

## **New Investment Regulations Good for Pension Schemes**

On 23<sup>rd</sup> September 2005, new regulations came into effect for pension schemes, covering a number of areas. This article looks specifically at the regulations that affect pension scheme investments, and the implications of these for pension scheme trustees. In particular, two separate regulations impact on the investment practices of pension schemes; the Occupational Pension Schemes (Investment) Regulations 2005 and the Occupational Pension Schemes (Disclosure of Information) Regulations 2005.

Mostly the impact of these regulations is to impose a legal requirement on practices already adopted by the vast majority of pension schemes. Therefore, the practical implications are minimal. For example, the investment regulations include a requirement that the assets of the pension scheme are predominantly invested in regulated markets, that the assets are diversified and that derivatives are only used in order to reduce investment risk or to facilitate efficient portfolio management. Meanwhile, the disclosure regulations dictate the information to be supplied to members of Defined Contribution schemes – most of which is already provided as matter of course.

Arguably, the most significant new requirement under the investment regulations is that all pension schemes, whether Defined Benefit or Defined Contribution, with over 100 members must produce a Statement of Investment Policy & Principles (SIPP). This is a written document that includes the following:

1. The investment objectives of the trustees.
2. The investment risk measurement methods.
3. The risk management processes to be used.
4. The strategic asset allocation implemented with respect to the nature and duration of pension liabilities.

In the UK there has long been a requirement for schemes to have such a statement. However, for Irish pension schemes this is the first time that such a statement has been mandatory. This is a very welcome development. In the past, it has been common for schemes to adopt investment strategies without taking into account the level of risk control or the appropriateness of the strategy for their own liability profile. Now, however, such schemes will be required to demonstrate that these factors have been accounted for. Consequently, trustees will have to stop and think about their investment strategies, rather than merely following their peers or the advice of their investment managers or consultants. Therefore, this new requirement can only be a good thing for schemes, members and employers.

The last point for inclusion in the SIPP is perhaps the most significant: “The strategic asset allocation implemented with respect to the nature and duration of pension liabilities”. For Defined Benefit schemes, this effectively means that trustees will need to adopt an investment strategy that takes the following into consideration. Firstly, their own scheme’s particular situation with regard to the mix of promised benefits between working, deferred and retired members. Secondly, the length of time before these benefits become payable. While these may seem like obvious considerations, it is only in the past few years that such an approach to setting investment policy has become popular. However, in order to

set such an investment strategy, many schemes have had to carry out expensive asset-liability modelling exercises. The cost of these exercises has made them impractical for small and medium-sized pension schemes.

A more practical and affordable alternative is to have an investment consultant prepare a less modelling-intensive analysis of the scheme's assets and liabilities. While not as sophisticated, such an analysis is much cheaper, and therefore more accessible for smaller schemes. This would provide trustees with a greater understanding of the relationship between their scheme's investment portfolio and their benefit liabilities. Such an analysis can therefore assist trustees in setting an investment strategy that is appropriate for their particular scheme.

Why is this so important? In the past there has often been a mismatch between the behaviour of the scheme's assets and its liabilities. For example, in the bear market of the early 21<sup>st</sup> century many schemes found themselves in a situation where the assets of the scheme were falling in value (sometimes by up to 50%) while the actuarial value of their liabilities kept rising. Schemes which had strong funding positions at the end of the 1990's suddenly found themselves with large funding deficits. Employers also took an increased interest in the funding position of their schemes following the introduction of new accounting standards (such as FRS17), which require companies to show the pension scheme's surplus or deficit on their balance sheets. The situation that schemes found themselves in at that time highlighted to both trustees and employers the need to adopt an investment strategy for the scheme's assets that reflects the behaviour of the liabilities. One barrier to doing so, however, has been the fact that those schemes with large deficits (where the value of the liabilities is greater than the value of the assets), had lost ground to make up. It is often the case that the adoption of a matched investment strategy will lead to lower long term returns. Introducing such a strategy at a time when the scheme's funding position was poor would have made it even harder to recover this lost ground without significantly increased contributions from the employer. Naturally, this was not a popular option with many employers. However, equity markets have recovered significantly over the past three years, and many schemes are now in much stronger positions. This, combined with the new regulations, means that there is no time like the present to review a scheme's investment strategy. Adopting an appropriate strategy now will mean that schemes should be protected against any future shocks like the collapse of the technology bubble in 2000.

A scheme's first SIPP must be included in the Trustees' Annual Report for the year commencing after 23<sup>rd</sup> September 2005. So if a scheme's year ends on 31<sup>st</sup> December, the SIPP must first be included in the Annual Report for the year ended 31<sup>st</sup> December 2006. The SIPP needs to be included in all subsequent annual reports, and must be reviewed at least once every three years and immediately following any change in investment policy.

*Fiona Daly is a Fellow of the Institute of Actuaries and Managing Director of Rubicon Investment Consulting. Links to the regulations mentioned in this article and other useful sites can be found on Rubicon's website: [www.RubiconIC.ie](http://www.RubiconIC.ie)*