Barnett Waddingham associate Chris Ramsey

The whole view

Pensions Age speaks to Chris Ramsey about how trustees should take a holistic approach to risk management

What are the most common risks for pension schemes and how can these risks be addressed holistically?
There are three key risks I see most trustee boards facing. There is the risk that the employer becomes less able to support the scheme, either being unable to afford the contributions, or it becoming insolvent.

There is also the risk that the cost of buying matching assets – such as annuities for buying out the pension scheme, or just buying safer assets in the long term – becomes more expensive through interest rates reducing or inflation increasing at a higher rate than expected.

Then there is the risk that the scheme's risky assets, such as equities, underperform.

These three risks are all essentially about the same thing – the risk that you have a deficit in the future that the sponsor is going to find it difficult to meet. All risks come down to that basic problem. If you think of it like that, it's quite natural that you would have to have an integrated view of the risks you're taking, because they all interact with one another.

It's crucial that trustees think of funding issues, investment issues and covenant issues together when they're making any decisions. A key part of this is making sure the scheme's advisers are talking to one another, to provide a really joined-up service, even if they're not from the same firm.

How should schemes approach managing their risks, in a way that is more than simply risk reduction? What practical advice would you give?
Risk management is a vital component of a scheme's overall strategy; it's just not an exercise that a pension scheme goes through. It is not a one-off project that you do, then lock in the drawer and forget about it. It is a an ongoing strategic process.

The first stage of this process is to think about your objectives. What are you really trying to achieve with your pension scheme? What are the key objectives that you're working towards?

Then consider your current investment strategy. Is it best able to meet those objectives? Can your covenant support the risks you're taking? If you are taking a lot of risk, what would happen if those risks were ever to materialise? Would that put too much strain on your employer covenant? Would it put so much strain on it that it would be forced to fail? If that is true, then you're probably taking too much risk, and you need to think again, if at all possible.

Also, don't just think about your covenant today, think about what it could be in the future.

We've all seen, in the news, lots of examples of the demise of once very strong and stable companies. Trustees need to think about what the key risks are in the employers' business, and try and monitor them, as well as monitoring the risks in your scheme.

It is important to remember that sometimes risks turn into reality. Try to have some contingency plans in place to make sure that you know exactly how you're going to manage that risk.

Also, have a clear monitoring framework, so if you're monitoring these risks over time, they don't come as a surprise at the next triennial valuation.

It is also important to remember that risk management is not simply about risk reduction. It's about understanding the risks that you're taking, and having plans to try and mitigate those risks occurring. Thinking about the risks in a pension scheme can lead you to reduce the risks that you're taking as a trustee board, but that isn't necessarily the conclusion. You could go through a risk management exercise, looking at the risks you're taking, and conclude that actually the best thing to do for the future of my pension scheme is to take more investment risk, because that means I'm more likely to get to my objective. I see that as a perfectly possible outcome of going through this process.

How should trustees work with the employer to take into account their considerations when making plans to manage a scheme's risks? How closely should they work together?
I think it's very important that trustees and employers work closely together. Ultimately, it's the employer who's on the hook for the deficit in the scheme, and so they should have a very keen, active interest in the scheme, and I think that the trustees should take that into account.

For example, if the employer is keen to buy out the scheme sooner rather than later, then the trustees should work with the employer to try and achieve that. In contrast, if the employer is not focused on buying out the scheme then the trustees may be able to take a longer-term view.

When setting their investment strategy the trustees need to be comfortable with the level of risk they are taking, independent of what the employer thinks. However, subject to them being comfortable that the

employer covenant is strong enough, I think the employer's views on investment strategy should be considered.

In summary it's really key to have an active engagement so that both parties are working towards the same goal – if they're working against each other, then that's a recipe for disaster.

In terms of managing the scheme, it isn't just about the employer and trustees. There are also the providers and consultants that all help the scheme to actually run. How can trustees work with providers to ensure that everyone is working towards the same goals? What other tools can trustees have at their disposal to help them achieve their aims?

Advisers need to talk to one another, even if they are from different firms. For example, investment advisers shouldn't go to a trustee meeting and surprise the scheme actuary with a new proposal. Advisers also need to focus on the really key issues for the scheme. What are the big things that are going to stop the scheme being successful? Let's spend their time and budget on those things.

New technology can help significantly with managing pension scheme risk. We've developed our Illuminate system, which is an online tool designed to guide trustees and sponsors through the financial management of their scheme.

It's designed to help trustees and sponsors set a strategy, to meet their objectives, understand the risks that they're taking in the strategy, and monitor that over time.

It also brings together funding, investment, and covenant issues into one system, and integrates them together.

This is a type of system that can really add value to trustees by really helping them develop that joined-up thinking.

There may be general risks that all schemes face, but how can they ensure that any risk management approach they take will meet their own individual needs?

The key, first of all, is to understand your covenant and your objectives. Once you understand where you are, what you're trying to achieve, and what your covenant restrictions are, then you can try and understand what your key risks are, and focus in on them. Those risks will differ between different schemes.

A scheme that isn't going through a buyout any time soon needs to take a long-term view. That scheme faces very long-term risks, so the trustees need to understand the long-term prospects for their sponsor. Is their employer in an industry that is at risk of long-term decline, for example? The key goal for that trustee board would be to keep the long-term contributions that the employer has to pay into that scheme affordable.

That is very different to a scheme that's nearing buyout. The key risks for a scheme that is going to buy out in the next few years are the short-term insolvency of the sponsor, and the risk that insurer pricing becomes unaffordable.

The scheme then needs to set up a monitoring framework to focus on their key risks. In the case of a scheme that is nearing buyout, you should be monitoring the buyout pricing, for example. However, a scheme that is more focused on the long term should be monitoring contribution requirements compared with what the employer can afford.

The size of the scheme, and a scheme's governance budget, is an important consideration as well.

So what practical tips would you give to trustees for how to approach their risk management process?

Think about the big picture. What are you really trying to achieve with this pension scheme? What are your goals?

What are the key risks to achieving those goals? Try and understand these risks, monitor them, and then plan for them happening.

Finally, and very importantly, keep an open dialogue between the sponsor, the trustees, and all the advisers, to keep them all working as one team to achieve your one objective.

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