

Issue 63: Managing Risk in Pension Schemes

Bad news on financial positions of schemes has created an incentive to focus on risks

Until quite recently the sponsors, trustees and members of most UK pension schemes have faced years of unremitting bad news relating to the financial position of the scheme. This has created financing problems for employers, difficult decisions for trustees and uncertainty over benefits (and in some sad cases, loss of benefits) for members.

Unsurprisingly, this has led to a much greater focus on the risks being run by pension schemes and the potential to manage those risks more effectively.

But cost pressures created a disincentive to implement a risk reduction strategy

The problem has been the symmetry involved in reducing risk – ie. reducing the potential downside usually means also reducing the potential upside. For example, many schemes have been financed on the assumption that equity investments outperform bonds over the long-term. Reducing risk by reducing equity investments leads to a lower expected asset return and hence a higher expected cost. At a time of significant financial pressure on schemes this has meant that a risk reduction strategy is painful to implement for sponsors as it may result in further increases in cash and accounting costs – a significant disincentive.

Has all this changed?

Even allowing for the recent falls in the equity markets, the last year has seen a significant improvement in the assessed financial position of the typical pension scheme. This has been because of rising bond yields (which reduce the assessed value of the liabilities) as well as rising equity markets. It is likely that this will be partially offset through recognition of the greater than anticipated rate of improvement in life expectancy – illustrating that the risks associated with pension schemes are not just about the investment strategy. Nevertheless, the net improvement in the financial position of schemes potentially makes the option of reducing risk more palatable.

Developing a risk reduction strategy

So how do you go about developing a strategy for risk reduction? The first step is to establish where you want to end up. At one extreme the objective might be to remove all exposure to pension risk – which leads you to a buy out. A less extreme approach might be to structure arrangements so that the potential volatility of the company accounting position is limited to a certain level – similar approaches can be constructed around different funding measures.

In essence, all such approaches start from considering a trade-off between how much potential bad news you are prepared to accept, versus how much potential good news you are prepared to give up (with expected higher costs as a result). This is a difficult assessment to make but without doing so you don't really have a risk management strategy. In the old cliché – if you don't know where you're going you probably won't get there.

There seems to be a common misconception that risk management is simply about removing risks through investing in bonds, or similar matching assets, and ultimately buying out. The reality is more sophisticated than that. The objective is to manage risks not simply to remove them. Any business is about taking risks – the judgement is in controlling how much risk is taken and where, in order to maximise the expected benefit associated with a particular level of risk. So for example, it may well be a valid strategy to accept some level of risk associated with equity investment, because the expected returns justify it. Leaving aside conscious tactical decisions, it is likely to be much more difficult to justify holding a portfolio of bonds that do not match a scheme's liabilities – that increases risk but with little or no corresponding expected benefit.

As noted above, when considering risk management, it is important not to forget the liability side. Does the scheme provide complex benefits, the costs of which are difficult to predict? If so, is there a “win-win” scenario where members can be offered the option of alternative benefits that are more predictable and so less expensive to provide (taking account of the cost of risk protection) but with a greater value to the member? An obvious example would be the swap of a complex pension increase structure for simple, or no, increases – but a high starting pension.

Enhancing transfer values can also be a useful option. There has been a lot of negative publicity about such exercises, but provided they are well run and the options and potential impacts properly communicated they give members a valuable option. After all, no-one complains about members taking “normal” transfer values – so why is giving members the option to take something better than this a bad thing?

Going back to achieving a desired end point, risks can be assessed against this and broadly categorised in one of three ways:

- Retain – the risk is appropriately rewarded
- Reduce – this is not a risk to be eliminated but the exposure to it is too great and should be reduced
- Remove – this risk is not appropriately rewarded and should be removed.

When talking about a risk being rewarded above, that reward can come in two forms. The first and obvious form is a benefit from taking it – e.g. the expected higher return on equities rewarding the associated risk. The other form of reward is avoidance of the cost and complications of removing the risk. An example of this might be exposure to longevity risk where it is difficult and expensive to reduce or remove exposure to this risk (although the market is developing rapidly and so this is potentially changing).

Having understood the objective and categorised risks, a strategy can then be developed to achieve the desired outcome.

Finally – returning to being clear with regard to your objectives, there is a lot of comment at present around potential “stranded surplus”. Any such potential surplus needs to be considered against the desired risk management strategy. If you have a “stranded surplus” but your risk exposure is higher than desired, what you have is an opportunity to reduce risk, not a stranded surplus problem.

For a paper giving more detail of the options available to help companies and trustees manage the risks associated with pensions schemes please talk to your usual Hewitt contact, or alternatively David Bush (david.bush.2@hewitt.com) or +44 (0)1727 888227.

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