Reward for your risk

The fifth and final part of this series reports on a roundtable hosted by RBS where treasurers familiar with the pension issue met with experts on pensions from banking and the actuarial and investment professions. The result? A fascinating glimpse into the current state of the pension debate. **Peter Williams** reports.

Executive summary

- The roundtable reflected on the issues raised in previous articles in the series looking at the importance of developing a risk framework; translating objectives into an appropriate asset allocation strategy – including agreeing a risk budget and managing unrewarded risks; trustee decision-making powers and the use of benchmarks.

If one lesson has become clear about dealing properly with defined benefit pension funds, it has been the realisation that the trustees of the fund and the sponsoring company have to join forces in defining the pension scheme's risk framework and risk appetite.

As Martin O'Donovan, ACT Assistant Director, Policy and Technical, said at the roundtable: "A 95% funded scheme with decent risk management may be a safer proposition than a 100% funded scheme without."

UNDERGOING THE VAR EXERCISE

Gathered at the roundtable were corporates with different experiences of the pension crisis of the last few years. One example of a pension fund and a company that was brought back from the brink is RHM. The company, which underwent an initial public offering (IPO) in 2005, certainly had some pension challenges back then, as described by Jonathan Clarke, Director of Treasury at RHM, namely that RHM at that time had an estimated market capitalisation of around £1bn prior to flotation and a pension scheme with a deficit of £0.5bn and a value at risk (VAR) of £0.5-£1bn. Clarke said: "In that state, the business was completely unsaleable. So we took various initiatives including going through a VAR process with the trustees. We wanted to work out with the trustees what the appropriate levels of risk were."

John Ashworth, Director, Pensions, Insurance & Leasing, Littlewoods Shop Direct Group, who joined the roundtable virtually, said: "Gone are the days when trustees, companies and advisers focused mainly on the size of the FRS 17 deficit when discussing corporate transactions. VAR is increasingly being used by trustees as a means for objective measurement of how much risk is being run by the scheme and company. Measures to reduce VAR, such as asset diversification and interest and inflation swap overlays can be evaluated in terms of how much VAR is reduced if these measures are implemented. The approach can also be used by the company as a constraint on the trustees, who may want to reduce VAR to unrealistically low and economically inefficient levels."

VAR has certainly become a standard exercise in a bid to quantify the risk the pension fund implies for a company's core business. For RHM the exercise determined the acceptable tolerance within the scheme, set a risk budget over and above the deficit, and took unrewarded risk off the table. Clarke said: "We had a 12-month to 18-month education process with the trustees teaching them the principles of VAR."

One of the advantages of going through such a process with trustees is to broaden understanding, so moving the focus off the age-old question: "how are our assets doing?" to "how should we position our assets to reflect the characteristics of the liabilities?" The feeling is common that if pension scheme trustees were left in their own space then they would be focused on asset return and might (implicitly) accept underperformance relative to the liabilities, mostly because they did not have a modern understanding of risk.

Instead, over the last few years trustees of pension schemes have been looking to redefine the control levers over their investment funds. Paul Wilkinson, Group Treasurer of Tomkins, said that his company/pension scheme liability investment approach in the US was targeting both the liability and the return. By taking some extra risk they now had a return target in excess of the return over

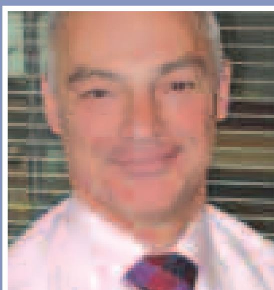
gilts but this was limited to broad-based equity portfolio risk rather than seeking alpha. Many pension funds are now looking at liability-driven investment (LDI) to reduce liability-related risks, typically using bonds and swaps.

Marcus Mollan, Director, RBS Pension Solutions Group, said: "We have seen a remarkable change over the last few years in the sophistication of trustees and sponsors, and VAR is an important part of that. Trustees are now removing generic and meaningless objectives like 'we are going to maximise our return and at the same time we will minimise our risk'. Both sponsors and trustees now recognise that the real issues are much more subtle than that and require more detailed analysis and a more adult discussion."

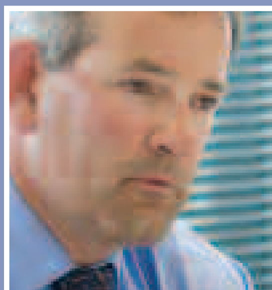
David Swann, Group Treasurer at BAT, performed a company-wide risk analysis using VAR 95% probability levels. He said: "The results were quite surprising. The pension scheme is one of the group's significant financial risks. The risk analysis found that the pension fund exposures were not intuitive." Perhaps all the more surprising with BAT UK's deficit at a modest £150m compared with its market cap of £30bn. Across the company there are 120 defined benefit schemes, although five are significant, of which the UK's is the largest. Swann added: "Our challenge is to extend the risk framework to cross-border pension schemes and situations."

In an ever changing situation, one of the scenarios Swann pointed to was the trustees and the sponsoring company starting to adopt diverging views on risk. Swann said: "Trustees rightly think about reducing the deficit." In a similar vein, as the idea of surpluses start to become a reality, opinions may differ as to how they should be viewed. He said: "A fully funded scheme highlights the need to agree on risk appetite. There has to be a convergence of approach between the company and the trustees. Risk has to be seen by all parties as a good thing. After all, historically, equities have outperformed bonds in the long term. The difference in risk appetite between trustees and the company can be catered for."

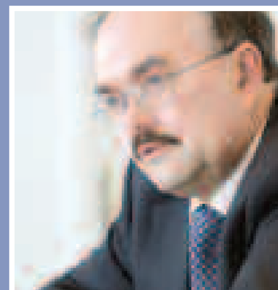
Roundtable attendees



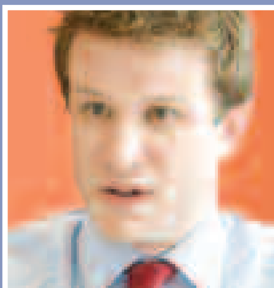
John Ashworth, Director, Pensions, Insurance & Leasing, Littlewoods Shop Direct Group



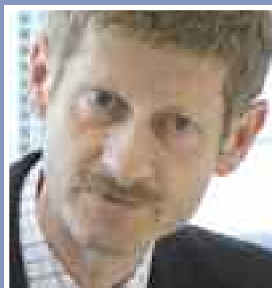
Jonathan Clarke, Director of Treasury at RHM



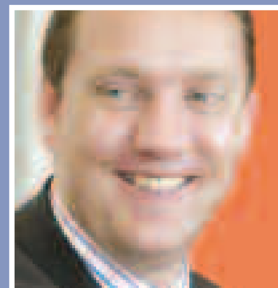
Reg Hinkley, Chief Executive Officer of BP Pensions Trustees



Marcus Mollan, Director, RBS Pension Solutions Group



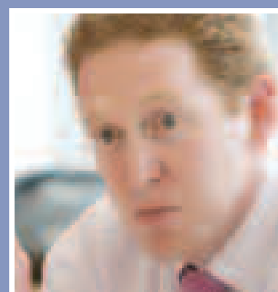
Martin O'Donovan, ACT Assistant Director, Policy and Technical



Kerrigan Procter, Head of Quantitative Products at Legal & General Investment Management

David Swann, Group Treasurer BAT

Paul Wilkinson, Group Treasurer of Tomkins



Stephen Woodcock, Senior Investment Consultant, Mercer Investment Consulting

ROLE AND POWER OF TRUSTEES The question of whether treasurers should act as trustees continues to elicit contrasting views, as it has over the last couple of years. The question also extends to whether treasurers should sit on subcommittees of the pension scheme, notably the investment committee.

At the roundtable the view was expressed that sitting on the investment committee was a net gain for both the scheme and the company with the benefits outweighing the risk of conflict. Stephen Woodcock, Senior Investment Consultant, Mercer Investment Consulting said: "While the circumstances will vary between companies, there is usually an advantage to having treasurers and/or CFOs on investment subcommittees because of the technical investment knowledge they bring, especially involving more complex financial instruments."

Kerrigan Procter, Head of Quantitative Products at Legal & General Investment Management, said that his experience of

working with trustees suggested that trustees often see company representatives as outsiders but trustees welcome the involvement of those from the company who share their particular financial or treasury expertise with the rest of the trustees.

Ashworth said: "A treasurer or CFO should be on the investment committee at the very least, either as an attendee or a trustee. The advantage of being an attendee is that it should reduce the potential for conflict of interest issues."

ERECTING CHINESE WALLS Martin O'Donovan explained that some companies had tried to erect Chinese walls so that trustees, such as treasurers, were not given certain corporate finance information – most notably on mergers and acquisitions (M&As) – since then they would be obliged to disclose this to the trustees and create much unnecessary work assessing the pensions impact of as yet uncertain projects.

But such niceties are not considered universally necessary. Reg Hinkley, Chief Executive Officer of BP Pensions Trustees, said: "In the case of BP, senior executives do serve as trustees. These are people with direct knowledge of the company's strategy and its financial framework, and what that might lead to in terms of transactions. The company does make considerable effort to inform trustees and the system is workable. Effectively we have a protocol around communication to the trustees and they understand the confidentiality that applies."

It is an approach which concurs with the experience of Paul Wilkinson, Group Treasurer of Tomkins. He said: "We favour upfront communications with our trustees rather than the artificial situation of being deemed not to know."

According to Ashworth an experienced CFO or treasurer should have the necessary skills to deal with difficult and confidential matters. He said: "If a company is usually involved in significant M&A then it will need a) a conflict of interest policy b) signed confidentiality agreements with trustees c) potentially an amendment to the trust deed carving out the non-disclosure by the CFO of, say, price-sensitive information d) a clearly communicated strategy presented to the trustees, so they are not surprised if they are informed a part of the company is being bought/sold."

BAT had performed a review of the potential conflicts of interest. And Swann, who is chairman of the trustees, said: "We set out a protocol, a set of core principles which are very, very straightforward. The company has a standard confidentiality agreement and if the question came to it trustees would be seen as insiders. But everyone is used to working in that sort of environment and it is not seen as an issue."

However, Swann added that conflicts of interest went further than just treasurers or CFOs who may sometimes be wearing more than one hat. He suggested that advisers – bankers, fund managers, consultants – are all potentially conflicted. It certainly is a question that trustees and sponsoring companies need to decide as they assess whether to go down the multi-advice route as opposed to the one-stop shop for advice.

THE BENCHMARKS Whatever the choice of advisers it is clear that the last few years have seen companies driving the idea of optimising pension scheme risk while working with the trustees to ensure that a comprehensive set of benchmarks and performance measures are put in place. The roundtable agreed that the key risks which pension funds have attempted to hedge have been interest rate risk, equity risk and increasingly inflation rate risk (see other articles in this RBS series for the detailed tactics around implementing such a strategy). While such an approach has become standard there are more question marks over monitoring and managing the performance of fund managers. Several members of the roundtable expressed a frustration with an alpha return which hardly covered the fees paid to the investment professionals. Yet while there was frustration at the poor value for money seemingly offered in this area, it was clear that trustees do need to delegate day-to-day decisions to appropriate fund professionals.

TRUSTEE DECISION-MAKING AND THE USE OF INVESTMENT SUBCOMMITTEES
Ashworth argued that investment subcommittees (ISCs) needed to ask the question as to how they should best spend their scarce time. Hiring/firing managers

can be delegated very efficiently, allowing ISCs to concentrate on asset allocation and risk management.

It was suggested that this need for performance monitoring should be one which the investment subcommittee be charged with addressing. The main trustee board may not have the experience or the focus to look at performance and return at a detailed level, whereas the investment subcommittee should have that knowledge and should be given the brief to assess the situation and make recommendations. This is a productive course to take. Swann suggested this had to be seen as part of the "risk behaviour and the risk budget".

It is clear that many company/pension schemes find it uncomfortable to dispense with the service of those advisers who fail to deliver on the benchmarks and performance targets which they have been set.

Also, timeframes can mitigate against decisive action. Pension funds clearly take the long view but still, while performance over a quarter cannot be seen as a reliable indicator, trustees should be prepared to act where performance is not acceptable. However, the practical difficulties of making appropriate decisions when trustees, or subcommittees, meet infrequently should not be underestimated. One member of the roundtable described the decision-making process as "going round in loops".

For instance, Mollan of RBS pointed out that current market conditions offered the best switching terms in six years to move out of equities into bonds. But after the market falls in February, many trustees were "kicking themselves" that they might have missed their chance to make the switch at the most attractive levels. In fact, markets had recovered since March but the lesson was that if a switch wasn't set up to happen automatically at certain trigger points, either through physical asset switches or the use of derivatives, then by the time the trustees were next gathered together to make such a decision the best opportunity may have passed.

This need for speed of reaction should not be taken as a decision-making process happening on the hoof. BP's Hinkley said that pension funds were in a privileged position because they were able to deal in the long term, up to a 50-year timeframe. But the price for that was that the pension scheme had to be working within clear objectives in which they set up elements such as the hedging strategy. It was important that the pension scheme consistently applied financial economic principles, not accounting principles.

THE QUESTION OF VALUATION The question of the proper measure of pension schemes' liabilities continues to be a source of vexation and dispute. One member of the roundtable said he was sceptical about the buyout basis as it was "not useful across the whole industry", while Woodcock from Mercer Investment Consulting suggested investment decision-making would be more transparent if a valuation basis was used which could be applied whether the pension scheme adopted a high- or low-risk investment strategy – namely, a gilt or swap-based 'economic' valuation measure.

Clarke said that his pension scheme was shortly to undergo a valuation and he had been looking at the various measures which could be chosen. The approach to valuation impacts on the risk appetite and the perception of attitude to risk. There is no emerging consensus on valuation and the roundtable reached none. While the last few years have seen a focus on pension deficit and the valuation methods used to assess deficits, the question of surpluses will start to be an issue for trustees and sponsoring companies. If questions have been asked over the quantification of deficits since the start of this century, equivalent questions will be asked over the quantification of future surpluses. Valuations in the 1990s reported surpluses and then came the pension industry's 'perfect storm'. Many identify the pension contribution holidays of the 1990s as one of the factors that led to the pension crisis. Trustees – backed by the Pensions Regulator – are unlikely to let corporates 'get away' with being seen to shirk their responsibilities.

Wilkinson said: "As schemes become more highly funded under the new funding rules, we are likely to see the issue of repatriation of surplus become more widely debated as well as the issue of balance of power in investment decision-making between sponsors and trustees."

REWARDED AND UNREWARDED RISKS

Another area of concern remains rewarded versus unrewarded risk. Ashworth said: "There are a variety of risks being taken within pension schemes so both trustees and companies need to make sure they are rewarded for the risks they want to take and remove the risks they don't want. So they may like the equity risk but not the inflation risk inherent in pension payments. The latter risk can be hedged very efficiently allowing greater focus on the risks they want to retain."

Mollan agreed that this move towards risk budgeting was very welcome. "Removing unrewarded risks such as interest rate risk and inflation risk is now commonplace. Nowadays, best practice for pension schemes demands that trustees and sponsors consider whether, or how much, interest rate and inflation risk removal is appropriate for their scheme. But the more forward-thinking schemes are also focusing much more on the rewarded risks. They are looking to diversify away from the traditional equity bias into previously underutilised sources of reward such as enhanced credit, which can offer a return similar to equities but in an uncorrelated way."

Wilkinson questioned whether it was valid to try and distinguish between rewarded and unrewarded risks and whether a rational definition of 'unrewarded risk' existed.

Mollan said that, firstly, most pension schemes were not sufficiently diversified in their investment strategies, and to be

Box 1. THE QUESTION OF VALUATION

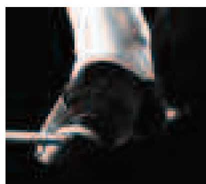
There should be no one detailed prescribed consensus on valuation – as by necessity each funding plan has to be scheme specific. The valuation approach will be very much driven by i) the strength of the employer's covenant, ii) the maturity of the scheme, and iii) the trustees' and employer's attitude to risk. One size does not fit all.

Box 2. FROM PREVIOUS ARTICLES

Hedging solutions
In 2006 an estimated £20bn of UK pension liabilities were hedged using inflation swaps, usually combined with interest rate swaps. Implementation of hedging strategies is an area where the sponsor has considerable experience while the trustees usually have limited experience. It brings greater comfort for trustees if the corporate plays an active role in giving input to the strategy of any solution.

A balancing act
Pensions have come to dominate the corporate finance scene. Yet trustees and company sponsors do not always see everything from the same perspective. Treasurers are now committing 20% of their working week ensuring the pension deficit is kept low. Fortunately, the pension problem is capable of a resolution in ways that work for the shareholders and members of the pension fund, and treasurers can seek to reduce accounting volatility.

Calculated risk taking
Trustees are engaging more robustly in negotiations with the scheme sponsor, and treasurers can help the trustees to set appropriate objectives and risk budgets by explaining where the corporate is likely to struggle to meet or accelerate its pension contribution commitments. Calculated risk-taking is a necessary part of running a defined benefit scheme, but often simplistic models can result in bad advice. With careful planning and the right input, making best use of a risk budget need not be complicated.



Broader horizons
When looking to diversify the spectrum of 'alternative' asset classes, the choice ranges from the established, to the new and the slightly obscure. Approaching the diversification challenge provides a wider view of the concept of alternative investing. A good approach when considering whether an allocation to an alternative asset class should be made is to consider the marginal risk/return benefits gained from an exposure to the asset class.

underdiversified always introduced an unrewarded risk for any investor. However, the definition of rewarded and unrewarded risk did differ between different classes of investor. For instance, for a long-term investor such as a pension fund, illiquid assets may offer an attractive reward opportunity, while these investments would be inappropriate for a short-term investor planning to liquidate their investment within a few months. Finally, the definition of risk for a pension scheme, whose main objective is to meet members' promised benefit payments, was very different from other investors such as an insurance company, an individual investor or a speculator. These factors meant that some assets offered a better risk/reward trade-off for pension schemes than they did for other investors.

When it comes to the detail of assets, the roundtable heard that pension schemes were embracing new investment vehicles such as hedge funds and private equity. As one treasurer commented: "Hedge funds as an investment class are here to stay. Hedge fund is an emotive term covering a wide range of the spectrum and it sets out a certain expectation of risk. Some hedge funds are far less risky than most people think… a pension fund shares some of the characteristics of a hedge fund."

It comes back to understanding the risks (for each instrument such as a derivative) and the drivers of those risks. A pension scheme risk framework should be able to cope with even the most traumatic of financial events, those that happen two or three times in a working lifetime and should be able to deal with the consequences. Treasurers have a specific role to play in this scenario because they should be comfortable dealing with the consequences of such shocks.

THE LONG-TERM PERSPECTIVE Hinkley from BP Pension Trustees suggested that looking at pension funds from an economic analysis was both interesting and challenging. He said: "Pension funds can be seen to be about shifting wealth from one generation to the next. And if they have such long-term horizons, maybe they are precisely the class of investor which should be holding risk."

For Procter of L&G, in the era of low yields, pension schemes had to return to the question of risk budgeting, the assessment of the amount of risk to be employed, and where it should be applied. He said: "Schemes have got a finite amount of risk they can take on and it is simply a question of where you can get bigger reward."

Mollan said that in the current market there was an insufficient supply of absolutely risk-free assets, if such things even existed, to meet all pension scheme needs.

Mollan concluded: "From the perspective of the economy as a whole, it is inevitable and probably desirable that pension schemes will hold a certain amount of risk. However, each individual scheme and sponsor must make up their own minds which risks they aim to remove and which risks they will actively seek to run. Treasurers have invaluable skills to bring to this process and are in an ideal position to play a pivotal role in determining the pension strategy over both the short and long terms."

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