very easily become the organisation's view.

We agree that a lack of diversity of actuaries could lead to 'group think'. We consider this to be particularly relevant in the context of education and training. As an example, the introduction of financial economics was not seriously adopted until the late 1990s, and even then it was met with some resistance from within the actuarial profession. As much as anything this resistance was because their training ignored financial economics. Thus "group think" is not just a theoretical concept; it has occurred in the past.

3.4.3 Understanding of risk and return

In our view, ideas of risk and return are indeed poorly understood by the general public. The concept of the relationship between these and the interrelationship of assets with different characteristics is even less well understood.

In relation to retirement income changes, we consider other advisers (in most cases not actuaries) will most commonly be involved in providing advice about retirement income options. Their communications may well fail to convey the risks and returns in a way that consumers can easily understand. We recognise this communication is difficult, given general levels of understanding on financial matters.

We agree that investors, trustees and some advisors may have a limited understanding of alternative assets and financial instruments which may have complex designs. With larger amounts of institutional money passing into these investments as investors seek returns in a low-interest environment, these risks are heightened, and this is a current issue.

3.5.2 Financial reporting

We consider the communication of pension fund financial information can sometimes be poor and is not always clearly understood by members of pension schemes. In particular, given our experience at the PPF, pension scheme members do not always appreciate a scheme may be underfunded when needing to buy out following insolvency even though the latest scheme funding valuation shows a funding level above 100%. Actuaries have an important role in informing trustees of the significance of buy-out information, but may not necessarily be involved or equipped to help convey information about funding levels, and their implications, in member communications.

3.5.4 Liability management of defined benefit pension schemes

Transfers out of DB schemes on enhanced terms and other incentivised exercises, are a high-profile area of concern. Actuaries do not always have control over the information conveyed to members, although they will have been involved at the calculations stage. Communication will be from the employer and trustees, on whom the onus must primarily be to facilitate sensible decision-making by members. There is clearly, as has been taking place for some time, a wider regulatory debate about appropriate treatment of members in these circumstances.

Concerns about transfers out of DB schemes have been exacerbated by the Government's Freedom of Choice agenda and the implications on members being able to make informed decisions. There is a real risk of ill-informed decision making or mis-selling if members do not have access to good quality advice that allows them to make the right decisions for their personal circumstances.

With reference to investment assumptions for closed schemes, we consider the risk of assuming investment returns based on historical long-term yields also applies to open schemes, not just closed schemes.

In relation to Special Purpose Vehicles, actuaries definitely have a role in explaining the value of the contingent assets in a range of circumstances to trustees. Trustees may well fail to appreciate the risks inherent in these complicated structures. Our experience in relation to these arrangements with regard to the pension protection levy is that while there are those who have a good understanding of the risks involved, broader knowledge and understanding is more mixed.

3.6.1 Changes in the external environment

In our opinion, there can be a serious risk of actuaries failing to acknowledge the world has changed, and thus not changing assumptions when that is really what is needed. Sometimes assumption change is delayed because the corresponding change in the external environment is perceived as being temporary by nature. However, often it will be preferable to react quickly. A couple of examples would be

- mortality assumptions, which have not moved as quickly as actual improvements over the last 20 years; and
- the assumption that gilt yields would revert to a more "normal" (i.e. higher) level quickly following the crash.

In relation to limits to growth and the consequent changes to long term assumptions to avoid risks, we understand the need to consider the impact of changes; we do, however, think that quantification of this would be extremely difficult in practice.

3.6.3 Economic outlook - impact on pension schemes

The risks to which the PPF is exposed are driven by scheme funding and employer insolvency. The quality of advice, and the actions then taken, are therefore of central importance to the PPF. We believe this strand, given the assets and liabilities in DB pension schemes, is of particular importance.

In respect of the hotspots, while we agree with the issues raised, the focus is on actuarial advice being given to trustees. There are clearly wider risks where actuaries are providing advice to an employer or third party, rather than the trustees. This may be in respect of scheme funding, corporate restructuring or other activities. In our recent changes to the levy we have pressed the matter that in certain circumstances, such as in relation to certifying Asset Backed Contributions, we would expect appropriate advice to be taken. Poor economic conditions alone may therefore be too narrow in considering where actuarial advice may have public interest implications. For example, in the past we have heard anecdotally of actuaries advising employers in relation to contingent assets to pension schemes which have value whilst the employer proving the guarantee remains solvent, but which would have little value if that employer were to become insolvent (thus reducing PPF levy without reducing PPF risk).

A consideration that has not been identified relates to the costs of trustees ensuring they receive appropriate advice. We agree that trustees need ideally to consider the different strands of advice and the impact of stress testing; however there are costs involved in providing this advice and as a result trustees may not be willing to commission the additional information.

We believe that there has been and continues to be a reduction in the role of actuaries as the trusted adviser to pension schemes, mainly due to the associated cost to trustees / sponsors.

3.6.4 Competitive pressures on insurers

We believe that more competitive bulk annuity pricing may lead to fewer schemes entering the PPF, but could also lead to weaker insurers (and potential insurance company failures).

3.6.5 Rapid change in the pensions market

The IORP directive (particularly if it eventually imposes capital requirements or higher funding requirements on pension funds) should increase the financial strength and quality of management of pension funds, but potentially at the risk of more corporate failures due to the increased cost pressures on the sponsoring employer (either from increasing governance/advice costs or from increased funding costs).

The concerns listed under 3.6.5. may be mitigated in part by transfers out from DB schemes (section 3.5.4 - Liability management of defined benefit pension schemes), as this may increase DB funding / reduce DB risk at the expense of members who leave losing their DB guarantee.

Stephen Rice
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