CUSHION THE BLOW

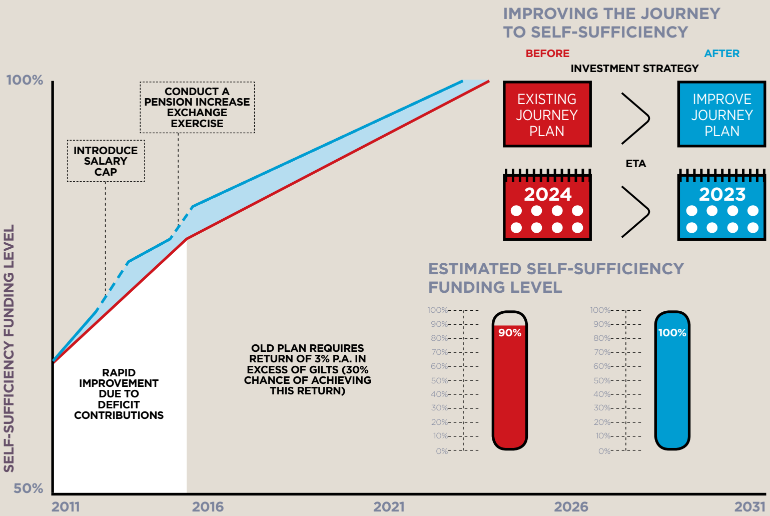
YOUR COMPANY'S PENSION SCHEME MAY BE THE BIGGEST RISK IT IS RUNNING. SO HOW CAN YOU PROTECT YOUR BUSINESS FROM ANY POTENTIAL SHOCKS THAT ARISE? IAN ALEY AND ALASDAIR MACDONALD EXPLAIN

For many companies today, their pension scheme could be their biggest subsidiary or even dwarf the size of the main business, and can have a real bearing on the value investors place on a company. So a business plan that sets out to measure, manage and reduce the impact that defined benefit (DB) pension risk has on a business is likely to deliver value.

At the ACT breakfast briefing, Managing Pension Financial Risk, on 12 September, Towers Watson examined the problems that face sponsors of UK DB pension schemes and discussed how companies can formulate a plan that helps them tackle those risks. A poll taken on the day offers an interesting insight into companies' differing attitudes towards business and pension issues: while two-thirds of the 90 treasury, finance and other attendees present were developing a eurozone break-up plan for their business, only a tenth had begun putting in place such a plan for their pension scheme.

A NEW DIRECTION FOR THE JOURNEY PLAN

This chart shows the way in which an example client's existing journey plan (shown in red) was improved via Tower Watson's pension risk analysis to reach the scheme's long-term target earlier and with a lower degree of risk. Risk management actions for this client included refining the investment strategy, reviewing member benefits and conducting a pension increase exchange exercise.



There are many tools available for those who are in the early stages of implementing a plan to manage DB pension scheme risk or who are looking to refresh a risk management plan that is already in place. These include:

- Asset-side options, including increasing holdings of assets that match pension scheme liabilities (such as gilts and swaps), interest rate and inflation hedging, diversification, etc.
- Liability management options, for example, encouraging members to transfer their pension benefits, on enhanced terms, to another scheme, or enabling members to reshape the way their pensions are paid to lower-risk alternatives.
- Plan design options, ie changing the benefits available to members to lower cost or lower risk pension choices.
- Third-party risk transfer options, for example, transferring longevity risk to an insurance company or bank, or transferring risks in respect of groups of pensioners to an insurance company via a buy-in or buy-out.

A glossary of some of the most commonly used terms within the sphere of liability management and risk transfer solutions is shown opposite. However, in populating an effective pension risk management plan, not all of these tools will be appropriate for any one scheme or business at any given time.

Developing a business plan for your pension scheme

So if you want to reduce the impact your DB pension scheme has on your business, and given the suite of available risk management or risk reduction tools that are at your disposal, how can you put in place a business plan for your scheme? The following three-stage process can deliver meaningful results, within a 'corporate-pace' time frame:

STEP 1: RISK REVIEW

The first step involves ensuring you have a clear understanding of the risks currently being run and the impact they have on your business. This understanding can quickly lead to determining a set of objectives for reducing that impact.

- To understand the risks fully you might consider 'value at risk' modelling, scenario analysis (for example, based on possible future economic pictures) and illustrations of one-off asset or liability events (such as interest rates falling or an increase in life expectancy assumptions). Flexing the parameters underlying pensions funding and reporting illustrates the impact the scheme may have on key corporate metrics such as profit and loss (P&L), balance sheet and cash contributions to the scheme.

◆ The business objectives in drawing up a business plan for the pension scheme, or refining an existing one, should reflect its relative tolerance to different types of pension 'shock'. For some companies, the emphasis will be on conserving cash within the business; for others, it will be managing messages to shareholders via published P&L and balance sheet figures; and for others still, the main driver may be maintaining dividends or agreeing future financing facilities.

The business plan will begin to come together when the available pension risk management tools (as described above) and the financial impact of each are lined up against the company's objectives, to arrive at a prioritised list of short- and medium-term actions for the business.

Throughout this process, a collaboration between the business and the pension scheme trustees is key – with agreed and shared objectives the trustees will be able to offer the vital support and stewardship needed to implement the chosen risk management options.

STEP 2: STRATEGIC PLAN

Developing a framework to measure, manage and reduce pension risk involves drawing up a 'journey plan', which takes the pension scheme from its current position to the agreed endgame, via a series of risk management steps and actions that ensure the objectives are achievable and affordable, and deliver the endgame in the most efficient way possible. The endgame may be a scheme that is 'self-sufficient', in terms of holding a portfolio of low risk and/or matched assets and no further contribution requirements from the company, or a scheme that has been fully bought out with all risks transferred to an insurance company.

STEP 3: IMPLEMENT AND MONITOR

The timing of some actions contained in the business plan for the scheme may depend on external factors: for example, buying annuities in respect of a tranche of pensioner members may depend on insurer capacity, competitive pricing factors within the provider market and the relative price of the portfolio of gilts held by the trustees to fund the transaction. Therefore, as well as a strong operational focus and robust delivery, a successfully implemented business plan for the scheme will include regular monitoring of the key drivers, PR decisions pre-agreed trigger points or tolerance ranges for action, and a streamlined and effective decision-making process.

DE-RISKING OPTIONS: LIABILITY MANAGEMENT AND RISK TRANSFER SOLUTIONS

OPTIONS	WHAT IS IT?	WHEN MIGHT IT BE USEFUL?
ENHANCED TRANSFER VALUE EXERCISE	TRANSFER DEFERRED MEMBER* DEFINED BENEFITS (DB), ON ENHANCED TERMS, TO ANOTHER SCHEME. *THOSE WHO HAVE LEFT THE COMPANY, BUT NOT YET RETIRED.	◆ SCHEMES WITH LARGE NUMBERS OF DEFERRED MEMBERS ◆ REMOVES RISK: REDUCES SIZE AND VOLATILITY OF DB LIABILITIES ◆ COST IS LOWER THAN INVESTMENT ALTERNATIVES ◆ ADDITIONAL MEMBER FLEXIBILITY
PENSION INCREASE EXCHANGE EXERCISE	EXCHANGE FUTURE PENSION INCREASES FOR UPLIFTED PENSION ON/AFTER RETIREMENT.	◆ SCHEMES THAT OFFER POST-RETIREMENT INCREASES ON PENSIONS BUILT UP BEFORE 1997 ◆ P&L GAIN ◆ REDUCES INFLATION AND LONGEVITY EXPOSURE ◆ REDUCES LIABILITIES ◆ REDUCES BUY-IN/OUT COSTS ◆ ADDITIONAL MEMBER FLEXIBILITY
LONGEVITY SWAP	TRANSFER OF LONGEVITY RISK TO A THIRD PARTY.	◆ USUALLY PENSIONER LIABILITIES OVER £250M ◆ REDUCES RISK ◆ MAY REDUCE CAPITAL REQUIREMENTS OR IMPROVE 'REGULATORY EFFICIENCY' ◆ IMPROVES EFFECTIVENESS OF OTHER HEDGING
PARTIAL BUY-IN	TRANSFER LONGEVITY, INTEREST RATE AND INFLATION RISKS TO THIRD-PARTY INSURANCE COMPANY. TREATED AS ASSET OF PENSION SCHEME.	◆ POTENTIAL BUY-IN LIABILITIES OF £5M TO £2.5BN ◆ REDUCES/TRANSFERS RISK ◆ TAKE ADVANTAGE OF OPPORTUNITIES TO TRADE GILTS FOR ANNUITIES
INSURED BUY-OUT	TRANSFER LONGEVITY, INTEREST RATE AND INFLATION RISKS TO THIRD-PARTY INSURANCE COMPANY. INDIVIDUAL CONTRACTS IN MEMBERS' NAMES.	◆ POTENTIAL BUY-OUT LIABILITIES OF £5M TO £2.5BN ◆ REDUCES/TRANSFERS RISK ◆ TAKE ADVANTAGE OF OPPORTUNITIES TO TRADE GILTS FOR ANNUITIES (PARTIAL BUY-OUT)

Ian Aley (top) is head of pension risk solutions and Alasdair Macdonald is head of investment strategy at Towers Watson. **Towers Watson has developed a risk review report, which compares the financial impact of a range of risk management options on a company's P&L, balance sheet and cash contribution requirements.**

For a one-page appraisal for your scheme, please contact ian.aley@towerswatson.com or alasdair.macdonald@towerswatson.com

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TIPS FOR DE-RISKING

The top three de-risking tips from Crispin Southgate, Institutional Investment Advisors, who chaired the ACT breakfast briefing panel discussion on 12 September 2012:

1. **Maintain a clear summary of the scheme's risk position and available options for improvement in order to reduce the deficit and its volatility.**

2. **Agree an action plan. Reducing risk in the pension scheme, and thereby the impact of the pension scheme on the business, needs the backing of both the company's key decision-makers and the scheme trustees.**

3. **Opportunities to reduce the costs of risk reduction won't wait, so be ready to act quickly. Empower an implementation team who are engaged, up to date on key metrics and clear on triggers for action.**