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Mr Brendan Kennedy Pensions Authority Verschoyle House 28-30 Lower Mount Street Dublin D02 KX27	Alan Flynn Department of Social Protection Áras Mhic Dhiarmada 1 Store Street Dublin 1

14 April 2022

Dear Brendan and Alan,

Funding Standard & Risk Reserve Review

We are writing to you in our capacity as the Investment Committee of the Irish Association of Pension Funds. We have also received input from the CFA Institute who have co-signed this letter and from the Society of Actuaries in Ireland. We are keen to engage with both the Pensions Authority and Department of Social Protection on evolving the methodology underlying the Minimum Funding Standard (MFS) and in particular the Funding Standard Reserve or "Risk Reserve" as applies under Section 44(2) of the Pensions Act 1990 (as amended).

Following on from the implementation of IORP II in 2021 and the DB Financial Risk Measure, we believe it is an opportune time to update the calculation methodologies associated MFS and Risk Reserve with a view to:

- Enabling more effective risk management; and
- Improving investment outcomes for DB schemes and their members.

The Pensions Authority has referenced that with the new forward-looking supervisory approach, there is a need for the Funding Standard to evolve. We agree and believe that a fundamental review of the Funding Standard and its methodology is required - this letter sets out items which could be taken into consideration by The Pensions Authority for evolving the Funding Standard.

The inclusion of the Funding Standard in primary legislation

A significant issue with the evolution and changing of the parameters associated with the Funding Standard and Risk Reserve is that there needs to be an overarching flexibility associated with the allowable assets and methodology to ensure that it can be easily updated as investment and actuarial best practices evolve over time.

To achieve this aim, it would be beneficial to remove the calculation mechanics underlying the Funding Standard out of primary legislation. This would give sufficient scope for future changes to be implemented quickly as things evolve in the future leading to better outcomes for pension schemes and their members.

The Funding Standard's calculation methodology

There are a number of areas where amendments should now be consider such that the calculation reflects the risk management strategies of DB schemes in 2022:

- All non-qualifying investments currently have the same stress sensitivity. Consideration should be given to applying a different percentage to different assets.
- The definition of a qualifying asset is currently binary. Consideration should be given to a sliding scale which allows for some recognition of credit risk e.g. global bonds.
- In periods when interest rates are near-zero or negative, the impact of a 0.5% fall in yields should be reduced or removed.
- Consideration should also be given in relation to how the calculations interact with the new DB Financial Risk Measure.

Enabling the construction of low-risk portfolios

We welcome the use of credit quality in addition to yield differentials as per the revised Guidance issued in December 2021 and feel there are further points which can be considered which would greatly assist Trustees in the construction of a low-risk portfolio:

- The definition of "qualifying asset" should be reviewed to reflect the ways in which DB schemes are now investing in order to minimise risks and best meet their benefit promises.
- This would include a clearer treatment of LDI (Liability Driven Investing) swap-based funds which are used entirely for risk management purposes.
- The calculation should not penalise schemes that are pursuing inflation hedging strategies as can be the case at present.
- It should consider global bonds which are currency hedged.
- The assets which insurance companies now use to back annuity solutions include a certain proportion of illiquid assets (e.g. infrastructure, social housing, mortgages) and this should be reflected in the calculation basis.

We set out the Investment Committee's thoughts below in further detail.

<u>Considerations in relation to the design of the MFS and Risk Reserve</u>

We firmly support the need for a statutory funding basis to define a minimum required level of solvency for a pension scheme below which remedial action is required to improve the deficit to an acceptable level. Consideration should be given to how the calculation interacts with the new DB Financial Risk Measure and though we agree with the need for a stress test there should be an ability for approaches which best fit individual schemes. Other factors for considerations should include:

- 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;
- 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;

- Many pension schemes can't "afford" to hedge liability risks using physical bonds as this would require the sponsor to "make whole" the deficit at its present value. Thus partially funded hedging solutions are required and used as a matter of standard industry practice and efficient portfolio/pension fund management in Europe and the UK i.e. use of derivatives to gain exposure to interest rates and inflation in order to reduce the volatility of a scheme's funding level;
- Partially funded hedging solutions need to hold collateral to meet any potential calls to cover movements in the valuation of the swaps used to provide the hedging exposures to interest rates and inflation rates. The type of collateral held is usually cash or "core" European government bonds;
- The Risk Reserve does not explicitly allow for these types of assets which seems counter intuitive given they are held to reduce the volatility of the schemes funding level;
- In summary, we propose that explicit consideration should be given to including:
  - Pooled cash funds within an LDI portfolio with a minimum credit rating of AA or equivalent
  - the net mark-to-market value of derivative contracts where:
    - such contracts are held for risk management (and not for speculative purposes)
    - the derivative value is collateralised

  This treatment would be consistent with the treatment of bonds. Note that the net mark-to-market value will in some cases be a negative asset value, thereby increasing the Funding Standard Reserve.
- The valuation of liabilities on a Funding Standard basis typically provide a lower valuation than on an economic basis. 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;
- We are agreed that The Pensions Authority needs to broaden the guidance associated with IORP II to include an evolution of the Funding Standard to ensure that liability risks are identified, quantified and managed accordingly;
- Ultimately the "end-game" for Irish pension schemes is holding a low risk portfolio of assets that can be used to either fund a "self-sufficient" pension schemes that runs off over time or transfers to an insurance company to "buy out" the schemes future liabilities;
- Both of these options require clarity for Trustees to help them define what an appropriate low risk portfolio of assets will allow them "solve the problem" to reach their end-game target;
- A framework that could be refined by The Pensions Authority that sets out 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).
- Further, in the current environment government bonds and credit have potential for large negative absolute returns over short time periods and allocations to government bonds and credit need to be within a specific framework to manage risks associated with low or negative nominal yields. Finally, consideration should be given as to how the strength of sponsor covenant might be considered/measured in arriving at the final amount.

Allowable assets under the Risk Reserve

Further to the above, 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 where high grade assets could also be included:

- Currently, only euro (and sterling where there are sterling liabilities) denominated sovereign and corporate bonds are deemed eligible under the calculation of the Risk Reserve;
- Non-euro denominated bonds should be allowed where the majority of the currency risk is hedged out;
- The largest supply of high-quality Investment Grade corporate bonds are US dollar bonds they are typically longer duration, more liquid and there are significantly more diversification of issuers and issuance;
- High quality (AA-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 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 (AA-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 Investment Grade credit portfolio and provides security over the underlying cashflows and pools of assets.
- Insurance companies in Ireland now typically allocate 20% of assets to illiquid income based assets e.g. infrastructure, social housing, mortgages, when writing bulk annuity business and consideration should be given to including an allowance for any such assets within the "qualifying assets" definition. In the case of social housing, pension schemes can access long term contracted inflation linked rent from a quasi-governmental body (i.e. the county council) thereby getting a solid return and doing a social good for the country.

Our opinion on the items stated have also been shared with the Society of Actuaries in Ireland as well as other stakeholders in the Irish Pensions industry including trustees, consultants and investment managers.

We look forward to meeting with you to discuss the contents of this letter in further detail.

Yours sincerely,	Yours sincerely,
Jerry Moriarty Chief Executive Officer IAPF	Niall McDonnell CFA President CFA Society Ireland