Summary
• There is currently no standardised process for measuring and comparing risks between schemes.
• Trustees should move away from viewing risks as a 'colour-coded risk score' to note and instead take a more questioning approach to making decisions regarding risks.
• De-risking through pensioner buy-ins is seen as an attractive proposition, along with integrated risk management.

Navigating a new path

Raji Menon looks at why trustees need to take a more dynamic approach to risk management

Faced with a plethora of wide-ranging risks, trustees of UK pension schemes are now adept at identifying, assessing and managing their key risks, but need to move away from the traditional approach to a more dynamic way of risk management, according to leading industry experts.

Falling interest rates, widening deficits, rising inflation and longevity have pushed pension schemes to take stock of their risk framework and take steps to address these risks. And while risk management is now a more accepted part of the pensions' governance framework, much more needs to be done to create a more standardised approach.

Consulting firm PwC's director of pensions, Dubravka Stables, states: "The risks facing UK pension schemes today are wide-ranging – from financial and demographic to data protection and cyber, to current actuarial valuation approaches that do not reflect the true nature of a scheme's liabilities, or provide a picture of scheme risks.

"And while things are moving in the right direction, there is still not a consistent approach to prioritising and managing risks, despite guidance from The Pensions Regulator (TPR)."

PTL's managing director Richard Butcher says that pension schemes needed to move away from the current approach of viewing risk management as a "colour-coded risk score" to understanding the nature and implications of risk.

"Marking your risks red, amber or green is not risk management – it is a prompt. Risk management is more dynamic in its approach, whereby trustees need to question what the implications are of a particular decision that has been taken or not taken. So it's got to be more of a discussion and not a schedule," he says.

Butcher says pension trustees should question what they wanted to achieve from their scheme in terms of key objectives, and what were the barriers to achieving these goals. Through this, trustees could focus on four to five "headline risks", followed by smaller, subsidiary risks.

"Mindless de-risking"

Pension consultant Willis Towers Watson, which uses stochastic modelling to rank risks based on the probability of schemes being exposed to those risks, says it was seeing an increasing trend to de-risk schemes through pension buy-ins and longevity swaps.

WTW's head of transactions Ian Aley says: "Pension schemes have taken steps to address some of their key risks like investment and funding risks, but in many cases longevity risks have not been addressed. So while the impact of other risks has fallen, the risk of longevity has remained or increased."

Aley noted that with the pricing on bulk annuity pensioner-only buy-ins currently at the most attractive level seen in 10 years, the consultant was seeing a lot of activity in that area.

"For many pension schemes, a buy-in can be a very attractive proposition, as investment risk is eliminated and the funding position of those assets are secure," he says.

A recent *Global Pension Risk Survey* by consulting group Aon Hewitt found that around 90 per cent of the 185 UK pension schemes it surveyed had a long-term low risk or buyout objective, and the time estimated to reach that objective had reduced from an average 12 years to 11.1 years since 2015, despite the low interest rate environment.

However, fiduciary manager and consultant Cardano's UK managing director Kerrin Rosenberg says there was a danger of schemes engaging in "mindless de-risking" of selling equities to buy bonds.

"This is really not a very sophisticated way of doing things because you are assuming you will buy bonds at a later time when your funding position improves. But what if your funding doesn't improve? This kind of fair-weather strategy only works when the markets are kind," he outlines.

Rosenberg says that, although schemes are now using more liability

driven strategies, derivatives are still not being used in optimal size.

"The use of derivatives has still not caught up with the market. Pension schemes need to be much bolder in their use of derivatives in managing their risk," he emphasises.

Rosenberg adds that Cardano employed the "scenarios" based approach to managing risk, where the firm outlined four to five key scenarios and in each scenario how the risk facing the scheme is assessed and managed.

Merchant Navy Officers Pension Fund (MNOPF) chief executive Andrew Waring says a key risk that many schemes had underestimated has been the interest rate risk, which had now led to ballooning deficits.

"Many schemes have not taken into account the sheer scale of interest rate risk, and how that interacts with other risks. For these schemes, the challenge is how to put in place recovery plans and improve funding without affecting their sponsors' long term sustainability," he says.

PAN Governance managing director Steve Delo adds that the effect of gilt yields on defined benefit liabilities is a "front of mind issue" for trustees.

"Most trustees have now realised they have historically paid inadequate regard to the liability side of the funding equation – the lesson has been learned and trustees should now, as a priority, properly scale their rates and inflation bets to the covenant strength," he says.

Other risks such as data risk and cyber security have also increasingly been coming into the mix.

Delo said inaccuracies in member data and GMP reconciliations sometimes came with "large price tags".

IRM

Overall, lay trustees have benefited from TPR's guidance on integrated risk management, with many viewing the three cornered approach to investment risk, funding and covenant something "they could identify and work with", Delo says.

"I think the regulator's push on integrated risk management (IRM) has had a positive effect on DB scheme behaviour. Whilst there is some 'motherhood and apple pie' in some of the guidance – and many trustee boards had already started thinking that way, perhaps less formally – it has created a lexicon for the industry to talk about," he adds.

Stables says that following guidance on IRM, three distinct groups of schemes were emerging. At one end were the smaller schemes that remained unconvinced of any real benefits of IRM and viewed it as simply another layer of burden they needed to go through and pay for, while at the other end of the spectrum were the larger schemes that believed in IRM and had been implementing it in some form for a number of years. In the middle were those that agreed with IRM in principle, but still struggled with what they should be doing in practice.

Stables adds: "These schemes are looking for more guidance, from TPR and advisers, on how to translate the principles into practice – for example how to measure risk, how to establish whether the amount and type of risk they are running are appropriate, and what to do if not when choices seem limited."

She comments that increasingly though, many schemes were relying on IRM to define their longer-term strategy rather than their triennial funding valuations.

"This is a welcome development as the fund strategy has to live inbetween the period when the triennial valuation is carried out, and reflect the key risks the scheme is exposed to," Stables says.

According to Aon's *Global Pension Risk Survey*, only 4 per cent of respondents had implemented an IRM with actions, and 46 per cent either had no IRM plan or had not documented it.

Risks in DC

For defined contribution (DC) schemes, Delo believes risks are more of an "administrative or practical" nature around accurate and timely collection and allocation of contributions.

And with most members still opting for the default investment strategy, trustees also need to focus on the design, structuring and ongoing evaluation of the default strategy.

"There are risks in communications as well – one big risk is at some point in the future – maybe in 10 years – there will be some PPI type pursuance of schemes for disconnections between what has been communicated and what has happened in practice," Delo says.

He adds: "Pensions outcome have been very vulnerable to being judged with the benefit of hindsight – especially by politicians who don't adequately understand the subject matter – and that will create fertile ground for third parties searching for compensation opportunities. It will be at that stage that the communications issued to DC members years earlier will come under scrutiny. Hence, it is essential that trustees do not cut corners now on communications now and get decent legal oversight."

Written by Raji Menon, a freelance journalist