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Risk Management for Pension Schemes

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Corporate perspective of pension promises has changed

- **Why**
  - Solvency problems (equity markets, interest rates, longevity trends, more prescription)
  - Immediate recognition under FRS17
  - Contribution holidays now history
  - Removal of walk away option; greater trustee power
  - New Regulator powers to stop sponsors avoiding DB pension liabilities
  - End game in sight for many schemes and risk management a key issue
- **Evidenced by**
  - Greater corporate engagement in funding and investment strategy discussions
  - Corporate finance solutions being applied to pensions, eg:-
    - M&S and GM issuing pension bonds
    - ICI ring-fencing receivables
  - Pensions prominent in corporate transactions, eg WH Smith, M&S, Allied Domecq
  - Ratings agencies and analysts more alert to pensions issues
  - Pensions Regulator on a mission to make pension trustees act like major creditors
  - Investment banks very active with new products to manage pension risks

Pensions are affecting corporate decision making

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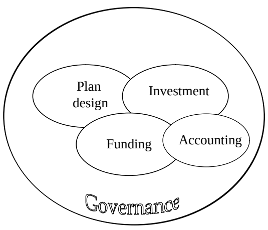
Sponsor reaction



Strength of value proposition lies on effectiveness of:

- Plan design
- Financial efficiency of contribution and investment strategies
- Corporate risk management
- Good governance

Focus on cost and risk control: minimum compliance or root and branch review?

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Risk and cost control

- Finance Act 2004: opportunities for risk reduction
- Other step changes for cost control, risk control and better alignment with changing needs
- More radical changes for future accruals

Many alternatives

- Reduce holdings in risky assets
- Reduce mismatches
- Hedge exposures
- Buy out liabilities
- Remove discretionary benefits
- Freeze pensionable earnings
- Increase employee contributions
- Close scheme to new entrants
- Close scheme to future accruals

But many factors to consider,
not least trustee power and member reaction

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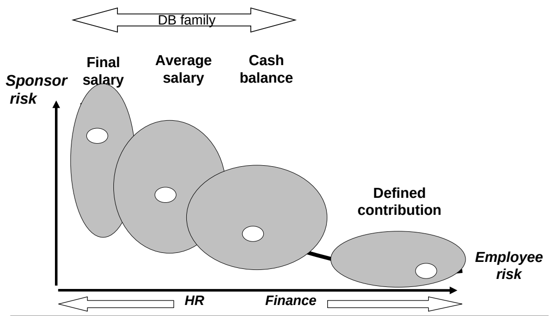
Plan design risk from both perspectives



Fundamental objective probably unchanged but risk is central focus and balance between employees' and sponsors' needs re-assessment

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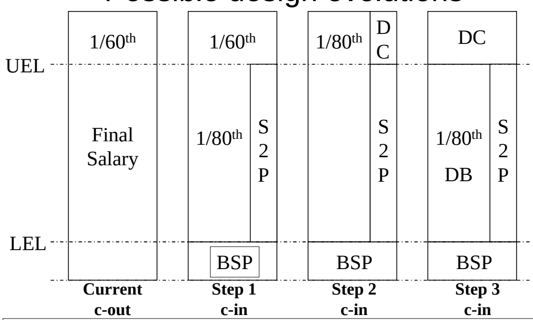
Possible design evolutions



Address varying needs of members and consider pension in wider total reward context

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Running off past promises

Managing the legacy better

In closed or mature schemes ….

Some generic risks acquire greater importance:

- Liquidity and cash flows
- Duration and credit risks
- Impact of liability options
- Matching
- Discontinuance
- Volatility from demographic assumptions

Liability risks assume greater significance for both trustees and sponsor

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Managing the gap

- Limited opportunity to re-shape past benefits
- Review controls over member options and discretionary practices
- Pay modest premiums to remove some liability risks
- Extra funding – direct or indirect
- Reduce volatility from pension risk
  - Strategic buy-outs to reduce gearing
  - Better matching of risk

Assets and liabilities more joined up; pension risk viewed as a component of corporate risk

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Investment issues

- Most companies recognise that they are strategically overweight in equities; but changing now would lock in some of the deficit
- Looking to de-risk gradually and at the same time squeeze additional returns from alternative assets.
- Derivatives can be used to change risk exposure and manage downside (at expense of upside potential); more training and education needed for trustees
- Risk budgeting and VaR techniques more prevalent in short term.

Paying for deficits through a combination of contributions and return seeking assets

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Funding and solvency

Managing cash flows under risk and security constraints

The funding issues

- The time horizon.
- Significance of buy out liabilities
- Matching assets and liabilities: Is investment in equities justified?
- Is it reasonable to plan on the basis that equities will outperform bonds?
- How relevant are short term measures eg FRS17? Is 'smoothing' justified?
- A minimum target to avoid risk based PPF levies?
- Transfer values!
- SFP: more discussions and negotiation; employer covenant issues; conflicts; greater trustee powers

Makes more sense to integrate funding and investment decisions?

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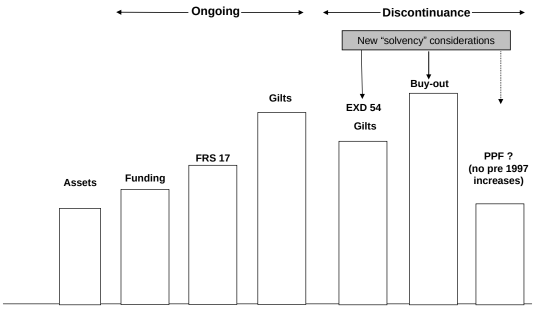
Possible funding targets



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Multiple & dynamic funding targets?

Start with	→	**"Ongoing" funding strategy**	←	*Sponsor support assumed*
Underpin with	→	**100% PPF cover**	←	*To avoid risk-based levy*
Aim for	→	**Discontinuance cover at desired horizon**	←	*Self-sufficiency from Sponsor*

Valuation will need to illustrate the interaction between these different measures, investment policy and sponsor's risk metrics

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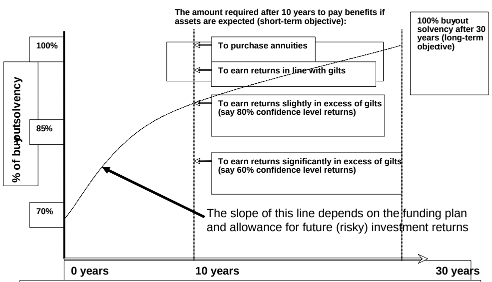
Funding road map



Coherent linkage of funding, solvency and investment principles with sponsor's risk management strategy

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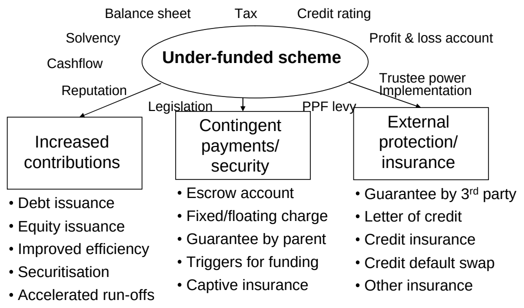
Filling the void: addressing deficits and security



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Takeaways

- Expect to see a greater variety of plan designs in future; more risk sharing but company/member pension deal must be clearly communicated
- Expect greater matching of assets and liabilities, reduction in equity exposures and greater use of alternative investments and structured products
- Risk management principles used in financial services industry expected to become more prevalent; pension scheme seen as an extension of the balance sheet and managed as a complicated financial instrument.
- Funding and investment decisions may be rolled together; deficit run-off plans will be negotiated much harder.
- Greater use of contingent funding vehicles for better capital management / better security
- Pension debt will continue to influence corporate activity: corporate structure; dividend policy; credit ratings; cash flow management; M&A

Corporate actuary: future role?

- Helping to make sense of short and long term uncertainty.
- USP: Doing liabilities better
- Need to acquire new skills
- Learn to communicate differently
- Live alongside investment bankers, corporate financiers and insolvency practitioners, risk and treasury officials.
- Work from traditional consultancy?