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SPOTLIGHT

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Pension Risk – Managed

With the increasing focus on pension risk, and an increasing range of solutions entering the market, it is time to take a fresh look at risk management in your defined benefit scheme. To make the most of the opportunities that exist, trustees and sponsors should have a clearly defined and *appropriate* risk strategy.

For some schemes reducing or removing risks will be a focus. For others retaining or even raising their level of risk will be appropriate. Before deciding upon a course of action it is important to be clear on both your short and long term objectives and constraints. Where risk is taken the focus should be on taking the right types of risks – the ones for which you are suitably rewarded.

How much risk can you take?
Managing risk is central to many pension scheme decisions, from investment strategy to funding policy. Without having a clear idea of the risks currently being run, and the level of risk acceptable to all parties, it can be difficult to reach the best decisions on these matters.

A key issue is the relative sizes of the sponsor and the scheme. Generally, the larger the employer is relative to the scheme, the greater the supportable pension risk. Conversely where the sponsor is dwarfed by the pension scheme it may be that little pension risks can be supported at all. A variety of other factors will impact the acceptable level of risk, for example corporate structure, future business plans, expected cashflows or levels of discretionary benefits within the scheme. Your circumstances will lead to your own conclusions on this fundamental decision.

Where are you heading?
We believe it is important for all parties to have a clear idea of the long term future for the scheme.

This can range from running the scheme indefinitely to securing a full insurance company buyout in the short-term. Many schemes have already started on the journey to their ultimate termination, even if they haven't decided the route yet. For example, if you have already closed your scheme to new entrants, is buyout now inevitable at some point even if it is many years away?

Even where the aim is to run the scheme indefinitely, it is important to have a clear strategy on the level of risk that can be taken. Some key considerations include how much risk you can afford to remove in the short term and how you expect the relative sizes of the sponsor and scheme to change in the future. If the scheme is expected to increase in size relative to the sponsor, achieving a low level of the risk in the future will be important. But how can you do this without increasing costs? You should make sure you maximise your return (reward) for the level of risk you are taking. For some it may be appropriate to take more risk now, while it is acceptable, in order to get to a higher level of funding from which they can de-risk. Alternatively, if your scheme is expected to reduce in size relative to the sponsor in the future, you may have more flexibility than you think with regard to acceptable risk.

If your overall aim is to reduce risk, which risks are you trying to eliminate? Is it short term volatility resulting from investment shocks? Or is it differences in the long term cost that may only become truly apparent over the next 30-50 years as a result of members living for longer than currently predicted? Different risks can be tackled in different ways and clear advice is needed to ensure you tackle them in the most effective manner. For example, if your main concern is short term volatility, tackling mortality risk while still heavily invested in volatile return seeking assets may not make sense.

How quickly do you wish to arrive?
The quicker you wish to reduce the pension scheme risk, the higher the short-term cost hurdle could be.

Seeking to reduce pension risk immediately - by buying out some of the liabilities for example - is likely to require a significant cash payment from the sponsor. Conversely, taking a higher level of risk in the short term - a controlled change to investment strategy for example - could set you on target to reduce risk in the medium term with an improved funding position. This is only true of course, as long as you are rewarded for the short-term risks you take.

Many people approach this issue by considering cost first. *However we believe that it is vital to formulate an appropriate risk strategy taking into account the context in which the scheme sits.* Then you can take your risks in as efficient a way as possible, to ensure you minimise the costs and maximise the potential gains.

Developing a "flight plan"
Taking your views on acceptable risk (now and in the future), the agreed destination, and timing together gives you a flight plan for managing your pension risk. The next steps are to translate this into reality, and to ensure you are taking your risks in the most efficient manner. We will talk about this more in a later Spotlight.

In summary
Risk and cost in relation to pension scheme funding are linked, and at a simplistic level removal of risk is normally associated with an increase in long term costs. So sponsors and trustees need to consider carefully the level of risks which are acceptable in both the short and long term, to steer a sensible cost effective course towards their chosen long term solution.

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