



Institute  
and Faculty  
of Actuaries

## Integrated Risk Management Working Party

Tim Keogh/Stuart Faloon

October 2015



## Integrated Risk Management for DB Pension Schemes Working Party

### Scope:

“The Pensions Regulator’s latest Code of Practice includes guidance to trustees on integrated risk management techniques i.e. ways of assessing the three keys risks relating to defined benefit pension schemes – funding, investment and covenant – and creating a framework for the management of these risks.

The concept of risk management is very familiar to members of the IFoA and the expertise that members have in this area means that the IFoA can make a significant contribution to this debate, and potentially lead the way in establishing risk management models that would be helpful to pension scheme trustees and sponsors”.

### Target output:

Presentation to Pensions Conference summer 2016

## Session purpose

- To identify the needs of actuaries in regard to IRM work for DB pension schemes
- To provide a first cut of the working party's assessment of its potential activity in this area
- To extend the working party's understanding of solutions
- To encourage actuaries (in all roles) to grasp the opportunities presented by ERM/IRM

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## What we think actuaries can offer

- Identification of the key questions to which sponsors/trustees need answers
  - What are the important risks?
- Tools/techniques to provide those answers
- Assistance with governance around responding to the answers
  - Appropriate structures
  - Wise counsel on decisions
  - Documentation of decisions
  - Justification of decisions
- Understanding that an unsatisfactory compromise may be the best which can be achieved
- Reconciliation between short term metrics and long term goals

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## Specific issues to address

- Effective communication and understanding
- How to identify and document risk capacity/appetites of the parties in the interests of sound management
- Quantitative assessment of overall risk across funding, investment and covenant
- How this risk is allocated to sponsor investors (debt/equity) and members and any other stakeholders (e.g. PPF)
- How to develop appropriate objectives, risk distribution(s), capital structures and long term plans/goals
- Appropriate internal monitoring tools and options to respond to changes (favourable and unfavourable)
- Integrating sponsor and trustee analyses to effectively meet the needs of both parties without duplication/unnecessary conflict
- Appropriate external disclosures to shareholders/members/regulators, in the light of FRC requirements/expectations

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## Short term vs long term A problem or the actuary's USP?

### What happens?

- Investment risk measured by 1 year VaR
- But what matters is long term delivery
- Covenant reviews often based on sense-checking short term business plans

### What matters?

- Paying the benefits!
- Survival (trustee)/ success (shareholder) of the sponsor
- Long term success/risks of investment strategy editing out noise
- Sustainability of covenant over business cycle relative to pension exposure

### But

- Stakeholders have to be kept on side and may have short term horizons
- Off-market valuations lack credibility

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## Regulatory perspectives

### TPR

- Expects IRM to be at centre of scheme financial management
- Part 3 morphing into IRM framework (with EU support?)
- Sets principles but [can't/won't/shouldn't] define how to do it
- Neutral on which profession leads

### FRC – new listed company requirements from 2015 year-end R&A

- Principal risks & uncertainties:
- Robust assessment: stress and scenario tests
- Reverse stress tests
- Long term viability statement: 3 to 5 years worth of risk

### Others (charities, government, etc)

- Typically advocating similar models

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## Past contributions from the profession

2001	Pensions, Funding and Risk (Chapman, Gordon & Speed)	Pension scheme funding in the context of shareholder value
2010	Risk Management for DB pension funds (Hatchett, Bowie, Forrester)	Applying some ERM lessons to the management of DB pension schemes in the UK
2011	Entity-wide risk management for pension funds (Kemp&Patel)	Applying ERM philosophy to schemes
2012	PPF financial management	Detailed case study of application of ERM principles
2013	Valuing sponsor support* (PwC)	Covenant adviser's approach to the valuation problem
2013	Market-Consistent Valuation of a Defined Benefit Pension Fund's Employer Covenant and its use in Risk-Based Capital Assessment *(B&H)	Theoretical valuation of covenant

\*These papers were prepared to support IORP2 research. You don't have to believe in IORP2 to find them useful!

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# Tools menu

## Analyse

- ALM
- Investment/covenant scenarios
- Sponsor cashflow potential
- Sponsor credit rating
- Benchmarking/surveys

## Plan

- Rightsize risk allocation
- Journey plans
- Agreed trigger actions
- Contingency plans/fire drills

## Govern

- SFP/SIP
- Deeds of agreement
- Risk registers (?)
- PPF model framework

## Monitor

- Dashboards
  - Funding/investment
  - Business performance
  - Gearing/credit rating
- Metrics connecting these

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# Covenant/funding interaction is key Example

- Business value vs stressed deficit
- Simple ex-pensions covenant valuation per 2013 paper

Phase of the demise curve	Covenant strength	Business value	Covenant valuation methodology – maximum value of sponsor covenant	Covenant valuation methodology – minimum value of sponsor covenant
Comfort	Strong or tending to strong	High	High level market multiples approach	Balance sheet insolvency analysis
Concern	Tending to Weak		Refined market multiples approach, DCF	Balance sheet insolvency analysis
Crisis	Weak		Refined market multiples approach, DCF	Balance sheet insolvency analysis
Insolvency	None	Low	Balance sheet insolvency analysis	Balance sheet insolvency analysis

- Trustees need risk to stay low
- Sponsor has range of options

- Too much risk for everyone
- What's the best balance?

Source: Valuing Sponsor Support (2013)

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**Questions**

**Comments**

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## **Time to vote**

- You have 5 votes
- Feel free to add additional items and/or comments

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## And the WP's risk management

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## References

### Pensions, Funding and Risk

<http://www.actuaries.org.uk/research-and-resources/documents/pensions-funding-and-risk>

### Risk Management for DB Pension Funds

[http://sias.org.uk/resources/papers/?resource\\_id=424&type=papers](http://sias.org.uk/resources/papers/?resource_id=424&type=papers)

### Entity-wide risk management for pension funds

Paper - <http://www.actuaries.org.uk/research-and-resources/documents/entity-wide-risk-management-pension-funds>

Slides - <http://www.actuaries.org.uk/research-and-resources/documents/sessional-research-event-entity-wide-risk-management-pension-funds>

### Financial management of the UK Pension Protection Fund

<http://www.actuaries.org.uk/research-and-resources/documents/financial-management-uk-pensions-protection-fund>

### Valuing sponsor support

Paper - <http://www.actuaries.org.uk/research-and-resources/documents/valuing-sponsor-support>

Slides - <http://www.actuaries.org.uk/research-and-resources/documents/sessional-research-event-holistic-balance-sheet-and-employer-covenant>

### Market-Consistent Valuation of a Defined Benefit Pension Fund's Employer Covenant and its use in Risk-Based Capital Assessment

Paper - <http://www.actuaries.org.uk/research-and-resources/documents/market-consistent-valuation-defined-benefit-pension-fund%E2%80%99s-employer-covenant>

Slides - <http://www.actuaries.org.uk/research-and-resources/documents/sessional-research-event-holistic-balance-sheet-and-employer-covenant>

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