# Risk management and UK defined benefit pension provision: A perspective from financial sociology

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**Abstract** This opinion piece draws on a tradition of sociological engagement with the fiscal and financial world to outline implications for risk management discipline. Risk management is considered through a sociological conception of economic agency. The emphasis is on the history of the management of defined benefit pension funds, reflecting empirical work conducted, but broader implications for financial institutions are also highlighted.

***Keywords:*** *financial sociology, agency, history, defined benefit pension funds, accounting*

## ECONOMIC AGENCY

Financial economic literature, used as a framework for risk management,[1,2] defines agency as consisting of the asymmetric possession of information by principals and agents. Within pension provision, principals are the shareholders of the sponsoring firm and the members of the pension fund. The agent of shareholders is the finance director and the agent of members is the board of trustees. The pension fund manager is the agent of both the finance director and the board of trustees. Financial economics argues that the pension fund manager and possibly finance director and trustee board possess information that is unavailable to shareholders and members and that these agents may utilise such information asymmetries to maximise their wealth relative to that of the principals involved in pension provision.

In this perspective, the rise of defined benefit pension provision in the 1950s[3] was the result of weakened shareholder control, associated with opaque pension fund financial accounting and inadequate internal controls, that is, with the absence of modern risk management practices. Opaque accounting enables the pension fund manager to internalise risks associated with the provision of guarantees to the members of the pension fund. The recent decline of defined benefit pension provision is attributed to the introduction of transparent accounting and increased shareholder and member control over pension fund management.

Advances in the application of behaviouralism in psychology to finance have been used to inform this conception of agency. In examining risk management in its regulatory, political and social context the institutionalist literature has moved away from the focus on asymmetrics in information[4–7] However, the consequence is that this literature and also that examing the qualitative context within which quantitative risk management tools are implemented,[8,9] assesses the efficacy of risk management without putting forward a competing model of economic agency.

In contrast, financial sociology provides an examination of the function of risk management through a relational conception of economic agency.[10] The objective is to provide a conception of agency that can facilitate the provision of quantitative models informing understanding of the functioning of organisations. This framework proceeds with the set of principals and agents that is adopted within the financial economic framework. The two principals are shareholders and members. The two dedicated agents are the finance director and the board of trustees. The pension fund manager is the agent of both the finance director and the board of trustees.

In this framework, the two principals in pension provision (shareholders and members) have conflicting objectives. Shareholders want to reduce the contributions they make to the pension fund and thereby increase profits and dividends. Members want increased contributions to be made to the pension fund in order to improve the security of their benefits. Insofar as they work underneath the finance director within the sponsoring firm, the pension fund manager is the agent of shareholders, and insofar as they advise the board of trustees on funding and investment policy, the pension fund manager is also the agent of members. In other words, the pension fund manager works concurrently for two principals with conflicting objectives.

Precedents of this conception of economic agency are provided by sociologists such as Herbert Simon and Harrison White. Simon[11] (see also March and Simon[12]) conceives the entrepreneur as mediating between the opposing needs of customers and employees in establishing the firm. However, Simon largely ignores the professional and regulatory contexts in which the firm operates. White[13,14] provides a conception of markets in which there is feedback between the organisation and the environment within which the firm is embedded. White's perspective is drawn on here to examine the specific role played by financial accounting and its relationship to risk management practices in the context of financial institutions such as defined pension funds.

## THE NEED FOR A HISTORICAL PERSPECTIVE

In order to appreciate the conditions under which the pension fund manager is able to conduct this mediating activity and how this relates to risk management, there is the need for a broad historical perspective. The take-off in defined benefit pension provision is conditional on the pension fund manager having sufficient autonomy to invest and fund the pension fund in accordance with the conflict of these two principals. This is provided by opaque financial accounting techniques and discretionary actuarial valuation practices. The opacity of financial accounting in the 1950s and 1960s, associated with discretionary actuarial practice, provided the pension fund manager with sufficient autonomy to conduct his role.[15]

This environment for the setting of financial accounting was associated with a traditional style of pension fund risk management. The traditional style consists of utilising actuarial discretion to assign values to pension fund assets and liabilities. In this scenario, the pension fund manager manages risk by negotiating with the actuary with respect to the values that the actuary places on the assets and liabilities of the pension fund. In other words, a relatively conservative funding basis is used to determine the sponsor's contributions. In the case of a market downturn, the pension fund manager negotiates with the actuary the basis upon which values are assigned to pension fund assets and liabilities. A temporarily higher funding level is assigned, which is reversed once the market value of assets has regained its former levels. This is conditional on opacity in financial accounting.

Over the successive 40 years, increasing rigour and stringency in financial accounting have eroded the discretionary aspect of actuarial practice.[16] Standardisation of the process of assigning values to pension fund assets and liabilities reduces the scope for the exercise of discretion by accountants and actuaries and therefore also the ability of the pension fund manager to negotiate over the values assigned to the pension fund assets and liabilities. As the pension fund manager becomes less able to manage risk through the traditional risk management style, there is the need for a modern style of risk management associated with quantification to substitute the form of risk management that has been eliminated. The two risk management styles are antithetical. As there is greater emphasis on corporate governance and increasingly rigorous financial accounting, there is a decline in the traditional style of risk management and the rise of a modern style associated with the implementation of quantitative tools to assess the risk posed to portfolios from changing market conditions. Further, as there is a decline in the ability of the pension fund manager to manage risk, there is a centralisation of the risk management function to the office of the finance director and the chief risk officer within the sponsoring firm.

The sociological perspective on pension provision, described above, is applicable more broadly. The general outline of this conception of agency is the profit centre manager mediating between shareholders and customers. Insofar as financial accounting enables the profit centre manager to conduct this role, there is take-off in organisational forms such as the multidivisional firm, which took place in the UK and USA between 1950 and 1970. The introduction of fair value accounting is associated with the centralisation of decision making within firms, evident in the introduction of new practices relating to risk and chief risk officers within firms.

This research approach presents three implications for the understanding of risk management. First, it urges a focus on the long-term relationship between financial reporting and the evolution of risk management in order to understand the strategic significance of the emergence of risk management practices within firms.

Secondly, insofar as the role of the pension fund manager is to utilise ambiguity to mediate between shareholders and members, while the profit centre manager mediates between shareholders and customers, decentralisation of management practice remains a necessary requirement of the operation and management of firms. The standardisation of the processes by which values of assets and liabilities are determined entails that such mediation becomes less easily achievable by pension fund managers, profit centre managers and other liaising between the firm and its customers.

The conclusion is that seeking to achieve the objectives of good governance may conflict with the objectives of achieving the management goals of decentralisation. Indeed, work examining the qualitative issues relating to the integration of risk management practices within firms can be viewed as engaging with the difficulties that are presented for firms seeking to achieve decentralisation while the impetus from the corporate governance perspective leads to centralisation of management. That is, in contrast to the financial economic perspective which presents management and governance as complementary objectives in pension fund management, the sociological perspective presents the disturbing possibility that governance and management are antithetical objectives. This model explains the phenomenon in UK pension provision, in which initiatives at improving governance lead to the closure of those organisations attempting to improve their governance practices.

Thirdly, there are macro consequences for such standardising away of the agency of those working within firms. One important consequence is that the financial system is less flexible than it was previously. The emergence of new risk management techniques may contribute to an increasingly brittle financial system that renders inadequate the responses of central banks to the economic challenges facing policy makers today.[17]

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