

**Pensions Week garners** the opinions of four risk experts to gauge the market's opinion on the various approaches to derisking and what they believe funds are keen to implement in the current climate

# TALKING HEADS



**David McCourt**  
Policy adviser: investment and governance  
National Association of Pension Funds

- 1** What are the biggest risks pension funds should hedge against today?
- 2** Have funds got the message that contingent assets are safe yet?
- 3** Where is the impetus to derisk primarily coming from, the scheme or the sponsor?
- 4** Have concerns about longevity taken a back seat during this economic crisis? What are the risks of ignoring it?

**1** Weakening of the employer covenant risk is probably the major risk facing UK pension schemes, but there is no obvious hedge against the sponsor being unable to support the scheme in the future. Increased longevity and (notwithstanding the current deflationary climate) rising future inflation are two risk elements that defined benefit (DB) pension schemes should consider hedging against given a suitable mechanism to do so.

**2** The 2008 NAPF annual survey reported that the use of contingent assets by UK DB schemes is not widespread. 85% of schemes surveyed said they had no contingent assets in place, while 89% said they had not yet considered their use. As around 25% of UK DB schemes are due to undertake an actuarial valuation during 2009, the profile and use of contingent assets may be on the increase as an alternative to further cash calls on the scheme sponsor.

**3** If trustees and scheme sponsors have a shared interest in maintaining existing DB pension provision, the identification and management of key risks will be an integral part of the ongoing dialogue between them. As such the NAPF suggests it is the end result rather than the starting point/impetus for such discussion which is most important.

**4** The economic crisis has clearly brought home the impact of volatile investment markets with regard to falling asset values and potentially rising scheme deficits, but trustees, scheme sponsors and their advisers should continue to focus their attention on all the risks facing their schemes, not just short-term market instability. However, addressing the issue of increased longevity should not be a short-term fix but part of a long-term derisking strategy to be reviewed through each funding valuation cycle.



**Emma Watkins**  
Head of relationship management  
MetLife Assurance

**1** While schemes face a number of serious risks in the current economic climate, the decision to hedge any of those risks requires a discussion between trustees and corporate sponsors about the appetite and ability to continue to fund pension benefits, regardless of asset performance or longevity. The sustainability of the employer covenant is one of the key risks that pension schemes should be considering.

**2** Trustees and their sponsors may turn to contingent assets as an alternative method of providing additional security for members' benefits, without the potential risk of locking in cash that could be reinvested in the business. However, the safety of such assets will depend on the terms and conditions agreed as part of the negotiations between the trustees and employer. Trustees may gain some comfort from the recognition the Pension Protection Fund gives certain contingent assets when calculating its levy.

**3** MetLife Assurance research shows the impetus to derisk is primarily being driven by trustees. It found that the majority (76%) of finance directors at companies with defined benefit schemes are not currently considering a derisking strategy. That's a significant disconnect from further research, which found almost half (44%) of trustees are now more interested in transferring risk as a result of the turmoil.

**4** Trustees are clearly worried about longevity risk, but with the recent volatility in financial markets, it could be taking a back seat to more pressing concerns. However, ignoring longevity risk could have significant implications for schemes, and paying less attention to it does not reconcile with demographic trends. As people live longer, scheme sponsors must evaluate the effects an ageing workforce and increasing employee/retiree longevity have on pension costs, and then decide how best to ensure adequate cash flows for each additional year members receive benefits.



**David Ellis**  
Principal  
Mercer

**1** It's helpful to think of risks as falling into two categories – unrewarded (those that affect the liabilities) and rewarded (those that affect only the assets). This is helpful because while some pension funds will now be looking to reduce rewarded risk at an affordable price, there is an argument that all should be looking to reduce unrewarded risks. Examples of unrewarded risk are longevity, interest rate and inflation risk.

**2** Most schemes are reliant on the covenant of the sponsoring employer and so in effect should treat this as a contingent asset. The question then becomes the extent to which this can be made safer by contractual paperwork with perhaps the creation of a charge over corporate assets given certain circumstances. The use of contingent assets is certainly on the increase, as is the variety of types of agreement.

**3** Both parties. Typically sponsors are initiating discussion around the pros and cons of large scale derisking; trustees are considering ways to maximise the likelihood (for an acceptable cost) that members receive all their benefits on a timely basis. This balance is to be expected because large scale derisking is likely to have a significant impact on long-term expected cash costs. There is plenty of common ground.

**4** Trustees and sponsors are focusing on funding and investment issues, and longevity is usually a key part of this. The key risk of ignoring it is that the trustees and sponsor might then target the wrong amount of assets to back the liabilities. Unexpected future enhancements in life expectancy or an unanticipated pattern of deaths could lead to higher than expected costs. However, the market for transferring longevity risk is new and untested, and being the first entrant into a new market of course brings its own risks.



**Andy Reed**  
Director, defined benefit solutions  
Prudential

**1** Clearly the current financial market turmoil has heightened the focus on investment risks. Longevity risk remains a key issue, while sponsor covenant is increasing as a concern due to perceived increased uncertainty of long-term sponsor survival. An additional risk for pension funds to consider is selecting the right provider for insured solutions. The long-term outlook/security of insurers is a matter of great importance when choosing a long-term solution, such as bulk annuities.

**2** This will vary for each scheme based on their specific situation. However, it's quite conceivable that in the current climate, such arrangements will be under scrutiny to ensure they provide the agreed level of security. Additionally, with the current scarcity of corporate cash, combined with depressed scheme funding levels, it's likely that sponsoring employers will regard non-cash assets as the only viable deal to be made with trustees.

**3** In short, both. Trustees are looking to significantly reduce their exposure to risks of insufficient funding to provide accrued benefits, while sponsors are seeking ways to reduce volatility within company accounts, reduce future cash requirements through funding payments, or improve credit ratings. Focus will be based not on the absolute cost of derisking but on the relative amount, over and above the value of the associated scheme assets.

**4** While the economic downturn focused everyone's attention to asset returns, scheme funding and pension deficits, the issue of longevity risk is still vital. Rebalancing the scheme funding level and investment performance alone does not fully achieve the aim of derisking. Longevity remains one of the greatest variables affecting the cost of pension provision and the impact should not be underestimated.