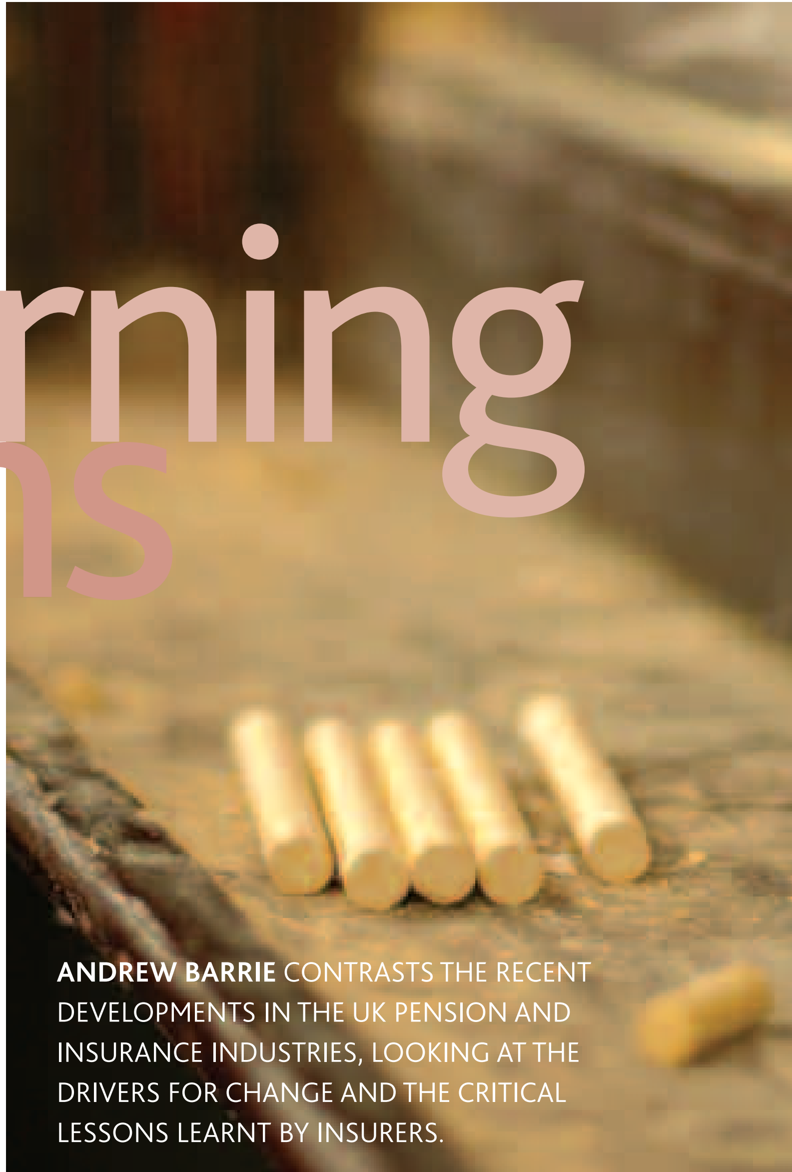
Learning lessons



ANDREW BARRIE CONTRASTS THE RECENT DEVELOPMENTS IN THE UK PENSION AND INSURANCE INDUSTRIES, LOOKING AT THE DRIVERS FOR CHANGE AND THE CRITICAL LESSONS LEARNT BY INSURERS.

Over the past few years considerable intellectual and financial capital has been invested in anticipation of a sea-change in defined benefit pension fund investment strategy. Investment banks and fund managers are gearing up their product offerings and resource. New companies are springing up every month to tap into the pension buy-out market. Investment consultants are now 'transition managers'. The liability-driven investment (LDI) mantra gets louder and louder. We await, expectantly, the sound of the thundering herd that heralds reform. Surveys by interested parties tell us we are almost there.

But nothing happens. Bankers grow edgier. Trustees doze over another sales pitch. Sponsors' blood pressure soars. Frustration mounts. Bankrollers fidget.

COMPARE AND CONTRAST Meanwhile, in an industry with a similar set of problems, change has been at such pace that the rest of the world aspires to its model. It operates in a sophisticated regulatory regime that has triggered massive changes in investment and management philosophy. What is this hothouse industry? Hedge funds? Venture capital? Private equity? No. UK life insurance!

Sure, there are some signs of change in the pensions space. Three years ago investment strategy was a one-size-fits-all approach of 65% UK equities, regardless of scheme-specific considerations. Since then, some early movers have started taking a more measured approach. Generally, dependency on equities is slightly lower. Almost 20% of funds have reduced their equity allocation by 10% or more.

Broadly, there have been three drivers for change:

- **Corporate actions.** It is almost *de rigueur* that, in any takeover or merger (WH Smith and Marconi provide two high-profile examples), the pensions issue is 'dealt with';
- **Tail wagging the dog.** The relative size of fund to the sponsoring company can mean that their fortunes are more sensitive to twists in the yield curve than anything management can do for the core business – look no further than British Airways; and
- **Financial companies.** Almost anyone who is an investment professional is changing or reviewing the way in which they manage their defined benefit pension fund. Insurance companies and banks are leading the way. Friends Provident was an early adopter of a more sophisticated investment strategy. Lloyds TSB recently announced a risk management system for its pension funds. Prudential, Schroders and many others have moved ahead of the pack to restructure their assets and liabilities.

A few years ago, the insurance and pensions industries were both underpinned by similar actuarial tenets and philosophies. The tension between different stakeholders was high: in pensions it was between sponsor and members; in insurance, between shareholder and policyholder. Both were structured to create guarantees, with any financing shortfalls falling on shareholders. They also faced similar sources of risk in interest rates, inflation, equities and longevity.

But around 2001-2002 these two industries diverged. In particular, insurers were forced into change by their regulator. There was a radical move towards financial economics and market pricing as the basis for capital reserving – a core consideration for the insurance industry. Insurers were forced to price benefits and reserve for

Table 1. Industry practice

	2000		2006	
	Defined benefit pension funds	UK life insurance	Defined benefit pension funds	UK life insurance
Hedge interest/inflation rate risk	~0%	5%	5%	85%*
Average equity exposure	65%	75%	61%	37%*
Financial risk management systems	0%	0%	<5%	90%

* Source: Barrie & Hibbert Insurance Risk Survey 2006

Executive summary

- The pensions world is slowly moving towards adopting the same underpinning philosophy of financial economics that has been a key driver of change in the insurance sector.
- The insurance and pensions industries used to have key parallels, underpinned by similar actuarial tenets and philosophies, but have now diverged.
- While there are differences between pensions and insurance, there are some key lessons for the pensions industry. Notably speed of response, investment mix and costing promises.

asset/liability mismatch risks appropriately. Rating agencies added incentive for quoted insurance companies to adopt more rigorous management practice. The pace of change has been electric.

The drivers for pensions reform have been more subtle – too subtle to focus minds and change practice. Extensive press coverage, disgruntled sponsors and union pressure are all indicators that change is needed, but nothing has had the cathartic impact of strong regulation.

How has this change manifested itself? *Table 1* looks at some key metrics for the two industries in 2000 and 2006. It shows that while the pensions industry has changed little in the period, there have been significant changes in insurance practice. In particular, insurers have been very active in removing risks (such as interest rates) for which they are not being wittingly rewarded. Further, most now have financial risk management frameworks in place.

A further example of change is the simple choice of discount rates used to value liabilities. The insurance sector has embraced a 'market consistent' basis that effectively reflects the price at which liabilities could change hands in the open market. The pensions industry hides behind a raft of different discount rates that apply according to context in which they are used.

A QUESTION OF RESOURCE The industries' different resources and environment are worthy of consideration. Most insurers have dedicated actuarial and investment resources that are continuously reviewing the management of the business. Pension funds depend on external investment consultants who occasionally review a fund's position. Further, the insurance regulator has adopted a strong position as a protector of policyholders. In the pensions' space this role is performed by trustees – who have significant responsibility but little clout in changing a sponsor's approach.

LESSON 1: THREE YEARS IS A LONG, LONG TIME IN FINANCIAL MARKETS. The pensions investment strategy model works along the lines of periodically reviewing a fixed asset allocation strategy (normally every three years). The problem with this approach is that by the time things go wrong, the damage is done. For those pension funds unlucky enough to be in the 1999/2002 review cycle, the consequences were dramatic. Falling equity markets and interest rates put a huge hole in most funds. By the time this was communicated to trustees and sponsors it was too late. The insurance industry (which used to have a similar approach) has now adopted a more dynamic strategy which maps out what actions will be taken in different scenarios and embeds this into their management process. This allows regulators, policyholders and other stakeholders to understand the future risks that the company will be faced with ahead of them happening and how prospective investment strategies will mitigate these risks. The result is a more thought-out and dynamic management approach.

LESSON 2: THE TORTOISE AND THE ONE-TRICK PONY. Pension funds are still dependent on equities as their investment 'earner'. The main rationale is the high expected return that equities have delivered over the long term. Expectation, though, doesn't equal outcome and, for many stakeholders, short-term pain is as important as long-term gain. In the insurance sector we are now seeing a much richer investment mix than pension funds. Further, the insurance industry, recognising that many of its liabilities are long-dated, has opted to try and outperform these liabilities by a small amount with a high probability every year – without risking all. As an example, an insurance annuity fund will look to add less than 1% a year on its assets over its liabilities. The wonders of compound interest are such that, over any meaningful period, this seemingly small increment can bring a significant benefit.

LESSON 3: PROMISES COST MORE THAN YOU THINK. In a world where we assume that equities grow at 8% every year and liabilities at 5%, then it is very easy to believe that any promises we make don't cost much. Both the insurance and pensions industry under-priced the financial promises they had made. Product features such as guaranteed annuity rates ultimately undid Equitable Life and contributed to the drive for reform in the insurance sector. Defined benefit funds, too, offer guarantees to members. The true cost and value of these benefits are only now emerging.

LEARN THE LESSONS So what could these lessons mean for the pensions industry? Importantly, they could give many funds a framework and strategy from which they can appropriately manage their way out of their current predicament over the long term. In particular, this could be achieved in a controlled manner that meets all stakeholders' conditions.

The pensions world is slowly moving towards adopting the same underpinning financial economics philosophy that has been a key driver of change for the insurance sector. The biggest danger is that the pace of change is too slow for impatient sponsors. Increasingly, they will perceive closure and buy-out as the only alternative to the status quo. Many will make sub-optimal decisions for the sake of expediency or closure.

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