risk management

PENSION FINANCIAL RISK

Paying attention

During May 2006, Mercer Human Resource Consulting and the ACT approached chief financial officers and treasurers for a second annual survey on managing pension financial risk. The survey sought to determine the extent to which this group viewed pension schemes and their deficits as significant corporate risk issues, and their perception of stakeholder attitudes towards such risks. Over 100 responses were received, with FTSE 350 companies well represented. This article summarises the responses.

CHANGING ATTITUDES TO PENSIONS RISK Participants were asked how they thought pension funding and investment strategies had changed in importance for various stakeholders in the last year.

A majority of participants thought that three stakeholder groups – board and senior management, employees and shareholders/analysts – were attaching either slightly or much more importance to these strategies. Board and senior management led the way (over half), followed by employees (around a third) and shareholders/analysts (over a quarter). One interpretation of this result is that the latter two categories are already aware of the extent of the issues and boards are now catching up. A minority believed there had been no material change year-on-year and it is perfectly possible that they were already taking pension strategy issues very seriously, or had schemes that were not material to the business.

CONTRIBUTIONS DRIVERS Participants were asked if they had made any 'special' contributions (in other words, over and above normal contributions) to company pension schemes in the UK or abroad within the last year. Those who had were asked to state the principal drivers and whether they had undertaken a specific financing arrangement in connection with the special contributions.

Almost 60% of participants had made special contributions during the period. By far the largest drivers were scheme-specific funding requirements (30%) and general risk mitigation (25%). Tax and Pension Protection Fund (PPF) levy considerations exerted much less influence. Fewer than 10% of companies had undertaken a specific financing arrangement to fund the contribution.

Scheme-specific funding requirements as a major driver for special contributions may seem surprising given that the relevant legislation is only now coming into practical effect. However, its arrival has been widely anticipated in negotiations between trustees and sponsors.

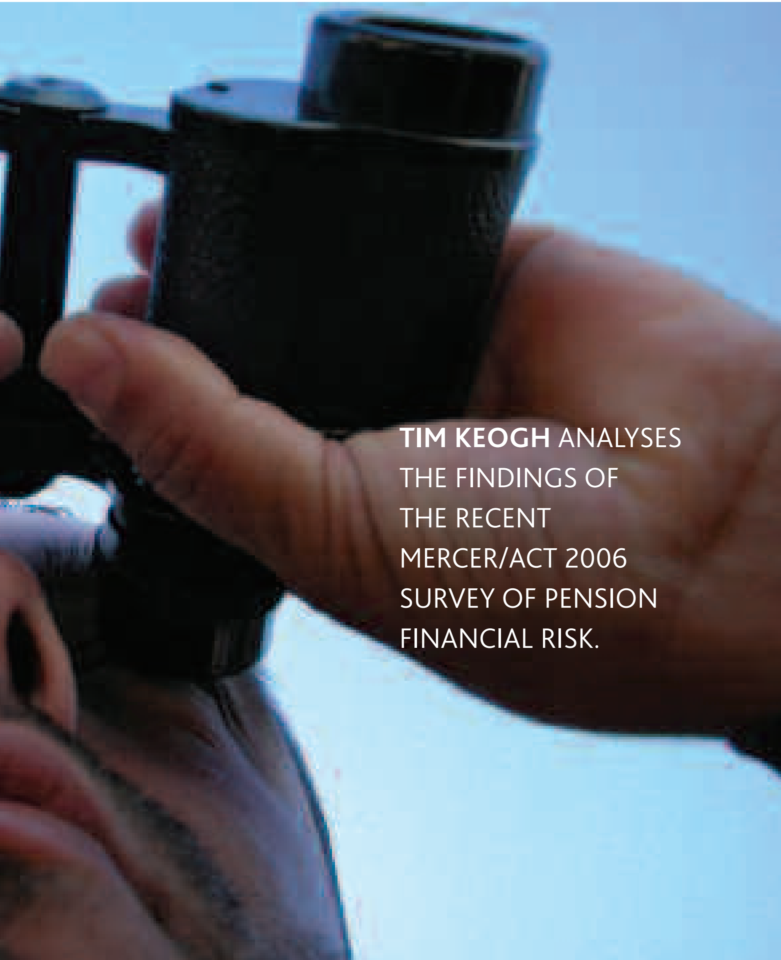
The other major driver was general risk mitigation, which supports anecdotal evidence of more treasurers and CFOs applying quantitative risk management assessments to business risks in general and pensions risks in particular. A few participants also mentioned other, company-specific, reasons for special contributions, such as the facilitation of specific corporate transactions.

Executive summary

- Board and senior management, staff, and shareholders/analysts are attaching more importance to pension funding and investment strategies.
- A majority of participants had made special contributions during the period under review.
- A very low percentage of participants used interest rate and inflation hedging instruments.
- Most disagreed with the Pensions Regulator's statement that the Pensions Act 2004 has had little impact on mergers and acquisitions.
- A greater focus on mortality assumptions is noticeable, supported by companies making voluntary disclosures in their reports and accounts.

INVESTMENTS AND THE PPF RISK-BASED LEVY The PPF has stated that it will consult on a possible modification of the risk-based levy formula to take account of the investment risk taken by schemes, which may be interpreted as the degree of mismatching between assets and liabilities. This approach lies at the heart of the nFTK pension regulations that are currently being put in place in the Netherlands.

Participants were asked if they would respond to the PPF's proposed consultation on introducing an asset-liability matching element into the risk-based levy formula. Those who said they intended to were asked if they were in favour of the risk-based levy being lower for those schemes with more closely matched assets and liabilities, all other things being equal. They were also asked if they were more likely to seek to increase the amount of asset-liability matching in their scheme in the event that the PPF did modify the risk-based levy formula to take asset-liability matching into account.



TIM KEOGH ANALYSES THE FINDINGS OF THE RECENT MERCER/ACT 2006 SURVEY OF PENSION FINANCIAL RISK.

Only a little over a quarter said they intended to respond to the PPF; the balance was divided roughly equally between those who had decided not to and those who were still undecided. The figure for those intending to respond is probably consistent with the proportion of companies responding to other consultations undertaken by the PPF.

Of those who did intend to respond, more than half thought there should be a reduction in the risk-based levy for those schemes that adopted a lower-risk investment strategy. Presumably, the others felt that they should be free to allow riskier strategies to contribute to deficit reduction over time without penalty.

The fact that around a third of respondents would modify their investment strategy to exploit any risk-based levy reductions that might become available is not surprising. However, nearly a third would not do so. One explanation for this might be that they expect to be paying a low levy anyway, perhaps through being close to fully funded on a PPF basis (that is, including contingent assets).

USE OF DERIVATIVES In general, investment risk minimisation strategies effectively require the use of derivatives, given the scarcity and illiquidity of assets that naturally hedge liabilities.

When asked whether they had used derivatives in their schemes in the UK or abroad in the last year, a very low percentage of participants said they had used interest rate (6%) and inflation hedging instruments (4%). This reflects anecdotal evidence that trustees have been reluctant both to accept the use of such derivatives and, even if they do so in principle, actually proceed to implementation. The fact that no participants had used credit derivatives may, in part, be due to the PPF's lack of acceptance of such instruments in assessing the risk-based levy.

However, over 10% of participants had used types of derivatives not listed in the question. These were divided principally between currency derivatives used to hedge non-UK bond and equity portfolios and various types of equity derivatives. We may speculate that in some cases these instruments were actually entered into by investment managers, therefore obviating the need for trustees to enter into documentation often perceived as "difficult".

IMPACT OF LEGISLATION ON CORPORATE ACTIVITY In response to the question of whether the Pensions Regulator was correct in saying that the Pensions Act 2004 has had little impact on corporate activity (such as mergers and acquisitions), 57% said they disagreed with the statement. However, only 31% felt that it had affected such activity in their own company.

PENSION ISSUES OUTSIDE THE UK Participants were asked if they had experienced significant pension funding and investment strategy issues outside of the UK; a third said they had. Of these, more than half felt that their importance had increased in the eyes of the board and senior management year-on-year.

REVIEW OF MORTALITY ASSUMPTIONS Trends in future longevity improvements are much debated. While actuarial tables have allowed for a degree of improvement for some time, additional variants of the basic PA92 tables – the short, medium and long cohort projections – have been published which suggest more rapid improvements are likely. The last of these gives rise to the highest levels of expected longevity improvements and therefore to the greatest increase in liabilities compared with other tables. For example, if a typical scheme were to adopt the medium cohort rather than the base projection, its liabilities could increase by 10%.

Participants were asked if they had reviewed their mortality assumptions over the last year and, if so, whether they had strengthened them in line with the so-called cohort effect.

More than half the participants had reviewed the tables used in their schemes, which is unsurprising given the relatively high profile now being granted to mortality assumptions. Of those that had not yet done so, around half intended to in 2006.

It has been clear for some time that the medium cohort effect projections are increasingly favoured. The responses show that almost 60% of those reviewing their assumptions adopted this basis. It is common to make further adjustments to the published tables to reflect the nature of the scheme membership.

LONGEVITY IS KEY RISK AREA The survey results clearly show that pension funding and investment strategies are increasing in importance at all levels, not only from the number of companies making special contributions to their schemes, but also the attention to the risks which remain even when a deficit reduction plan is in place. One key risk area is longevity, and an increased level of attention to mortality assumptions is also noticeable, supported by the number of companies making voluntary disclosures in their reports and accounts this year.

It is less clear that significant strategic changes are being made to deal with investment risk. Despite press headlines and an intensive marketing drive by investment banks, the adoption of hedging investment strategies and derivatives is far from widespread. It remains to be seen whether a change to the PPF levy arrangements which encourages higher levels of hedging will change this.

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