An tÚdarás Pinsean
The Pensions Authority

Submission form

Consultation on Code of Practice for trustees of occupational pension schemes and trust RACs

Please save a copy of this form, then add your comments under each chapter. There is also space at the end of the form for general feedback.

Please keep your responses as succinct as possible and address any comments you have in relation to the text as set out in each of the separate chapters.

Please email your submission by 5pm Thursday 16 September 2021 to: codeconsultation@pensionsauthority.ie

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Initial comments

Thank you for the opportunity to submit a response into the consultation process for the EU Directive (IORP II) that was recently transposed into Irish law by the Minister for Social Protection. We are keen to contribute to the evolution of the Irish defined benefit pension scheme industry in view of the discussions that we have had with The Pensions Authority and market participants over a number of years on better risk management for Irish occupational pension schemes. Below, we set out the main points that we deem important for The Pensions Authority to consider in providing comment or guidance for trustees via amendments or additions to the Code of Practice. We would welcome the opportunity to further discuss any of the points set out below or any items that you may wish to discuss in more detail.

Executive summary

We welcome the transposition of IORP II into legislation and deem it an important step in the evolution of the management of Irish occupational pension schemes as they become increasingly mature.

The draft Code of Practice currently stresses the need to set and implement a framework for the management of risks. We view this positively but would emphasise that risk needs to be measured and managed relative to an objective. It is our opinion that the risk management policy should explicitly provide a framework for “identifying, measuring, monitoring, managing, mitigating and regularly reporting” on all asset and liability risks relative to a pre-defined, prudent, long-term funding outcome.

For less funded schemes, this funding outcome could be full funding on MFS, but better funded schemes, should be encouraged to set a further, long-term objective. For example, a secondary long-term objective could full funding on a “swaps + 50bp valuation basis in 10 years’ time”, with The Pensions Authority providing guidance on the appropriateness of funding and timescales

We believe that the liability risks associated with a DB pension scheme becoming more mature are a fundamental risk that need to be addressed in the IORP II consultation and its associated risk management guidance. The Draft Code of Practice currently makes no explicit references to the assessment and management of liability risks and we believe that, as this is a fundamental risk, it should be stated as a requirement with associated guidance and information for trustees and their advisers. Currently, the majority of Irish pension schemes are not focused on managing liability risks and this results in significant volatility in funding levels due to the duration of the liabilities and their sensitivity to changes in interest rates and inflation expectations. It also leaves Irish pension scheme members exposed to worsening deficit positions and loss of benefits in the future if a scheme’s funding position deteriorates because of liability or asset risks. To prevent this outcome, trustees need to define their liability risks to allow a significantly greater chance for the assets of a scheme to grow to eliminate any deficit.

The IORP II Directive stresses the importance that our elderly and disabled are not “placed at risk of poverty and can enjoy a decent standard of living”. The Directive is intended to both “guarantee a high degree of security for all future pensioners through the imposition of stringent supervisory standards, and to clear the way for the sound, prudent and efficient management of occupational pension schemes”. With this encouragement, trustees, pension scheme members and the Pensions Authority should be demanding the highest standards of risk management to ensure members have the greatest certainty of receiving the pensions they expect. We are highly concerned that the implementation of IORP II (as currently set out in the Code of Practice) could result in more pension schemes with low funding levels or low governance budgets choosing to wind up in future. From discussions with industry participants, we are also aware that some consultants are strategically recommending a wind-up approach to some of their clients that will result in more schemes transferring into the consultants’ own master trust structures. This represents a significant conflict of interest to advisers that are a provider of master trusts to the same pension schemes.

Finally, our firm stance is that The Pensions Authority needs to broaden the guidance associated with IORP II to include an evolution of the Minimum Funding Standard to ensure that liability risks are identified, quantified and managed accordingly. We believe that the current design of the Minimum Funding Standard and its associated Risk Reserve contain some fundamental flaws in its construct that inadvertently increases the risk to members that they will not receive the retirement benefits they expect. The relationship of The Funding Standard and long-term liabilities is an extremely important consideration as more schemes may choose to wind-up due to the implementation of IORP II. Also, this is equally important under the categorisation of IORP II as there are theoretically some cases of inequity between schemes of similar funding levels due to differences in maturity and this is a major issue because of how the Funding Standard currently values liabilities.

Insight Investment is a stakeholder to Irish pension schemes

Insight has been operating in Ireland since 2007 with assets under management (AUM) growing year on year. We currently manage c.€18bn for over 50 Irish institutional clients[1]. Insight has AUM of over €142bn domiciled in Ireland within pooled fund structures as well as segregated assets of c.€6bn. We manage over €13bn of AUM to hedge liabilities for Irish pension schemes including 7 out of the top 11 largest defined benefit pension schemes.

Since 2007, we have been at the forefront of developing and implementing risk management frameworks for Irish DB pension schemes to manage risk in a manner that is consistent with the aims of IORP II in order to achieve full funding within a specified timeframe. The fundamentals of this framework bring a requirement for trustees to measure and manage risks by taking a long-term view of investment, covenant and liabilities. We are open to sharing the framework with The Pensions Authority in order that the philosophy can be utilised more broadly by trustees and their advisers.

The Code of Practice currently does not address the largest risk for Irish DB pension schemes

We welcome the transposition of IORP II into legislation and deem it an important step in the evolution of the management of Irish occupational pension schemes as they become increasingly mature. Over the last 10 years, the majority of Irish pension schemes have not focused on managing liability risks and this has resulted in rising liability values and significant volatility in funding levels. It also leaves Irish pension scheme members exposed to worsening deficit positions and loss of benefits in the future if a scheme's funding position deteriorates because of liability or asset risks.

To prevent this, liability risks need to be "locked down" as far as a scheme's funding level permits to allow a significantly greater chance for the assets of a scheme to grow to eliminate any deficit. Trustees need to explicitly assess the magnitude of their liability risks and then make an informed decision as to how much of this risk they can afford to run.

- With many schemes addressing their shortfalls in funding in recent years by closing to new members and ceasing to accrue, the time horizon associated with the profile of a scheme's liabilities is now becoming shorter with schemes whose duration of liabilities is less than 20 years deemed to be "decumulating" rather than "accumulating". The liability risk mentioned above is even more relevant for decumulating schemes as the time horizon to eliminate any deficit is reducing, putting increasing pressure on the timeframe required for delivery of asset returns. The shortening duration of a scheme's liabilities brings increasing risk:
  - Liability risks are larger than asset risks for a maturing underfunded pension scheme that has a low level of hedging, i.e. the funding level of a scheme is exposed to adverse changes in the level and volatility of interest rates and inflation expectations;
  - Maturing schemes also have less time to shrink their deficit to achieve full funding; and
  - increasing pensions payments mean that the path dependency of returns on assets leaves a pension scheme exposed to forced selling risk.
- We believe that these liability risks associated with a DB pension scheme becoming more mature are fundamental principles that need to be addressed in the IORP II consultation and its associated risk management guidance. with IORP II and any associated guidance. The Draft Code of Practice currently makes no explicit reference to the assessment and management of liability risks and we believe that, as this is a fundamental risk, it should be stated as a requirement with associated guidance.

Chapter 1 – Governance

For this section, we have contributed our comments to the Irish Association of Pension Funds and Society of Actuaries in Ireland for their respective submissions.

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Chapter 2 – Administration

For this section, we have contributed our comments to the Irish Association of Pension Funds and Society of Actuaries in Ireland for their respective submissions.

Chapter 3 – Internal control system

For this section, we have contributed our comments to the Irish Association of Pension Funds and Society of Actuaries in Ireland for their respective submissions.

Chapter 4 – Investment for schemes

The IORP II Directive states that in order to "protect adequately the rights of members and beneficiaries, IORPs should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities". A trustee's appetite for risk should therefore be based on the principle of taking risk only where necessary to achieve an objective.

Schemes should be encouraged to mitigate and manage all asset and liability risks that reduce the certainty of achieving the prescribed outcome unnecessarily. This should have the implication of actively encouraging trustees to hedge unrewarded risks (eg interest rate, inflation and FX risk) and to reduce risk by selling non-contractually returning assets (eg equities) in favour of contractual assets (eg corporate and government bonds) as funding positions improve.

The Directive also explicitly recognises that "a significant level of investment risk is borne by beneficiaries in the pay-out phase". We agree with this statement and would therefore encourage reduced focus on present value funding status and greater focus on forward cashflow outcomes when assessing progress relative to a long-term funding objective. This would have the desired effect of shifting the focus from a % return requirement towards a monetary cashflow outcome requirement, within a defined timeframe. This would be a critical shift to help schemes mitigate the emerging risks in the decumulation phase.

For example, trustees should be encouraged to quantify the value of cashflows to be paid out between now and the target date of full-funding (e.g. in 10 years time), and the value of residual assets required to be fully funded on the long-term funding basis, by the target date. To illustrate the importance of this focus, the charts below show two investment strategies with the same % return pa, but very different monetary outcomes when assets are required to be sold to meet pension payments.

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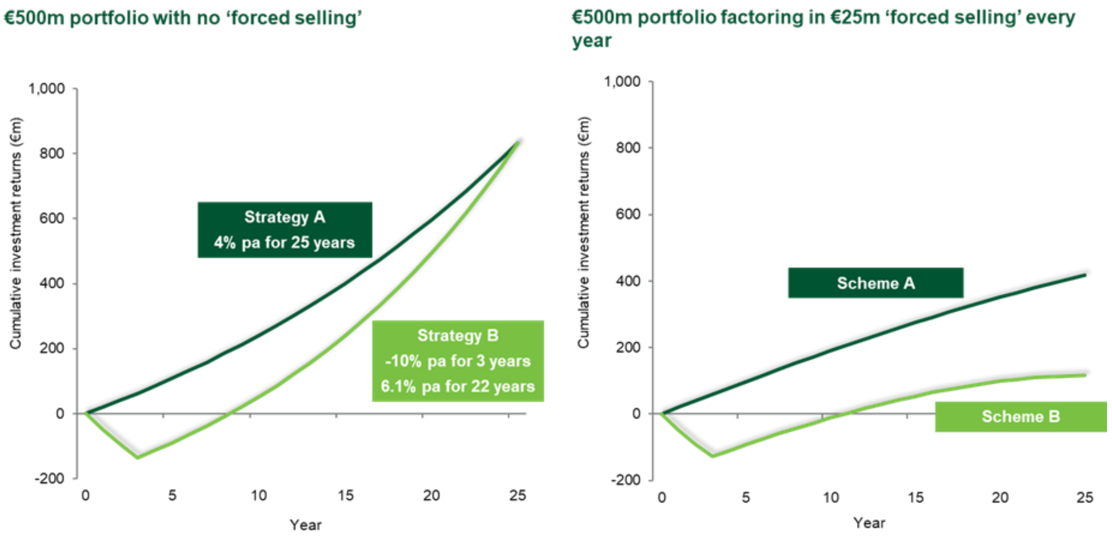
It is important for trustees to be aware of, and manage this risk:



For schemes that are 'decumulating' by paying greater amounts in pensions outflows than are being received from investment returns and sponsor contributions, Insight has developed a framework that is designed to help our clients implement an approach to maximise the certainty of achieving a target outcome: that of full funding within a specified timeframe.

This framework allows for the constraints imposed by the need to shrink deficits while meeting pension outflows. The fundamentals of this framework are consistent with the aims of IORP II and bring a requirement for trustees to measure and manage risks by taking a long-term view of investment, covenant and liabilities.

We have categorised the framework as an overarching risk management system for DB schemes below by setting out the main considerations associated with each of the components depending on which of the three categories under IORP II that a scheme is currently required to be categorised within.

Our proposed framework takes account of both asset and liability risks in a forward-looking manner including both a scheme's maturity and cashflow management. The respective considerations listed under each category can be determined by the Risk Management Function and Key Risk Holder with inputs from the scheme actuary and investment consultant. For clarity, the Minimum Funding Standard would apply to all Categories of schemes. In the next section, 'Chapter 5 Defined Benefit Funding' we set out revisions to the MFS and Risk Reserve that we think are necessary to evolve it to a standard that is fit for purpose.

<u>'CATEGORY 1' SCHEMES</u>

- For schemes that are assessed as Category 1, ("schemes that look likely to be able to meet their obligations") it is critical that all risks are mitigated as far as possible to protect funding levels.
- We believe that trustees should be required to set a long-term, prudent funding objective within a target timeframe. This could take the form of either self-sufficiency on a low-risk basis or a realistic estimate of the costs of buying-out the scheme. This addresses requirements to consider "insurance and other risk mitigation techniques" stated in the draft Code of Practice.
- The investment opportunity set should focus on contractual returning assets given the healthy funding position.
- This could be required of all schemes that have a duration of less than 15 years.

‘CATEGORY 2’ SCHEMES

- For schemes that are assessed as Category 2 (“schemes with risk to member benefits unless scheme practices changed”), a risk management plan should be adopted that quantifies each asset and liability risk eg it includes € amount of interest rate, inflation risk as well as the € asset risks.
- A potential objective could be to move from Category 2 to Category 1 within a specified timeframe. Funding level risk could be reduced by increasing liability hedging over time with a growth allocation helping to achieve required returns. Utilising leverage within the “matching portfolio” will be an important component of this solution to enable deficit reduction via a higher allocation to a “growth portfolio”.

‘CATEGORY 3’ SCHEMES

- For schemes assessed as Category 3: (“schemes which look most unlikely to be able to meet obligations”) the Minimum Funding Standard (“MFS”) basis is likely most relevant, i.e. funding level of the scheme is assessed on a wind-up basis. An appropriate funding proposal should then be implemented by the trustees in consultation with The Pensions Authority to get “on track” to reach Category 2 within a specified timeframe. The timeframe should not be limited to 10 years as our assessment of Irish pension schemes is the average duration is more applicable for funding proposals eg 20 years.
- **We are highly concerned that the implementation of IORP II could result in more pension schemes that have low funding levels or low governance budgets choosing to wind up in future which would appear contrary to the goals of the overarching IORP II directives. From discussions with industry participants, we are also aware that some consultants are intending to recommend a wind-up approach to a number of their clients as it is a valuable commercial opportunity that will result in more pension schemes transferring member benefits into the consultants’ own master trust structures.**
- **This represents a significant conflict of interest to advisers to trustees that are a provider of master trusts to the same pension schemes. We believe that this conflict should be addressed explicitly within the Code of Practice.**
- **We would stress that we deem it of utmost importance for The Pensions Authority to address this particular Category of pension scheme in a manner that does not result in many schemes “availing of an opportunity to wind-up”.**
- **Essentially, choosing not to wind-up a pension scheme is a free option for active and deferred members to retain their benefits as a scheme wind-up will result in a significant reduction on their accrued benefits. We believe that, in order to allow a scheme wind-up to be undertaken, specific analysis should be required to be presented to The Pensions Authority showing that a funding proposal over, for example, a thirty-year timeframe (with appropriate sponsor contributions over this entire period) would still result in a deficit position that was unsustainable at the end of the thirty-year time period.**
- Given the critical importance of The Minimum Funding Standard, we believe the current deficiencies should be urgently addressed. We set out our rationale for evolving the MFS and Risk Reserve in Chapter 5. We are engaged with the IAPF and the Society of Actuaries in Ireland to discuss our assertions on the construct of the MFS and we are also keen re-engage with you to address deficiencies of the MFS and Risk Reserve and ensure that Irish pension schemes are managed to in a manner that is appropriate by comparative global standards.

THE ROLE OF LIABILITY DRIVEN INVESTING (LDI) IN RISK MANAGEMENT

Whilst we agree with the need for a funding basis to define a minimum required level of solvency for a pension scheme; we believe that the current design of the Minimum Funding Standard and its associated Risk Reserve contain some fundamental flaws in its construct. A pension scheme's obligation to its members is to meet liabilities / pay pensions as they fall due. The onus is on trustees to implement and manage an effective investment strategy that achieves this aim in the lowest risk manner that is appropriate to the profile / characteristics of the scheme's membership.

Present value valuations of liabilities under the Funding Standard provide a lower valuation than an economic valuation for immature schemes with discretionary benefits (such as pension increases). This results in schemes targeting an asset valuation to meet this liability valuation that will not meet the "true future cost of liabilities". Schemes are therefore unlikely to be fully funded within the timeframe that they are aiming for and this is potentially an extremely important consideration whereby more schemes will choose to wind-up due to the implementation of IORP II. Further, there is a (rapidly rising) scale whereby at the other end of the scheme maturity spectrum, there is no doubt that the Funding Standard overvalues liabilities for very mature schemes with guaranteed benefits. This issue is that many trustees therefore see the Funding Standard as a target to hit for their de-risking plan and associated hedging rather than a minimum level. Also, this is equally important under the categorisation of IORP II as there are theoretically some cases of inequity between schemes of similar funding levels due to differences in maturity and this is a major issue because of how the Funding Standard currently values liabilities.

Our firm stance is that The Pensions Authority needs to broaden the guidance associated with IORP II to include an evolution of the Minimum Funding Standard to ensure that liability risks are identified, quantified and managed accordingly;

Many pension schemes cannot currently "afford" to hedge a high level of liability risks using physical bonds as this would require the sponsor to broadly "make whole" the deficit at its present value. Thus, partially funded hedging solutions are required and used as a matter of standard industry practice in Europe and the UK. This approach involves the use of derivatives to gain exposure to interest rates and inflation in order to reduce the volatility of a scheme's funding level. Pension schemes need to "lock down the problem" by solving for the required deficit reduction and reducing risk when it is "affordable" to do so. This involves both a need for a dynamic asset strategy over time as well as reducing and minimising liability risks so that scheme funding levels are not exposed to changes in the value of interest and inflation rates. Ultimately the "end-game" for Irish pension schemes is achieving self-sufficiency by holding a low risk portfolio of assets that can run off over time.

Partially funded hedging solutions allow a scheme to retain a higher allocation to 'growth assets', e.g. equities, in order to reduce a scheme's deficit over time in conjunction with sponsor contributions – the role 'Liability Driven Investment' plays for DB schemes is set out in this research paper from the Institute & Faculty of Actuaries:

https://www.soa.org/globalassets/assets/files/resources/research-report/2021/liability-driven-investment.pdf

Currently, trustees frequently comment that they perceive the hedging of liabilities as a tactical call on interest rate levels and not a risk management exercise. This is a problem as it leads to the under-hedging of liability risks. The starting point should be a 100% hedging of liability risks and then trustees can strategically decide in conjunction with their investment advisers as to how much risk they can take by hedging less than 100% of the interest rate and inflation components of their liabilities (relative to their current funding position).

Chapter 5 – Defined benefit scheme funding

The Code of Practice has stressed the need to set and implement a framework for the management of risks. It also stresses the need to set an objective. We view this positively but would emphasise that risk needs to be measured and managed relative to a desired outcome. It is our opinion that the risk management policy should explicitly provide a framework for "identifying, measuring, monitoring, managing, mitigating and regularly reporting" on all asset and liability risks relative to a pre-defined, prudent, long-term funding objective. In our view, there should be greater focus on setting long-term funding objectives within this Code of Practice. For example, a scheme should aim to be fully funded on a "swaps + 50bp discount curve in 10 years' time".

This would support the Directive's statement that "*a prudent calculation of technical provisions is an essential condition to ensure that obligations to pay retirement benefits can be met both in the short and the long term…those prudent rates of interest shall be determined by taking into account:*

(i) the yield on the corresponding assets held by the IORP and the projected future investment returns;

(ii) the market yields of high-quality bonds, government bonds, ESM bonds, EIB bonds, or EFSF bonds or;

(iii) a combination of points (i) and (ii)"

An appropriate framework that could be adopted and refined by The Pensions Authority that defines a forward looking self-sufficiency basis is the UK DB Funding Code:

https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2021-press-releases/db-funding-code-tpr-publishes-interim-response-to-consultation

We would be happy to contribute to and advise on the design of such a framework by The Pensions Authority at any stage in the future.

EVOLVING THE FUNDING STANDARD AND RISK RESERVE UNDER IORP II

A significant issue with the evolution and changing of the parameters associated with the Funding Standard and Risk Reserve is its current position within primary legislation. We firmly believe that there needs to be an overarching flexibility associated with the allowable assets and methodology under the Funding Standard so that it can be updated to include investment and actuarial best practices over time.

We have spoken with stakeholders throughout the industry about our assertions that it would be beneficial to remove the Funding Standard from primary legislation to give sufficient scope for industry stakeholders to confer with The Pensions Authority on the design and metrics associated with the Funding Standard to remove risk and achieve optimal outcomes for Irish pension schemes.

ALLOWABLE ASSETS UNDER THE RISK RESERVE

- Further to the above points within the section of Chapter 4 titled THE ROLE OF LIABILITY DRIVEN INVESTING IN RISK MANAGEMENT', the allowable assets under the Risk Reserve severely restricts the diversification and yield available to institutional investors and therefore by definition actually increases risk for schemes.
- We propose that the definition of assets allowable in the Risk Reserve should be those that would be held in a low risk portfolio of assets that would be universally accepted as 'global best practice' for pension schemes:
- Currently only euro denominated sovereign and corporate bonds are deemed eligible under the calculation of the Risk Reserve. Non-euro denominated bonds should be allowed where the currency and interest rate differential risk is hedged out. The largest supply of high-quality Investment Grade corporate bonds are US

dollar bonds, they are typically longer duration and there is significantly more diversification of issuers and issuance;

- High quality (AAA-rated) Asset Backed Securities are included in low risk portfolios of global pension schemes. Increasingly, European pension schemes are diversifying the assets held in their liability hedging collateral pool so that it is not a drag on returns. This typically consists of holding short dated Investment Grade credit and high quality (AAA-rated) Asset Backed Securities that are deemed equivalent to euro government bonds by banking counterparties. High quality ABS allows for a higher yield to an equivalent rated IG credit portfolio and provides security over the underlying cashflows and pools of assets.

Chapter 6 – Fit and proper requirements

For this section, we have contributed our comments to the Irish Association of Pension Funds and Society of Actuaries in Ireland for their respective submissions.

Additional comments

- Below are other points that we have commented on from a review of the Consultation document.
- Page 6 - 1.2.1 Trustee meetings - References “Trustees must hold a sufficient number of meetings to maintain effective oversight and control”, there should be a minimum requirement for the frequency of meetings, we would suggest that this should be at least quarterly,
- 4.3 “Investment strategy must include the maximum acceptable level of investment risk” – as this will be based on historic measures of volatility but brings obvious flaws depending on the timeframes considered and is inconsistent with a forward looking / stress test approach.
- 4.4 Mentions delegating the implementation of the investment objective to a fiduciary manager, the rest of this section is not clear which duties relate to a fiduciary manager and to an investment manager. This needs to be made clear that it applies to all investment managers including fiduciary managers.
- Page 25 - 4.5 Investment contracts- the language used means that these could just apply to segregated mandates and would not apply where a scheme is investing in a pooled fund. This should be made clear that it applies to both throughout. Where a scheme is investing directly in a multi-client pooled fund, some of the requirements outlined will not apply. These appear to refer to segregated mandates, for a direct investment into a multi-client pooled fund the scheme will open an account and then invest the intended amount. There is no separate contract signed between the manager and the scheme, only what is contained in the application form. Fiduciary managers are not referenced in this section but should be.
- Page 26 - 4.6 Overseeing investment performance - This section applies to investment managers only, it will need to be made clear that this should apply to a fiduciary manager also.
- 4.6 Performance benchmarks – this is addressing asset risk but the Consultation ignores liability risks which are of an order of magnitude greater than asset risk. Investment performance is best assessed

periodically rather than reacting to short-term events. The requirement for trustees to conduct a critical review of the investment manager's performance will lead to increased costs and where mandates are passive is wholly unnecessary.

- Page 27 - 4.6 Overseeing investment performance- It is not clear what the difference is between a review and a critical review. Trustees should meet with the investment or fiduciary managers to ensure that they have an understanding of any changes to the investment approach or changes at the manager that might impact their ability to deliver the performance and level of risk originally agreed. As currently set out, there does not appear to be a requirement for the trustees to meet with the investment or fiduciary manager. The trustees should have an understanding of the approach and background to performance directly from the investment or fiduciary manager.
- Page 28 - 5.2 Solvency - we have previously set out in detail how the Funding Standard valuation of a DB pension scheme's liabilities significantly undervalues them – see section 4 above. Whilst there is reference to the trustees' own funding objectives, there is no detail on this and this section does not appear to require trustees to consider any other valuation methodology and thus the target funding level is likely to be insufficient to meet the long term objective of that scheme. The section states that trustees "must examine projected cashflows as well as discounted totals" but we would suggest that their requirement needs to go further; to evaluate the volatility inherent within the liabilities and have a written policy as to the level of volatility/risk they are prepared to accept and how this volatility will be mitigated. We would hope that the Pensions Authority risk measure, still to be seen, includes a requirement for asset and liability risks to be quantified and a decision made as to the level of acceptable risk and how this is implemented.
- 5.4 The Pensions Authority should consult with industry experts to agree an appropriate risk and we would ask that sufficient time should be given to consult on this.
- 5.5. Actuarial triennial valuation and funding proposals should be referenced here. It is not clear that further valuations will add value, whereas they will certainly add cost. Many schemes cannot have regular discussions with the sponsoring employer to assess the ability of the employer to support the scheme with contributions if needed. This is a commercially sensitive topic which sponsoring employers do not want to disclose information on if not required and can have an unintended impact of sponsors walking away from supports if continually pushed for assurances on contributions in the short term
- Appendix 1, 3. Investment Risk - as a control for investment risk, we would have expected to see the identification and quantification of asset and liability risks and an assessment of the acceptable level of risk for the scheme to be able to meet its objective of meeting members cashflows as they fall due. Quantifying liability risk will need to specify the parameters associated with an appropriate funding basis that is forward looking in nature.