Can regulation drive suboptimal outcomes for stakeholders???

Definition

*sub·op·ti·mal /sʌbˈɒp tə məl/ [suhb-**op**-tuh-muh l]*

- ***adjective*** *being below an optimal level or standard.*

Suboptimal for which stakeholder?

- Regulator?

Or

- Trustees / Members?

Or

- Sponsors?

Different stakeholders with different objectives

Investment Regulations

Institutions for Occupational Retirement Provision ("IORPS") Directive

- "…ensure the security, quality, liquidity and profitability of the portfolio…"
- "…having regard to the nature and duration of the expected liabilities…"
- "…predominantly on regulated markets…"
- "…in a diversified manner…"

The fundamental question….

Are defined benefit pensions

- Conditional promises

Or

- Unconditional guarantees?

Member communications may set expectations that contrast with Trust Deeds??

Take a step back from the problem…the Regulator's view

2007 — *"The Board continues to be concerned that the investment and funding of too many defined benefit schemes is based on aggressive investment return assumptions and does not take enough account of investment risks and downsides."*

2008 — *"Too often it seems that schemes' primary goal is to keep contributions to a minimum and they give little or no thought to risk."*

2009 — *"Defined benefit scheme funding needs to be sustainable for the long term, and trustees must therefore consider realistic costs, investment risks, and the ability and willingness of the employer to support the scheme."*

2010 — *"Hope is not a risk management strategy…"*

2011 — *"…it is unfair to overpromise, and it is dangerous to try to compensate for low contributions by over-aggressive investment strategies"*

Regulator’s response?

- Pension benefits can be considered to be like a stream of cashflows into the future
  - Best matched by a similar series of interest and capital payments from bonds?

- Assessment of risks needs to be conducted by both Trustees and Company
  - Need to have clear answers about how adverse outcomes are to be handled

- No longer ok to simply “hope for the best” in pursuing risky investment strategies
  - has to be a focus on the worst case scenario

Specifically…

- Extended funding proposals
  - Expected to match at least pensioner proportion of liability with bonds

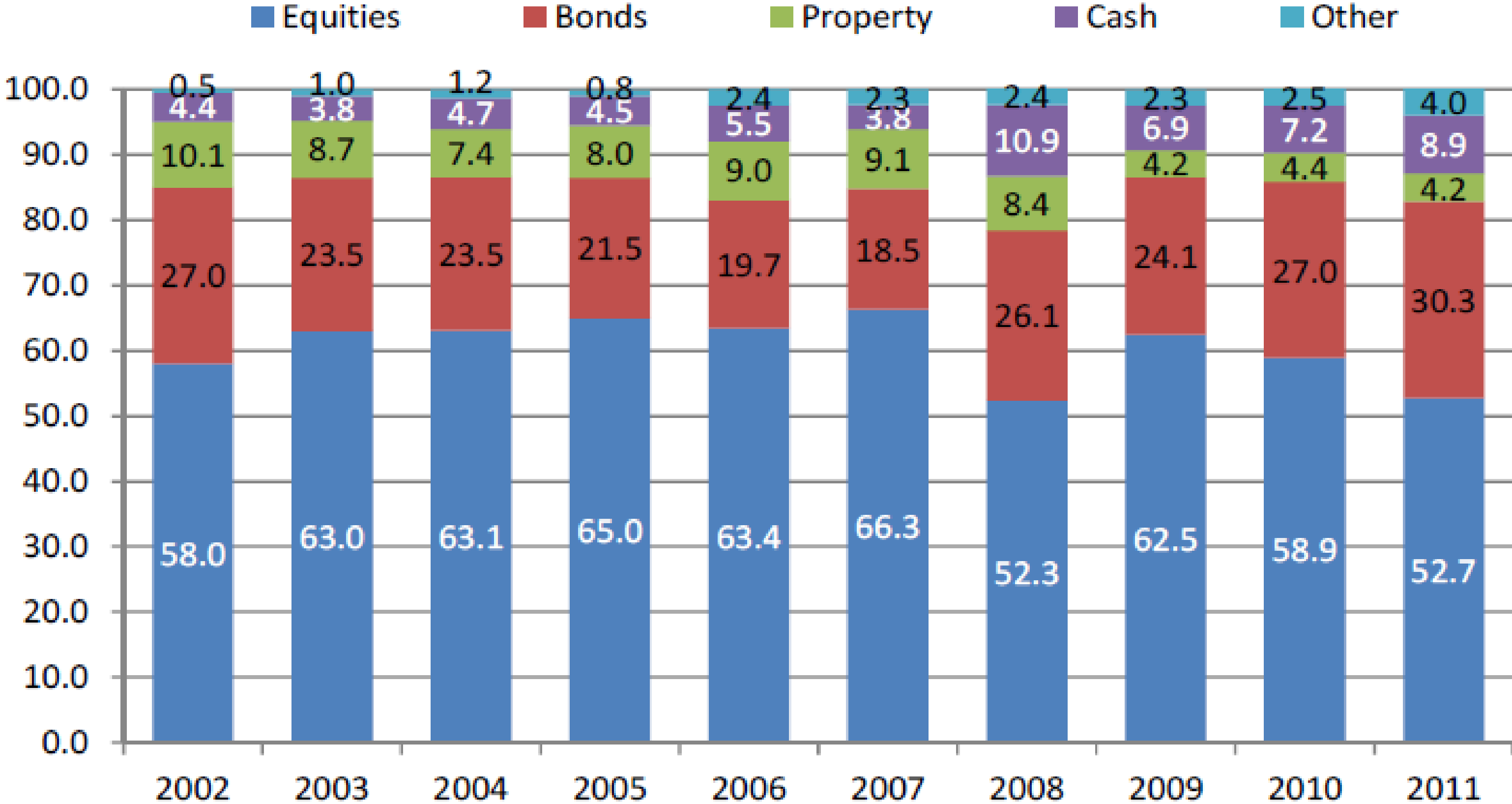
- Risk reserves
  - from 2016 need a plan to reserve for risk of mismatched strategies

- Section 50
  - A broken promise so must be more sustainable into the future
  - cap on expected return discourages risk taking

So far…so sensible…but is it enough??

Reaction to date

Figure 17. Asset allocation of Irish occupational pension schemes, 2002-2011

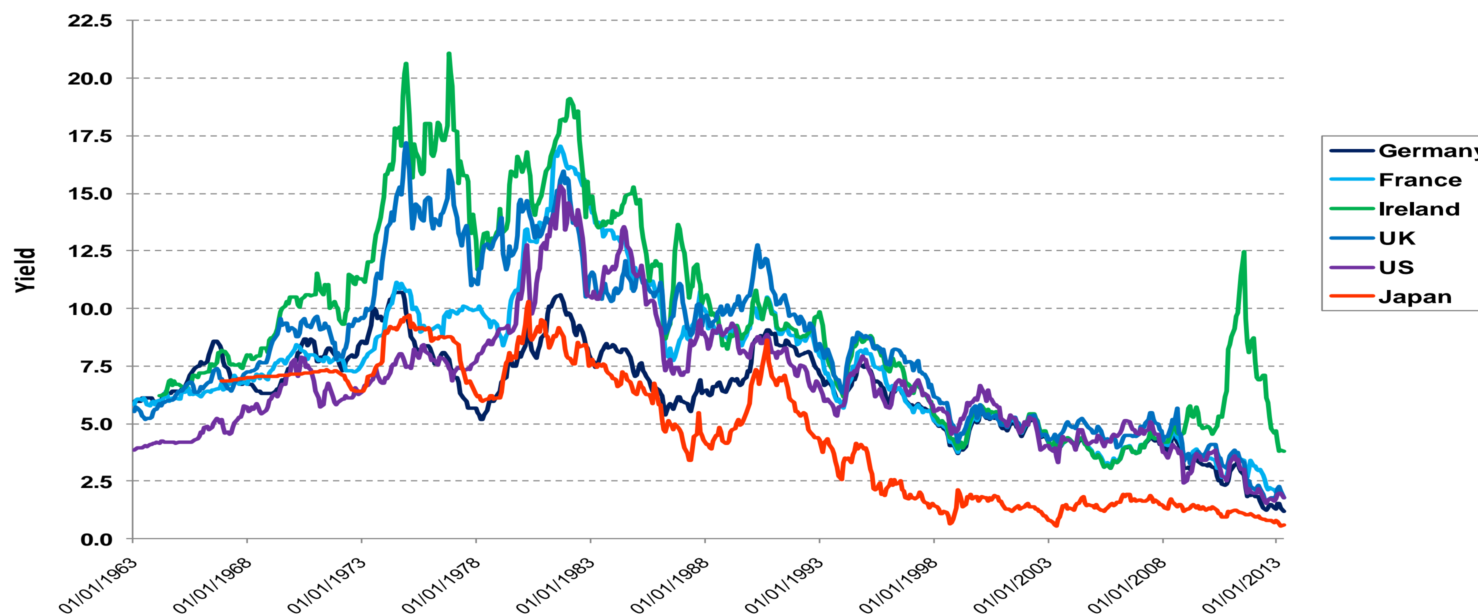


Source: OECD Review of the Irish Pensions System, April 2013

"…within the OECD, Irish plans displayed the greatest exposure to equities in 2011…"

What's the problem?

- Actuarial valuations typically calibrated assuming assets will return c6% pa pre retirement
  – Lower returns typically assumed post retirement
- Certainty requires greater matching / bond investment
  – But bond yields at all time lows…



Are these level of "defined" benefits affordable?

EIOPA's view of the world…pensions through a Solvency II lens

€ bns	Belgium	Germany	Ireland	Netherlands	Norway	Sweden	UK
Total assets	15	155	42	878	14	13	1863
Total liabilities	17	162	100	972	13	10	2155
Funding Level	88%	96%	42%	90%	106%	127%	86%
Excess of assets over liabilities	-2	-7	-58	-94	1	3	-292
Solvency Capital Requirement	1	5	35	107	1	1	234
SCR as % liab	8%	3%	35%	11%	9%	14%	11%
Surplus	-3	-12	-93	-201	0	1	-527
Overall funding level	82%	93%	31%	81%	97%	112%	78%
Surplus/deficit as % GDP	< 1%	< 1%	56%	31%	< 1%	< 1%	28%

Source: QIS on IORPs Preliminary Results for the European Commission, April 2013

Irish pension schemes significantly worse funded and riskier than EU counterparts

How low can yields go…or can they rise from here?

- Financial repression…governments channelling money to themselves
  - Subtle form of debt restructuring
  - Governments can issue debt at lower rates than would otherwise be possible
- Key features

Zero interest rate policy (ZIRP)	✓
State ownership of Financial Institutions	✓
High reserve requirements	✓
Captive domestic market for government debt	✓
Capital controls	?

- Other periods of Financial Repression lasted for many years!
  - Real interest rates in advanced economies were negative roughly half the time from 1945 - 1980
  - Low bond yields may be here to stay for another while?

Yield reversion may be the solution…but is not guaranteed!

How have Regulators in other DB geographies reacted?

	UK	US	Canada	Netherlands
Regulatory attitude to derisking	Regulator challenges risky recovery plans	Risk premium charged on unfunded portion Encourages funding and derisking	Sponsors to explain the mismatch between assets and liabilities	Encouraged through solvency test Reserve for mismatch risks
Approach to liability valuations	Scheme specific funding based on sponsor covenant Market related and gilt based	Corporate bond rates with some smoothing (effect is wearing away)	Pensioners at annuity buy out Others at mix of lump sum or annuity	Market (swap) curve discounting predominantly
Typical time horizons	Recovery plans typically 10 years TPR announced longer horizons may be accepted	Immediate to 80% funding level No max period but guide plans to be fully funded in 7 years	In theory 5 years Recently extensions to 10 and beyond allowed	3 years to get to 100% 15 years to build up reserves

What's the alternative?

- A world without regulation?
  - Only recently we have a greater link of funding and investment strategies
  - Unlikely to go back to the way it was!

- Imagine if this was in place say 15/20 years ago
  - Schemes more derisked?
  - More sustainable?
  - Probably better funded?

- Strong Regulation is needed
  - Most stakeholders want greater certainty and security
  - But maybe greater flexibility to meet those regulations is needed
    - Time horizons
    - Sharing of risks between members

Regulators role from here

- Do we need even tougher funding and investment rules?
- Do we need stronger enforcement of those rules?
- Powers to rival insurance regulator?

May lead to more wind ups but surviving schemes would probably be more sustainable?

Conclusions and observations

- Many pressures to derisk
  – Not least of which is desire for greater certainty in funding, benefits etc
  – More derisked does not have to mean fully derisked!

- Are benefits promises or guarantees?
  – What about members reasonable expectations?!

- Need for more flexibility?
  – One size does not fit all
  – Greater risk sharing between categories of members
  – Need more time to target greater sustainability

- Maybe we need a regulator with even stronger powers?