New risks for old

JOHN HAWKINS DISCUSSES THE INCREASED FOCUS ON PENSIONS RISK MANAGEMENT.

Executive summary

- Counterparty risk is greatly reduced by collateralised pension schemes, but there are also lessons to be drawn from the use of risk reduction, transfer and mitigation products.

Had anybody had the job of raising the awareness level of risks associated with pension schemes five years or so ago, they would probably be feeling pretty pleased with themselves right now. It is difficult to open a financial newspaper or journal without finding some reference to pensions risk management and the topic is highlighted in pension conference flyers. So far, so good, but as usual there is no such thing as a free lunch; what we need to remember is the law of conservation of risk.

Many risks associated with pension schemes can be hedged using derivatives, which are also used to gain exposure to additional asset classes. Unlike derivatives transactions in the corporate world, swaps and other derivatives entered into by pension schemes are almost invariably collateralised. This does much to reduce the counterparty risk that is now substituted for the interest rate, inflation or longevity risk that has been hedged, but truly minimising the counterparty risk requires schemes to pay more attention to the collateral arrangements than many typically do. In fact, those schemes taking advantage of umbrella International Swaps and Derivatives Association (ISDA) and collateral arrangements offered by their investment managers, or a segregated or pooled fund management vehicle, may be entirely ignorant of the underlying collateral arrangements.

WHAT ABOUT RATINGS? For schemes considering buying out their liabilities with insurance annuities, or selling the scheme to a third party (such as in the recent Citibank/Thomson Regional Newspapers transaction), a more fundamental issue arises: the comparison of the credit risk of the old sponsor with the new sponsor.

This is not always straightforward. For example, some of the new entrants to the annuity market have still to write any business and are not rated. How do you assess their creditworthiness over the 40-year-plus life of the annuity portfolio? Any corporate credit rating that does exist will have an associated historic probability of insolvency over a 10-year time horizon that it is easy to look up, but can it be extrapolated to 40 years in the future? In other cases a proposed deterioration in creditworthiness when the substitution occurs may be accompanied by an immediate offsetting increase in funding that would otherwise be unavailable. These trade-offs can be compared – for example, using value-at-risk techniques – but are hardly trivial. Indeed, model limitations can be crucial. Insolvency events lie at the extreme ends of the distribution where issues of model construction can illuminate and obscure in equal measure.

The use of insurance contracts in connection with buy-outs and some types of longevity hedging brings its own risks.

First, insurance law is based on fundamentally different principles to normal commercial law, including full disclosure of all material relevant facts; do not assume that you understand the implications of what looks like straightforward documentation.

Second, the regulatory regime for insurance companies (such as the Financial Services Authority) and compensation arrangements (such as the Financial Services Compensation Scheme) are different from those of pension schemes (the Pension Regulator and the Pension Protection Fund respectively).

Third, derivatives deals can usually be restructured, transferred or unwound if circumstances change. This is not necessarily the case with annuity buy-outs, where the control that can be exercised on the future actions of the original insurance counterparty is much more limited. If the insurer's subsequent actions are inappropriate, they may come back to bite the trustees, or the sponsor.

So what are the lessons if we wish to take advantage of risk reduction, transfer and mitigation products? Understanding all the qualitative aspects of a proposed derisking is fundamental. This includes a full appraisal of the risk map after the derisking (taking into account any mitigation steps) as well as before. Some of this can be done with an appropriate quantitative analysis and this is essential. However, qualitative issues such as reputation and the impact of future black swan events may be equally important. There is no such thing as a total risk transfer, but that should not stop transactions that improve the current position across the spectrum of issues.

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