De-risking in pensions, insurance and other financial services: good or bad?

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About the speaker

- *Malcolm Kemp is Managing Director of Nematrian, a Board member of the Actuarial Association of Europe (AAE) and a visiting lecturer in enterprise risk management at Imperial College Business School, London. He has written and presented extensively on many actuarial and risk management topics, see: http://www.nematrian.com/PresentationLibrary. Until 2023 he was a member of the Advisory Scientific Committee of the European Systemic Risk Board and chairperson of the AAE Risk Management Committee. Until 2021 he was the Chief Actuary (Actuarial Function Holder) of Threadneedle Pensions Limited and an Associate in Barnett Waddingham's insurance consulting practice.*

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Agenda

- Some background (emphasis on UK)
- The regulatory agenda in Europe
- Good or bad? Some personal thoughts

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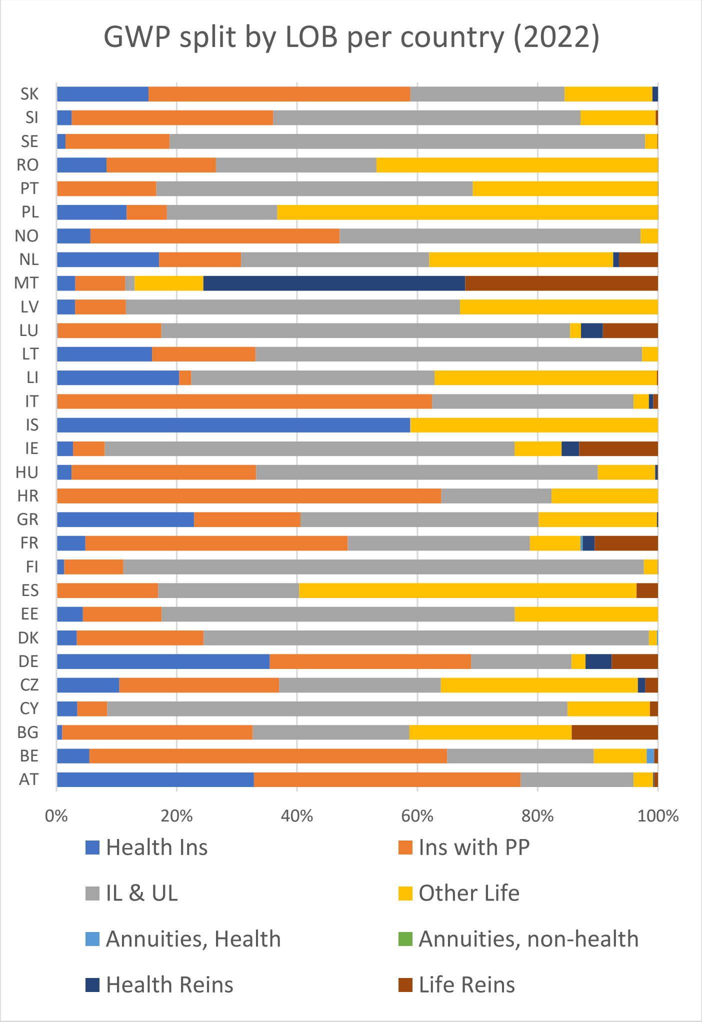
Background

- Many apparent examples (to actuaries) of de-risking in financial services
  - E.g. apparent decline in provision of investment guarantees in life insurance (but only in some jurisdictions?)
  - E.g. shift from Defined Benefit (DB) to Defined Contribution (DC) private sector occupational pension provision (particularly USA and UK)
- Are these “problems” or “opportunities” and if so for whom? Are they trends we can materially influence?



Source: EIOPA Insurance Overview 2023

Business perspective

- Businesses generally exist to make a profit
  - For-profit businesses will want to take on risks only if adequately compensated
  - Successful businesses are generally the ones that maximise the trade-off between (upside) opportunity and (downside) risk over the longer-term
  - (Typical) economist view: ongoing competitive exploration by business of this and other economic trade-offs likely in the long term to benefit society
- Not-for-profit enterprises (including charities), regulators and governments have other perspectives
- Noteworthy that de-risking debate in actuarial circles more prominent in some (private sector occupational) pension areas than in insurance
  - And that social security is still mainly DB in developed countries
  - How important are the “social” aspects of pensions?

Customer / citizen / societal perspectives

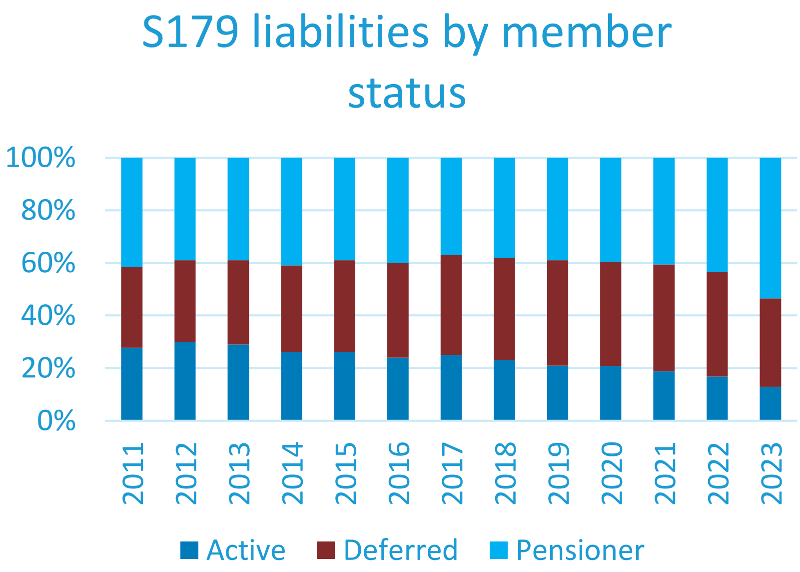
- Quality of financial services hard to assess in advance. Creates an asymmetry and tension between businesses and customers
  - Regulation seeks to address this imbalance
- “Customers” can typically choose whether to buy a service (and/or from whom)
  - Introduces an **individualistic** (rather than **collectivist)** perspective
  - Unless part of the “contract” is more explicitly for the public benefit (e.g. charity or other not-for-profit contexts)
- Broader societal trends
  - How individuals and firms react to these interactions day-by-day builds up to broader societal trends, such as “derisking”

Occupational pensions (UK)

- Long history, especially in public / quasi-public sector
  - Roman military pensions, pensions for Royal Navy personal (1590, 1666, 1836), Bank of England (1739) and East India Company (by 1750)
  - First universal state (DB) pension provision introduced by Bismarck in 1880s, concept copied by other countries including UK
- Heyday of UK private sector DB occupational pension provision arguably in 1960s and 1970s
  - Separate schemes to protect against corporate failure, initially with many discretionary elements (e.g. discretionary inflation protection). Lower life expectancies, tax incentives, helped corporate restructuring
  - Push for better pre-retirement vesting of benefits eventually reduced effective amount of discretion

UK DB pension scheme liabilities: stylised description

- Most (accrued) UK occupational pension provision is still DB
  - But most DB schemes maturing. Less than 10% open to new members, 52% closed to new benefit accrual (c.f. 12% in 2006). ONS data indicates at end 2019 DC members (22.4m) outnumbered funded DB and hybrid scheme members (18.3m).
- Reduced link between scheme and Human Resource factors (except arguably in public sector, including universities)
  - Commonly viewed in private sector as a “legacy” problem, involving a “journey” towards buy-out of the liabilities (typically with an insurer)



Source: UK Pension Protection Fund Purple Book 2023 (Fig 4.14)

Weighted average UK DB pension scheme asset allocations

Year End (31 Mar)	Equities	Bonds	Property	Cash and deposits	Insur. policies	Hedge funds*	Annuities*	Diversified growth funds	Absolute returns	Misc.
2006	61.1%	28.3%	4.3%	2.3%	0.9%	n/a	n/a	n/a	n/a	3.1%
2011	41.1%	40.1%	4.4%	4.1%	1.6%	2.4%	n/a	n/a	n/a	6.3%
2016	30.3%	51.3%	4.8%	3.0%	0.1%	6.6%	2.1%	n/a	n/a	1.7%
2017	29.0%	55.7%	5.3%	-0.9%	0.1%	6.7%	3.3%	n/a	n/a	0.8%
2018	27.0%	59.0%	4.8%	-2.5%	0.1%	7.0%	3.4%	n/a	n/a	1.2%
2019	24.0%	62.8%	5.0%	-4.4%	0.3%	7.4%	4.0%	n/a	n/a	1.0%
2020	20.4%	69.2%	4.9%	-7.2%	0.1%	6.8%	5.0%	n/a	n/a	0.8%
2021	19.0%	72.0%	4.7%	-9.5%	0.1%	6.1%	6.6%	n/a	n/a	0.9%
2022	19.5%	71.6%	4.6%	-8.8%	0.1%	5.2%	6.8%	n/a	n/a	1.0%
2023	18.0%	68.9%	5.3%	-5.1%	n/a	n/a	7.4%	1.5%	3.1%	0.9%

Source: UK Pension Protection Fund Purple Book 2023 (Fig 7.3) Weighted average asset allocation in total assets. Purple book notes that “*The weighted average proportion of assets held in cash and deposits being negative represents a number of large schemes with significant negative cash holdings which are likely to be related to investments such as swaps and repurchase agreements held as part of LDI strategies*”. Fig 7.5 includes split of bonds (2023): 19.5% government fixed interest, 36.5% corporate fixed interest, 44.1% index-linked. Fig 7.7 includes split of equities (2023): 7.6% UK quoted, 1.4% Overseas quoted (tier 1), 53.6% Developed markets (tiers 2 and 3), 7.8% Emerging markets (tiers 2 and 3), 29.5% unquoted/private (c.f. 2011: 28.0% UK quoted, 57.2% non-UK quoted, 4.8% unquoted/private).

The IFoA’s Great Risk Transfer Campaign

- Extensive engagement with stakeholders
- A broad focus:
  - Transfer of risk not necessarily contractual or even formal. Balance of responsibility for risk likely to reflect societal emphasis on individualistic or collective values
  - 4 main areas in Interim Report: Pensions, Work, Health / Care, Insurance
- Final proposals grouped under two headings
  - Rebalancing risks by shifting prime responsibility back towards institutions
  - Helping consumers manage financial risk through good decision-making

Source: IFoA (2023) [Great Risk Transfer]

Final Proposals: (1) Rebalancing risks

Area	Proposal (summary)
CDC schemes	Government action to promote attractions of collective DC to employers
Decumulation pathways	Introduce default decumulation pathways for all pension arrangements
Access to insurance cover	Set minimum levels of insurance coverage needed by all (including low-income families)
Learning from ‘Re’ schemes	IFoA to promote research into what makes model like FloodRe successful as a means of addressing protection gaps
DB scheme regulation	The ‘bespoke’ framework in The Pensions Regulators DB funding code should genuinely enable consideration of each case on its own merits
Post-Brexit insurance regulation	HM Treasury to use UK Solvency II Review to enable and encourage life insurers to offer affordable guarantees

Final Proposals: (2) Helping consumers manage financial risks through good decision-making

Area	Proposal (summary)
Pension Wise	Target significant increase in take-up (of this free-to-access public-supported pension advice service) prior to individuals accessing their pension benefits
Pension dashboards	Prioritise consistent estimation and presentation of retirement income
Risk transfer incentive exercises	Introduce regulation or guidance to strengthen consumer protection in risk transfer incentive exercises
Adequacy of pension contribution rates	Better public messaging that auto-enrolment minima unlikely to deliver an adequate income in retirement

The regulatory agenda in Europe

- Some emphasis on protection gaps
- Otherwise less focused on de-risking than UK actuarial profession
  - Trend away from participating towards unit-linked is less strong vs. UK
  - Bulk of occupational pension provision is in NL and is often Collective DC in nature (although IE provision has some similarities with UK)
- Many other topics given equal or greater importance or emphasised differently, e.g.
  - Financial stability (including financial stability implications if critical functions impaired, e.g. DORA)
  - Digitalisation
  - Sustainable finance

EIOPA 2024-26 work plan

1. To integrate sustainable finance considerations across all areas of our work
2. To support the consumers, the market and the supervisory community through digital transformation
3. To enhance the quality and effectiveness of supervision
4. To ensure technically sound prudential and conduct of business policy
5. To identify, assess, monitor and report on risks to financial stability and conduct of business, and promote preventative policies and mitigating actions
6. Ensure good governance, agile organisation, cost effective resource management and a strong corporate culture

Source: EIOPA (2023) Work programme 2024-2026

Good or bad? Some personal thoughts

- Various perspectives:
  - Society
  - Policymakers
  - Customers
  - Insurers and insurance substitutes
- Views are inevitably personal:
  - My career has ranged through pensions, insurance and investment consulting to asset management
  - Has included some elements inside the regulatory community

Society

- More focus on risk management nearly everywhere
  - E.g. risk assessments and risk registers in daily life (education, …) and across business / government
- But society's entrepreneurial spirit still strong
  - E.g. continued technological innovation, AI, green transition, …
- Actuarial profession keen to promote actuarial involvement in risk management
  - Hard then to fault our clients exploring de-risking
- Are we worried that this might result in socially undesirable outcomes in our own area of expertise?

By Prompt by JPxG, model by Boris Dayma, upscaler by Xintao Wang, Liangbin Xie et al. - https://github.com/borisdayma/dalle-mini/ BSD 3-Clause, Apache License 2.0, https://commons.wikimedia.org/w/index.php?curid=118813978

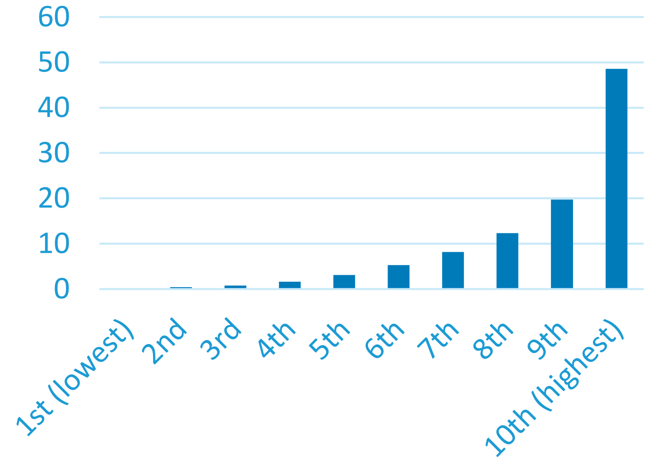
Policymakers

- Have many competing interests
  - Interested in protecting the public purse. Tend to give higher priority to financial stability and systemic risk than the insurance and pension industry
  - Tend to view insurance and pensions industries as good at lobbying (relative to e.g. banking industry)
  - Policymakers likely sceptical about own ability to swim against the tide of social trends
- Tax angles add complexity
  - Tax often an important consideration with life insurance and pensions and may be of significant political interest
  - E.g. tax breaks that benefit annuitants can reduce resources available to finance social care and health provision

Customers

- Are our (pensions/savings) customers representative of society as a whole?
  - UK poorest decile: wealth mostly in physical items (e.g. household possessions and vehicles). <50% own property with positive equity or have any form of private pension
  - UK wealthiest decile: mostly positive bank balances (median net financial wealth £90,000), own property (median £310,000) and have a private pension pot (median £627,000). On average, 50% of their wealth in pensions and 32% in property.
- Highlights practical importance of:
  - **(Publicly organized) social security arrangements**
  - **(Private) savings that do not involve pensions or life insurance**

Percentage of total wealth held by individuals in each individual wealth decile, Great Britain, April 2018 to March 2020



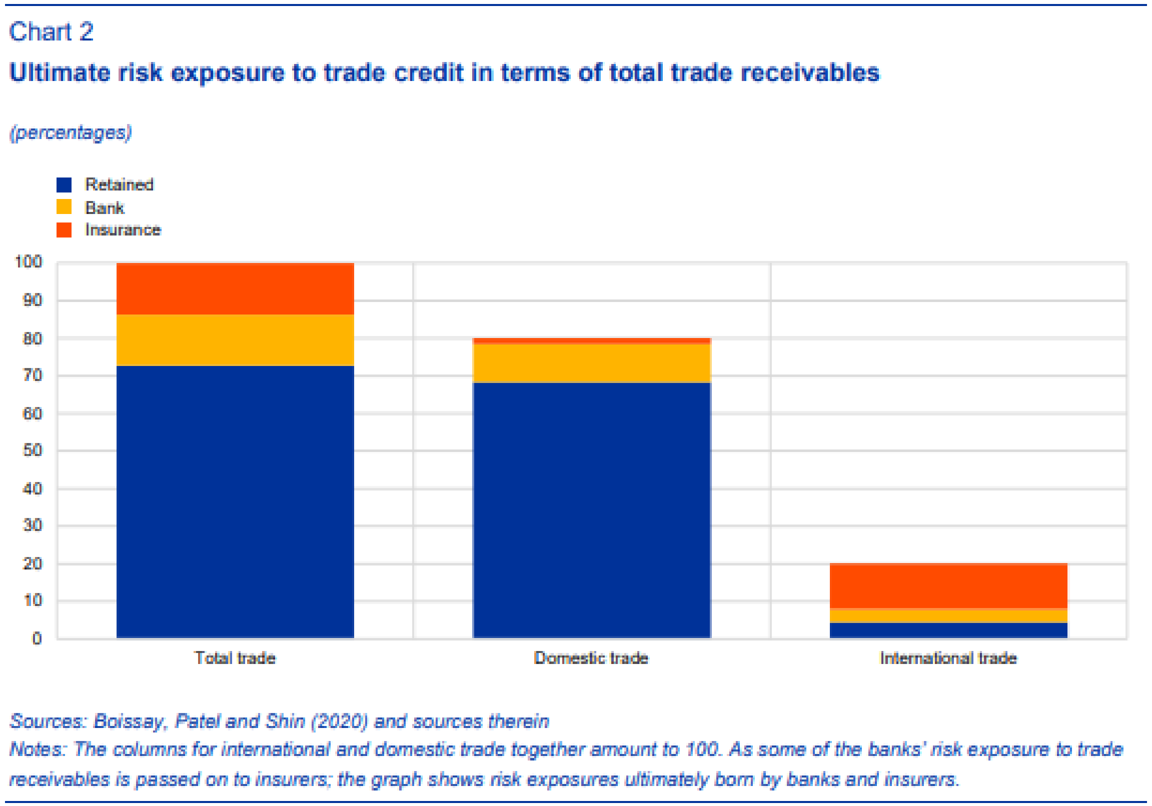
Source: UK Office of National Statistics Wealth and Asset Survey

Insurers

- Insurers are in the business of risk management (as are banks, …!) so de-risking trends impacting them interact with their profit motive
  - If we believe that economic experimentation and creative destruction are ultimately good for society then hard to fault insurers if they find it beneficial to offload risks onto their customers
  - Particularly if the risks are expensive and undervalued by customers
- Possible ways of protecting customers:
  - Encourage financial literacy
  - Ensure customers better understand the risk transfers involved
  - Keep products simple and transparent (and focused on meeting customer needs)

Insurance substitutes

- Structure appropriate safety nets for those who can’t afford or can’t access basic insurance coverage
  - Might involve mandatory coverage
- Is (private) insurance always the best solution?
  - Self-insurance or other financial products may be valid alternatives
  - Some risks too large to be carried just by private sector (e.g. FloodRe)



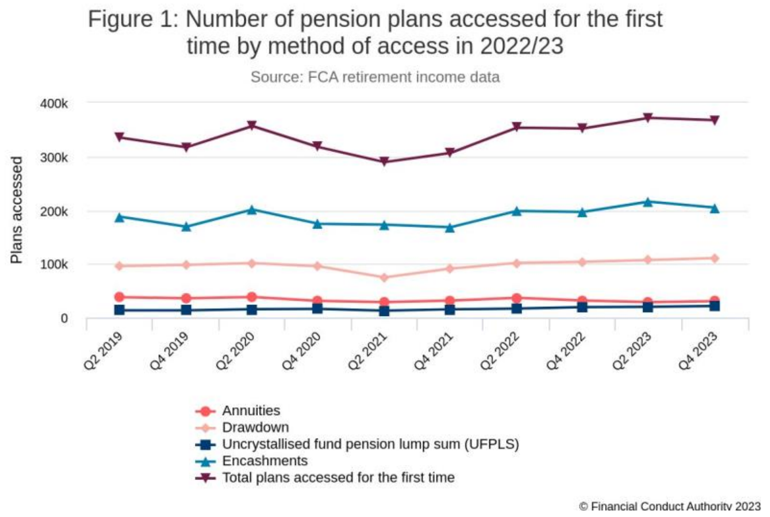
Source: ESRB (2022) Issues note on aspects of trade credit insurance

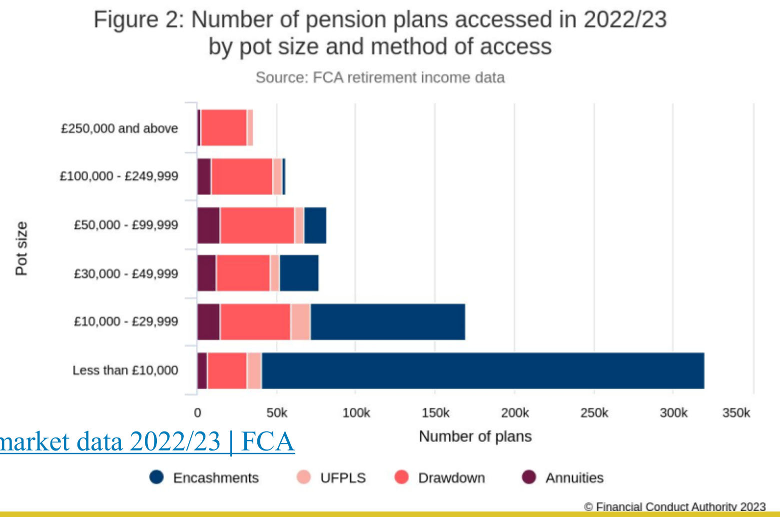
Don’t assume regulatory change can solve everything

- Can regulation really make guarantees more affordable?
  - Monetary guarantees are inherently expensive to provide in a low interest rate / low inflation world
  - If customers valued them sufficiently then they would already be widely provided
- Capital regulation is generally aiming to contain risk of failure to address asymmetry between an undertaking and its client
  - Ideally agnostic regarding source of failure, why single out guarantees?
- Pension schemes and insurers seen by governments as a ready source of “patient capital”, e.g. for long-term infrastructure needs
  - Most likely to be sources of patient **risk** capital if liabilities relatively unconstrained

Is annuitisation always sensible?

- Most people who might choose to buy annuities likely to be relatively well-off. Much of their wealth may not be in pension schemes.
- May want to give some of this wealth away to dependents/charities
- Actual behaviours when they have the choice suggest that annuitisation not necessarily their ‘go to’ option





Source: FCA (2024). Retirement income market data 2022/23 | FCA

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Concluding thoughts

- Many de-risking trends apparent in today's financial landscape
  - Drivers are often deep rooted, with regulation often **reacting to** rather than **driving change**.
  - Some professional bodies (e.g. IFoA) have highlighted de-risking trends
  - Regulators and other **policymakers often have a broader range of priorities**
- *"In this world nothing can be said to be certain, except death and taxes"* (Benjamin Franklin, 1789)
  - Individuals adopt diverse financial strategies to cater for these certainties: **private sector pensions and insurance form only a part of a typical individual's wealth**
  - Prevailing business models familiar to actuaries are often underpinned by favourable tax regimes: **these regimes can change over time**

Thank you

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