

## FEATURE

**GOVERNANCE MODELS** Pension consultants' roles and client relationships are changing, explains Zuhair Mohammed, as they gear up to deliver an alternative approach to risk management

# An agile approach



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**B**lue-sky thinking. Brainstorming. Martian landscapes. Three expressions that have one thing in common. They describe a very important process for everyone involved in financing a pension scheme.

It pays to step away from your day-to-day activities from time to time and reconsider the route you have chosen, as well as your mode of transport. It is too easy – and risky – to wait for something to go wrong and then start criticising the way things are done. The more constructive approach is to define your aspirations and outline a process or business model that could deliver these goals. The final, but equally important step is to consider the practicalities of moving from the existing process to a new one and identify any potential barriers to a successful transition.

It is unrealistic to expect a new process to work without fault first time. You must also be prepared to look up again at periodic intervals and refine your plan as events unfold.

## Defining aspirations

Now that the majority of pension schemes are closed to new entrants and therefore represented by a declining population of active members, it is not surprising that more and more sponsoring employers are considering offloading their pension risks to a third party at a reasonable price.

Whether companies intend to sell their pension scheme or continue to manage it in-house, the delicate balance between the employer's desire to minimise cash



Schemes that embrace flexibility could see their governance models improve in leaps and bounds

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injections to pension schemes and trustees' anxiety to guard against any unpleasant surprises remains the same. It takes a smart approach to risk management to satisfy both requirements.

Like every other financial instrument, pension schemes are exposed to economic cycles and opportunities arise and fall away over time. The smart approach depends on a combination of locking in profits wherever possible and closing out risks at opportune moments.

To achieve maximum value, flexibility and the ability to move swiftly are essential. Because the supply and demand factors driving mortality, interest, inflation and equity risk protection are largely uncorrelated, it is in the scheme's best interest to lay off these risks separately, timing each to make the most of market conditions.

This approach neatly sidesteps one of the limitations of traditional insurance buyout policies, where all the risks are simultaneously transferred to the insurer at the same time.

## Constructing an exit strategy

For those planning to offload their pension obligations, it is in the interests of both the trustees and the employer to investigate and construct an 'exit strategy' and agree an achievable timescale. Clearly this requires the setting of a full funding target on a 'fair price' actuarial basis by the end of an agreed period. But how do we construct a fair price basis?

One way is to consider what is the smallest sum a rational long-term investor would require to pay all the benefits. An alternative method can be constructed by

referring to the insurance buyout industry, starting with the insurance buyout costs and then deducting the cost of regulatory margin reserves as well as factoring in an estimate of the insurance company's own profit margin.

Whichever method is used, this can be described as the 'self-sufficiency' basis, and its strength will vary according to individual circumstances. Major factors will include the maturity of the pension scheme, the security of employer contributions and demographic expectations for the pension scheme membership.

Having determined your destination and timescale, the next step is to make sure your funding levels measure up.

### The path to improved funding

There are a limited number of ways of improving your funding position. Generally, the two most material being employers' contributions and investment return (for mature industries, investment returns can often far outweigh employer contributions).

Negotiating feasible contribution strategies with employers is becoming an increasingly important part of the trustee role. However, agreeing a new longer-term self-sufficiency funding objective does not necessarily mean that the existing contributions must go up, particularly as, in most cases, trustees will presumably have already negotiated a contribution strategy to fund any existing deficits.

If the current employer contributions cannot deliver success within the agreed timescale, it may be necessary to turn to the investment policy to fill the self-sufficiency funding gap. Clearly the investment policy has to operate within achievable bounds. For example, it would be foolhardy for a poorly funded pension scheme to adopt ever-increasing investment risks in order to meet an unrealistic funding goal. In this case it would be wiser to recalibrate either funding expectations or the employer's contributions – an approach which, based on guidelines issued to date, would win the support of the Pensions Regulator.

## KEY FACTS

### Methods of improving a funding position:

- Employer contributions
- Investment return

### Real-time risk assessments

As soon as this funding review is complete, it is time to move towards a more agile approach to governance – with the launch of a real-time financial health monitor capturing asset and liability movements, as well as undertaking real-time assessments of all the risks your pension scheme faces.

Such assessments can be broken into three stages:

- identify all the risks that may prevent you from achieving success;
- quantify those risks, as well as the rewards that a rational long-term investor would expect in return for holding each risk. (In practice this stage involves assessing the fair value of risks currently held by the pension scheme and those that could reasonably be held within it and identifying any opportunities to improve the balance);
- take actions to retain, reduce, combine or remove these risks to ensure that they are in line with your defined levels of risk tolerance.

Real-time monitoring is an essential tool for identifying the best time to act – and acting swiftly. When, for instance, the financial position of the pension scheme exceeds your expectations, your risk consultant will have the information he or she needs to reduce or remove the risks that are most favourably priced at that point in time and, much like a traditional rebalancing investment manager, retain a risk (and associated reward) that is rebalanced just enough to achieve the self sufficiency objective.

For example, at the end of June, pension scheme funding should have improved, creating an opportunity to lock in some gains. However, the cost of inflation protection increased almost simultaneously. Under these circumstances, the sale of equities and/or interest rate protection was the most effective way of reducing overall risk.

### Making it achievable

This process is a far cry from the environment where lay trustees discuss narrow objectives based on an existing funding metric, and are presented with annual or tri-annual actuarial valuations and

quarterly investment reports showing returns benchmarked against a generic investment index.

The first steps of our ideal process are achievable under the existing model with the assistance of a risk consultant, and a willingness from both trustees and the company to step away from the existing routine and commit to a programme of training in this area. However, few trustee boards would be capable of the second step: supporting real-time identification, pricing and action decisions in relation to investments and other risks. Trustees therefore have a choice between increasing their in-house governance capacity and outsourcing risk management to their advisers.

One solution is delegated, or implemented consulting, which offers trustees a mechanism to outsource real-time investment decisions to experts. This kind of service goes beyond the traditional manager concept and includes advice on investment risk management tools such as interest and inflation swaps and views on the outlook for risk (and associated return) for different investment opportunities. The linking of fees to delivery success offers an effective way of aligning the interests of the adviser with those of the trustees.

Such models are particularly attractive for pension schemes with limited in-house capabilities. For larger schemes, the adviser may work with a small subset of trustees who can commit to meetings at short notice to make investment decisions. Here the decisions are retained by the trustees, but the time delay between proposal and implementation is significantly reduced.

As the burden on trustees and employers continues to increase, this model opens up an important opportunity to improve the governance framework for pension schemes and keep abreast of latest market developments. **PM**

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