Government Actuary's Department

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Investment Bulletin

In this first article of a series on risk management for defined benefit pension schemes we recap on the concept of the integrated risk management framework (IRM).

What is IRM?

IRM, as introduced by The Pensions Regulator (TPR) in 2014, is a way of assessing and managing key risks of defined benefit pension schemes. Within this framework TPR identifies 3 types of risk affecting schemes. There is **investment risk** that the investments of the scheme give a lower return than forecast. There is **funding risk** that the scheme will become underfunded, with liabilities becoming greater than its assets and there is an **employer covenant risk** that the employer may be unwilling or unable to pay liabilities as they fall due.

Source: TPR

The key aspect of IRM is that the risks are considered together and regularly. For example the risk that a scheme may become underfunded is intrinsically linked to the risk that the return on asset investments is lower than expected relative to liabilities. While it may require time and cost to initiate IRM, it is argued that it should pay off from more efficient advice and decisions and an enhanced ability to meet scheme objectives.

What does IRM mean for scheme investment returns?

There have been concerns that IRM might lead to trustees taking overly risk-averse approaches with negative implications for scheme investment returns. However, the purpose of IRM is to ensure that the risk a scheme is exposed to is appropriate to its objectives and risk appetite. In particular, TPR is clear the benefits of taking on more risk should be considered within the IRM framework. Another benefit of IRM is that risks are constantly monitored, with trustees looking for new opportunities to mitigate risk and to implement contingency plans. The continuous nature of IRM allows the potential for schemes to change risk exposure in response to changes in risk appetite in real time. This in itself may mean that a scheme is actually able to take on a higher level of risk under IRM than otherwise.

The accessibility of IRM and ongoing development

Due to the high initial time cost, IRM is more accessible for larger schemes. However there are obvious benefits to smaller schemes of implementing some sort of IRM. Various approaches can be used, which seek to simplify, standardise and ease the implementation of the IRM tool and thus enable smaller schemes that have limited budgets to gain some of the benefits of IRM. One example is the 'risk bow tie' approach which demonstrates how the impacts of events, illustrated as the knot of the bow tie, can be managed by preventative and corrective controls, illustrated as the 2 sides of the bow tie (more information on this approach can be found here).

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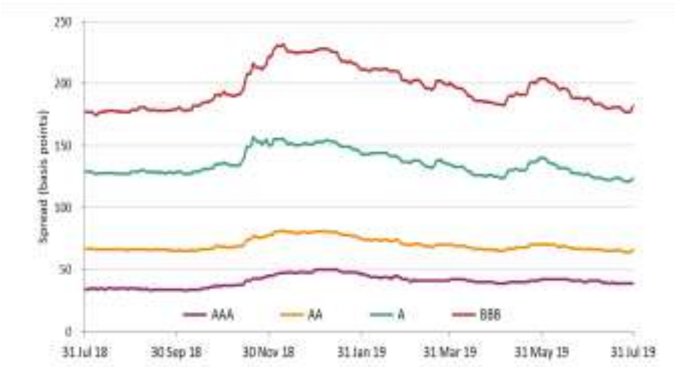
This month in brief

With continuing uncertainty over Britain's international outlook, and a new government, the pound fell to a 10 year low, against the Euro, at €1.0724. House prices rises were stronger than expected over July, 0.3%, instead of 0.2%, also stronger than the 0.1% of growth seen in June. This was coupled with the publication by the Bank of England (BoE) of a stronger than expected number of mortgages being approved during the same period. Unemployment continued its 2019 trend of remaining at 3.8%, near record lows.

The BoE quarterly inflation report was released, announcing that inflation was hit its 2% target. The BoE issued forward guidance of a "gradual and limited" raise in the Bank Rate over the next few years, along with warning of reducing business investment and a slowing economy. A few days later this was borne out in data released by the Office for National Statistics showing that GDP shrank by 0.2% in Q2. This was attributed to the stockpiling associated with No Deal Brexit planning by firms, nationwide.

Real and nominal yields on short term bonds fell over the month.

Credit spreads of lower rated bonds fell over the month.



All equity markets remained stable over the month.

Real and nominal yields are slightly lower than last month.