Institute and Faculty of Actuaries

# Fiscal Risks Report

IFoA response to Office for Budget Responsibility

27 January 2017

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The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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Office for Budget Responsibility
102 Petty France
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Dear Office for Budget Responsibility,

1. The IFoA welcomes the opportunity to respond to the Office for Budget Responsibility's 'Discussion paper No 2: What should our Fiscal risks report cover?' The IFoA's Risk Management Board is responsible for the drafting of this response.

2. We welcome the Discussion Paper, which covers the relevant issues comprehensively with extensive helpful background information. We believe that the paper addresses thoroughly the key principles of risk identification, assessment, measurement and forecasting. We wish to make the following general comments, in addition to contributing responses to select questions asked in the paper.

**General comments**

3. Chapter 2 discusses an IMF analysis of historic shocks to public debt, which suggests that the largest shocks tend to be macroeconomic or financial in nature. However, we would emphasise that any Government must be prepared to deal with shocks from unforeseeable sources. In such circumstances the Government may be forced at very short notice to find an extremely large sum of money which is not provided for in the budget or its contingency allowances.

4. We suggest that the Fiscal Risks Report (FRR) could include an indication of the plausible scale of such funding requirements and the shortness of the time period that might be available. Further, the FRR could also indicate the impact such a scenario might have on the cost of Government borrowing (assuming the funding arrives through borrowing) and hence on the ability to support such increased levels of debt. Such analysis could be of benefit to the Government in its planning for such events.

5. Chapter 2 also discusses "natural disasters" and notes their relatively low frequency and severity. We would argue that it is still important to consider them in depth, given the short period of time in which such events typically emerge, and the fact that they are uncorrelated with other economic-type fiscal risks and may reinforce these.

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6. Similarly, the confirmation of the importance of the interest rate - economic growth differential is well made and introduces a significant exogenous influence of global interest rates and related currency implications.

7. In Chapter 3 the summary of the various ways of measuring and considering risk looks to be comprehensive and to provide a good base from which to develop the initial approach for the OBR. The IMF approach is well thought through, but it would be helpful to compare and contrast it over a suitable period with the alternative approaches set out. This should provide valuable additional insights as actual experience is reviewed.

8. We also have comments on some of the specific questions posed in this chapter:

*Should we focus on adverse risks to the public finances?*

9. We think that it is appropriate to focus on adverse risks. However, there should also be appropriate emphasis on beneficial risks. These should be considered not only in the short term, but also as to how they might balance long-term risk issues such as health provision, state pensions and unfunded public sector pensions.

*Should we take a broad approach to the sources of fiscal risk?*

10. We encourage the OBR to emphasise the complexity of the very wide range of diverse risks that may affect UK fiscal funding. Many are connected and they change over time so it is essential to start with, and maintain, a broad perspective as experience of fiscal risk analysis and reporting is gained and the world economy evolves. In particular, we feel that proper weight should be given to the analysis of, and commentary on, the long-term issues of health provision and pensions for an ageing population, and how these may influence other types of risk e.g. legal claims.

*To what extent should we focus on quantitative stress-test-style analysis vs broader discussion of different types of risks, some of which may be more difficult to quantify on a consistent basis?*

11. We believe that it is essential to start with, and maintain, a good balance between quantitative model risk assessment and qualitative, broader assessment. There is a danger of focusing primarily on risks that can be quantified practically, and becoming constrained to discussions with Government about financial assumptions based on historic information. A broad, qualitative forward-looking component should be included.

12. Chapter 4 focuses on international examples, and we agree it is important to continue to look widely for different practices in other countries and to consider how they may improve the way fiscal risk is reviewed in the UK.

13. The other countries featured in the paper generally aim to be comprehensive and address all major risks, but in some there is more descriptive analysis and commentary with limited quantification. As stated above we believe that it is helpful to have a good level of quantification for all risks where practical, considered in the context of a broader qualitative discussion.

14. The summary of current UK practice in Chapter 5 is very informative and provides a wider context for the FRR. It was encouraging to see the formal approach to analysing in detail the actual outcomes against forecast in recent times – the learnings from this inform future forecasting and the understanding of risks that occur. In particular, it illustrates the way in which risks can reinforce or combine in different ways e.g. the impact on revenue of structural changes to the tax system when another risk of low economic growth and inflation occurred.

15. We welcome the detailed yet broad analysis and commentary on contingent liabilities, both explicit and implicit. It is important to include this to ensure a comprehensive assessment of overall risk. It is also a good reminder that while the individual issues may not repeat, the Government faces a real exposure to the unanticipated costs of fixing any problem that emerges. Government may have a compelling obligation to meet the costs even if this is politically driven. In this context, it will it will be helpful to consider potential long-term implications for fiscal risk from Government policy changes and to seek Government commentary on these.

16. In the process of looking at fiscal risk holistically, it is likely that it will be necessary to identify and start collecting new streams of data – as a result, the risk analysis and reporting should be expected to change and develop over time.

17. In respect of how best to present the outcome of the OBR's work on fiscal risk, as set out in Chapter 6, it is important to recognise and reinforce that the range of risks that may impact Government borrowing is huge and complex with many subtle and changing interconnections. Accordingly, it would be unsatisfactory to oversimplify the presentation of a complex and evolving risk profile, to ensure that risk management is properly informed. We therefore do not believe it is appropriate to reduce the risk analysis to a single number, a simple heat map of risk or a few charts. Instead, techniques such as scenario analysis may be better able to present this complexity appropriately.

18. In addition to such techniques, the OBR's review should be based on sound research, objective assessments, robust and justified assumptions. It should make clear the way in which certain risks may aggregate and reinforce, and it should ensure there is appropriate exposition of contingent risks, both long and short-term. However, it should not concentrate solely on financial projections, which might encourage the Government to focus on discussing the underlying assumptions in its reply.

19. We suggest that the report should include a summary of the key risks that the OBR considers that the Government should be addressing based on OBR's analysis, with detailed commentary and quantification where practical. It should not suggest how the risks might be mitigated but it should invite the Government to comment on the analysis and how it proposes to manage the risks.

20. We welcome the introduction of the FRR as a means of supporting and enhancing the identification and assessment, and ultimately the management, of the complex fiscal

risks the Government faces. While the report will no doubt evolve over time, we recommend that you set a high standard for the first report with a comprehensive, holistic analysis including both quantitative and qualitative information and related discussion.

21. If you wish to discuss any of the points raised in further detail please contact Matthew Levine, Policy Manager (Matthew.Levine@actuaries.org.uk / 0207 632 1489) in the first instance.

Yours faithfully,

Fiona Morrison
**Immediate Past President**
**Institute and Faculty of Actuaries**