Institute and Faculty of Actuaries Sessional Research Meeting
Financial Management of the UK Pension Protection Fund

Opener's Comments, Malcolm Kemp, 27 February 2012

Good evening ladies and gentlemen. It is my pleasure to open the discussion on this evening's paper on the Financial Management of the UK Pension Protection Fund. As someone who actively encouraged the authors to commence this project I am very pleased to see it come to fruition. I consider its outcome, the paper you have in front of you, to be an impressive piece of work. My sincere hope is that the authors themselves will be proud of their efforts, will be amply rewarded by a fruitful discussion of the paper here and elsewhere and that this paper will encourage others, including actuaries, to apply ERM in the wider pension arena and not just to the special case corresponding to the PPF. The UK Actuarial Profession has kicked off a strategic initiative recently to promote the expertise of actuaries in the risk management space and in this context to build on its traditional areas of strength such as pensions. It is great to have a paper like this that demonstrates in a tangible and coherent way the value that actuaries can bring to the party in this area.

Of course the aim of the opener on an occasion like this is not to wax lyrical on the strengths of the paper under discussion. Instead, it is to set a framework for the debate that will hopefully follow. To do so, I would like to pose four questions, some perhaps addressable by the authors but most aiming for a response from the floor.

The first question I would like to pose is to the extent to which the application of ERM disciplines to the PPF as set out in this paper form a helpful role model for the pension community more generally. The authors were kind enough in Section 1.1 to quote from a paper Chinu Patel and I presented to this chamber about a year ago that explored some of the challenges faced when applying ERM to pension schemes. One challenge, it seemed to us, was the relative lack of resources that particularly smaller pension schemes could apply to such disciplines.

It is clear from this paper that the PPF is unusual in the extent of resources it has available to apply to effective risk management. For example, Section 5.1.7 explains how the PPF's Audit and Investment Committees are supported by two executive committees, a Risk Management Committee and an Asset and Liability Committee, and also by the presence within the management team of a Chief Risk Officer. The table in Section 5.2.1 indicates the presence not only of an in-house investment team but also of an in-house risk team. So maybe some of the disciplines the PPF have been able to introduce are not practically implementable by many schemes, particularly smaller ones. But which then are the most important ones for those schemes to focus on?

My second question is whether the floor thinks that the mix of ERM resources applied to different sorts of risk by the PPF is optimal. Even though the PPF appears to have well-resourced risk activities, the resources it can apply to this task are not limitless. Are there any gaps you can see in what they are doing or any areas where you think that the effort being applied is disproportionate to the practical impact of the risk in question. Two possible areas that I noted in this context related to the coverage of operational risk, which the PPF intends to focus on to a greater extent as it becomes larger, and to reverse stress testing, which I shall come back to in a moment.

My third question is to ask to what extent the floor thinks that the PPF's risk and governance disciplines will actually prove to be robust in the longer term. The main reason for posing this question is that EIOPA has recently triggered considerable debate on how EU pension schemes might in the future be regulated. One of their proposals relates to the possibility of getting pension schemes to construct so-called holistic balance sheets. These types of balance sheets aim to take into account the security provided to members from security mechanisms such as sponsor covenants, conditional benefit structures and, particularly relevant to us tonight, pension protection arrangements.

I'm aware that EIOPA's proposals have generated heated debate particularly here in the UK. Personally I am with the EU Commission in thinking that some of the reactions to these proposals have been overdone. The holistic balance sheet proposal, it seems to me, provides a mechanism allowing pension schemes to have a smaller amount of tangible assets on their balance sheet than might otherwise be expected of them, as long as they can demonstrate that off accounting balance sheet elements, such as their access to legally enforceable sponsor covenants or pension protection arrangements, bring the level of benefit security they are providing to their members up to a suitable level. So one might have expected UK pension schemes to have welcomed EIOPA's proposals, because in the main UK pension schemes are underfunded but have access to just the sorts of security mechanisms that the holistic balance sheet is designed to recognise. I guess that the rub is that EIOPA is in effect asking for some objective justification for the assertion that the status quo is acceptable. Who likes to be told to justify what they are currently doing, especially if it might involve a lot of extra work?

The applicable pension protection arrangement in the UK is the Pension Protection Fund. The paper usefully in my opinion (and particularly usefully for the 40% or so of the Institute and Faculty's membership that is based outside the UK) also summarises in an Appendix some similar pension protection arrangements operating elsewhere in the world. Implicit within the holistic balance sheet concept is the need to form a view on how reliable might be the security underpin offered by the PPF or by its compatriots elsewhere in Europe.

I think that it is instructive to think laterally in this context. Let's take an ultra-high level overview of the entire pensions industry of a country. Let's suppose that the country in question has pension structures similar to those prevailing here in the UK and that at some stage in the future it runs into a situation where its pension schemes are in aggregate materially underfunded *and* at the same time the aggregate sponsor base supporting these schemes is too weak to afford to make much of a dent in the aggregate level of scheme underfunding. In this hopefully hypothetical scenario what is the impact of including a pension protection arrangement such as the PPF?

In early years, the pension protection arrangement would provide coverage like the PPF does at present, so beneficiaries of schemes whose sponsors defaulted in those years would be well covered. However, schemes whose sponsors hadn't defaulted would be making levy payments to fund this support. Therefore, all other things being equal, their funding shortfalls would be increasing over time, as would the levies they would be paying to the pension protection arrangement. Ultimately the position would become unsustainable with schemes whose sponsors hadn't yet defaulted exhausting their asset base to support schemes whose sponsors had already defaulted. The lucky ones would then be the members of schemes whose sponsors defaulted early on in the process. In practice, of course, something would give in the meantime. If this was ever the situation in the UK then this might involve the PPF reaching the limit of its levy raising powers or asking the Secretary of State to rein in the benefits that it was covering. Thus inclusion of a pension protection arrangement might redistribute resources between schemes but wouldn't in this case solve a systemic problem if the problem was sufficiently large.

In this context, I would note that one aspect of modern ERM disciplines that did not seem to be covered in this paper was the concept of 'reverse stress testing'. This involves adoption of the hypothesis, however improbable, that the operating model of the organisation in question has become bust and then brainstorming how this might have happened and what risk mitigating strategies might have been implemented to make the outcome less unpalatable. Perhaps this is already done by the PPF just not shared with us via this paper or perhaps we can do some of this brainstorming tonight if we think it appropriate.

The fourth and final question I would propose we discuss involves asking to what extent we think pension schemes *ought* to be allowed to take into account the existence of pension protection mechanisms such as the PPF when assessing the level of benefit security being provided to their members. This sounds like it is the same as my third question. However, life is not this simple. The UK has a conceptually similar protection arrangement applicable to insurance companies and banks called the Financial Services Compensation Scheme. The regulatory solvency assessment of insurers and banks disregards the potential recourse individual policyholders or bank depositors might have to the FSCS. Perhaps this derives from a conscious desire by regulators and politicians to limit 'moral hazard'. By this I mean the possibility that shareholders of insurers or banks may otherwise be incentivised to pursue overly risk strategies because of the presence of lifeboat mechanisms such as the FSCS. Is this type of issue relevant in the pension arena and if so what is the right balance to strike?

To summarise, in my opinion this is a great paper and I want to commend the authors for producing it. If it were entirely up to me, I would encourage us to explore in the next few minutes at least the following topics:

(1) To what extent are the ERM disciplines being applied at the PPF a good role model for other organisations in the pension community, bearing in mind the differences in resources available to different organisations?

(2) Is the balance of resources being applied to the different types of risk faced by the PPF appropriate, either for the PPF itself or for the industry more generally?

(3) How reliable might be the underlying frameworks within which the PPF and its compatriots elsewhere operate? The PPF's longer-term reliability, it seems to me, rests on the validity of the assumption set out in Section 3.2.1 that UK pension scheme funding will in the long term improve on account of the efforts of trustees, sponsors and the Pensions Regulator. What might derail this assumption?

(4) To what extent is it appropriate when assessing the benefit security being provided by a pension scheme to its members to take into account the recourse the scheme or members might have to a pension protection arrangement such as the PPF? What role if any applies to moral hazard in this context?

However, I am conscious that meetings such as these rarely follow paths proposed by their Openers and there are plenty of other topics that we could also pursue from this paper. As long as you have useful insights to offer I would encourage you to contribute to the debate we are just about to have. It is in the wider interests of society that the best possible risk management disciplines be applied at the PPF and in the pension funds it covers. It is also in the particular interests of the significant proportion of the individuals here today, myself included, who are members of the 6550 or so pension schemes covered by the PPF or who advise them or who merely do business with them or with the PPF itself.