Too big to fail: Could some UK schemes pose systemic market risk?

Teneo Insights / August 2015

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The International Monetary Fund has warned that the practice of companies derisking pension schemes to an insurer, meaning one entity would cover the risk for numerous funds, could threaten the stability of the US financial system should an insurance company fail.

Looking at this issue from a UK perspective, the situation is rather more sanguine.

The buyout market in the UK is small, relative to the size of the insurance market as a whole. Should the current increases in the buyout market continue apace, perhaps the matter should be revisited.

For now, the subject may not be significant enough to cause anxiety this side of the pond.

However, a potentially more current theme was mentioned in May by the OECD.

It shared concerns that pension funds moving towards riskier asset classes, in trying to chase increased returns and reduce deficits, could “seriously compromise” their long-term solvency.

While a significant move to do this in the UK is yet to be seen, it is possible rerisking in future may occur.

This could be due to, for instance, negative real rates on bonds or the belief that interest rates must revert to historic levels.

Domino effect
To see if this presents systemic risk, it is important to define just what that risk is.

In short, systemic risk is the danger that one failing institution – sometimes referred to as ‘too big to fail’ – could cause other related organisations to also fail, harming the economy as a whole.

It concerns risk around the interconnecting relationships rather than the sole first entity to collapse, and is traditionally used when discussing sizeable financial institutions.

When looking at systemic risk, two broad questions stand out:

- First, is an institution likely to cause a significant, wide-ranging financial and economic detriment were it to collapse?
- Second, is it too large or interconnected to be allowed to do so?

But can defined benefit schemes fall into either of these categories?

The OECD comment expresses concern that overly ambitious investment strategy may not solve deficit issues and could compound them.

Might that lead to a DB scheme being too big to fail?

Some schemes may be seen as too big to fail, although if systemic risk derives from being interconnected, DB pensions and their investment strategies should fall outside of this where a sensible approach is taken.

An extreme example is taking the assets of a scheme and placing them on red or black at a roulette table – good news if it works out, disastrous if it does not.

It is highly unlikely that a scheme’s investment strategy has all of its eggs in one basket in this manner, and so while they might have shares in large companies that might pose a systemic risk, one view could be that the scheme itself may not.

Assessing the sponsor’s strength
This is where employer covenant is useful.

Referring back to the roulette illustration, an employer could potentially negate the risk posed by an overly racy investment approach if it is genuinely financially strong enough to absorb any adverse outcomes.

If the strength of sponsoring employers is assessed appropriately, with investment decisions based around the ability of the employer to foot the bill if they are not achieved, then it could be argued that UK DB pension schemes pose little systemic market risk.

Of course, there might be a case for saying ‘never say never’.

This article was originally published by **Pensions Expert**

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