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Supervising DC Pensions: Liquidity Risk

OECD/IOPS Global Forum

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What is ‘Liquidity Risk’

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- Risk that pension funds cannot meet their financial obligations when they fall due, at all or without incurring significant unexpected costs.
- It does not capture falls in market prices.

The issue

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- Funds have typically been cash flow positive but liquidity issues, portability and imminent retirement of a large cohort of members alters the scenario.

The Australian context

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- Mandatory 9% contribution, significant tax concessions relative to other forms of saving and tax free benefits post retirement age 60.
- Funds under management exceed A$1 trillion or more than 100% of Australia's GDP.
- No real need for liquidity concerns until recently.

APRA's prudential alerts and actions

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- 2007 alert regarding illiquid investments and ageing membership.
- 2008 liquidity survey found that funds should:
  - undertake more comprehensive liquidity stress testing
  - manage liquidity at investment option level
  - avoid over reliance on historic positive cash flows
  - achieve better balance between member investment choice and the ability to meet payment requests in the context of choice

Adjustments to DC supervisory processes

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- Funds should treat liquidity risk as a material risk and should document appropriate measures to manage this risk.
- Fund managers need to ensure that they fully understand the nature of underlying investments and their structures.
- Liquidity stress testing should be at individual investment option level not just 'whole of fund'.
- Funds should be aware that liquid investments can become illiquid and stay that way for some time.