

Issue 70: Making sense of Risk?

It seems difficult to open the pensions press now without seeing the words Risk or Risk Management. Attitudes to financing and investment seem to be changing substantially for many schemes, leading to a greater emphasis on risk techniques. Why is this, what are the new techniques and tools and how can trustees and sponsors make best use of them? With so many solutions being offered, how do you sort out what is in your interests rather than those of the salesman?

The emergence of risk evaluation and risk management techniques stems from some fundamental changes in corporate attitudes towards pension schemes in the past few years. The scars brought by repeatedly trying to deal with burgeoning deficits, negotiating deals with trustees, getting pensions to be subsidiary to corporate deals rather than centre stage or even deal breakers, has led many sponsors to want to have greater control over pension risks. Many would, to be blunt, want out, if the price were right. Their change in attitude affects all aspects of how they view their plan and the associated financing and investment policy. The table below highlights the change in *corporate* attitudes:

	Yesterday	Tomorrow
Benefit	Ongoing, open final salary scheme	DB scheme closed to new entrants and existing members
Corporate attitude	Employee benefit	Corporate debt
Ownership of issue	HR Director	Finance Director
Contribution policy	Pay in minimum	Pay off eventual deficit
Investment objectives	Minimise cost (Maximise return)	Minimise (unrewarded) risk
Performance benchmark	Market benchmark	Liability benchmark
Investment timeframe	Long-term view	Short-term view
Recognition	Smoothed cost recognition	Little to no smoothing
Funding goals	Ongoing, accounting	Solvency, self-sufficiency
Investment style	Pack mentality	Customised solutions
Assets held	Traditional investments – (long) equities and bonds	Swaps + alternative investments + unconstrained equity mandates

Risk management techniques are not just about exit strategies however. Even for schemes which are continuing with final salary accrual, sponsors want to understand, quantify and manage the risks, given how large pension assets and liabilities can be. Risk measurement and management techniques start from the fundamental position that pension liabilities are a bond-like series of future payments – the financial economists and accountants have convinced us that our liabilities are like bonds – yet very few plans invest wholly in bonds because of the cost this would give. Herein lies one of the fundamental dilemmas – risk mitigation techniques address this issue.

Quantifying the risks associated with the operation of a pension plan will often start by talking about overall objectives, and then move rapidly to quantifying the level of risk that can be tolerated - the so-called risk budget. Phrases like “Value at Risk” will be bandied around – the financial impact of bad outcomes. A word of warning – Value at Risk is not a uniquely or well defined phrase – there can be as many variations of it as there are measures of pension scheme funding! The basic idea is simple – how much bad news can you – the sponsor or the trustee – “afford” and then how do we arrange matters to ensure that the outcomes fall inside this limit? Bad news might be sudden cash calls for contributions, deterioration in funding levels that have to be disclosed to members, or an adverse impact on corporate balance sheets and earnings numbers.

To manage against whatever you agree as your risk budget you can look at assets, or liabilities – or better still look at both in the context of your overall objectives. Changes on the asset side are now becoming more mainstream – LDI tactics are used to take away interest rate and inflation risks, and then the scheme charges off in search of alpha and multiple sources of uncorrelated beta. But is hedging out interest and inflation risk always a sensible thing to do? Many of those who have a vested interest in persuading you to execute a swap programme will argue that these are “unrewarded risks” that cost you nothing to remove. But to remove or reduce a risk you usually have to pay a price. In the case of these risks, the price could mean locking into unfavourable long term interest rate or inflation exposures. You might well insure your house – but you wouldn’t take out insurance regardless of the price, and hedging these risks is no different. Your adviser should be able to give a view on WHEN is the right time to hedge interest rate and inflation exposures – or equivalently the price to pay.

New techniques to “manage” liabilities are emerging with frightening frequency. Enhanced transfer exercises are set to explode, and Members can be offered the chance to restructure their benefits in a way that may suit them – and make the revised benefits more amenable to risk based approaches.

Managing assets and liabilities in isolation is not enough. Every week seems to see either a new buy out provider – insurance based or a capital markets player – or a new form of longevity protection (mortality swaps, and traded mortality securities). There are multiple new types of insurance – insurance against the sponsor defaulting on contributions, guarantees on 10 year contributions, credit default swaps and so forth. As if that wasn’t enough there are new concepts like parallel funding, the use of contingent assets and the like. Enough!

The number of possible solutions to deal with risk, to get the best value from taking risks, or to mitigate risk, has exploded- and all it seems in an incredibly short period of time. More than ever, clients need a trusted adviser who can steer them through this maze, help them map out a flightpath that will get them to their objectives and make sure that they are dealing with the right risks, in the right way, at the right time, and at a sensible price.

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