

# Technical Briefing

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## Mitigating Risk and Controlling Volatility

Following a period of significant market turbulence and growing legislative pressures on the bases for calculating the liabilities of a defined benefit pension scheme, more and more trustees and scheme sponsors are considering less traditional ways of managing risk. As such many are turning to solutions that better manage the variability inherent in defined benefit schemes to remove uncertainty and limit the volatility of results.

There is reducing appetite for the long standing acceptance of investing long term in growth assets whilst accepting the short term volatile results. This is especially true given the much greater scrutiny of trustees, by regulators reviewing valuation results, and sponsors, by markets reviewing accounting disclosures.

For sponsors and trustees there are a range of different strategies being considered. Technical Briefing (TB) 34 discussed the option of buy-ins, and this remains a growing market, but there are a number of other strategies worthy of review.

### Liability Driven Investments (“LDI”)

The term “liability driven” is one that is used in a number of scenarios and can mean a number of different things. At **cprm**, we use this term to refer to setting a Statement of Investment Principles that seeks to marry up the basis and assumptions used to value liabilities, or set “technical provisions” with the asset allocations used for investment. The aim is to derive an asset allocation that, based on a number of critical assumptions, will lead to assets moving broadly in line with the liabilities thus better controlling the volatility of a scheme’s funding position. Such an analysis can relate the departure from a matched position to the relationship between scheme funding and the strength of the employer covenant.

The extent to which volatility can be controlled clearly depends upon the basis used to assess liabilities – a more bonds based approach lends itself better to managing volatility than a more equity based one. We can, however, model various scenarios using stochastic projections to assess the impact of different asset allocations to help trustees and sponsors quantify the risks they are taking and set their investment strategies accordingly.

### Absolute Return Funds

An approach akin to LDI is to use the relatively new approach of absolute return funds. These are very actively managed funds from specialist providers that use combinations of direct investments and a wide range of financial instruments and derivatives to target a defined positive return on assets. For example, they may target a return of cash + x% p.a., or a simple fixed return of y% p.a.

Whilst these are relatively new funds, those that have been in place over the period of the credit crunch and the global market crisis have performed relatively well against their targets, which bodes well for their future ability to achieve what they have set out to do. Some trustees are considering these funds as part of a balanced strategy, whilst others are still uncertain given the lack of longer term performance history. It is, however, certainly a potential solution worth keeping a watchful eye on.

### Enhanced Transfer Values

In this scenario, a scheme sponsor offers to enhance the transfers that members can take from a scheme to a new pension arrangement for a limited period. These enhancements, if carefully





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calculated, can be set at a level that is attractive to members who, with professional advice, will view a transfer away from the scheme as financially beneficial.

From the sponsor's point of view, the fixed cost of the enhancements are attractive as a premium for achieving absolute certainty – the liabilities in respect of these transferring members is fully discharged. Further, this can often be done at little or no balance sheet cost relative to the bases used to report liabilities in company accounts.

If carried out properly, very high success rates can be achieved in a way that is positive for all stakeholders – sponsors, trustees and members. **cprm** have significant experience of these types of exercises, having achieved typical success rates of 70-95% of liabilities being discharged.

### **Annuity Buy-In**

Whilst Enhanced Transfer Value exercises work very well for members who have not yet attained retirement age, the annuity buy-in solution fits well for pensioners. Our TB34 discusses this option in detail, but overall it involves trustees securing all of their pensioners' liabilities with an insurance company, but still within the scheme's trust. Terms have been attractive over the past 12 months, and remain broadly so, with record volumes of business being reported by insurers for Q1 of 2010.

The key advantages of a buy in exercise are that this option not only removes the longevity risks associated with pensions in payment, but would also remove the investment and inflationary risks backing the members who have been included in a buy-in. In turn this leads to a significant reduction in the volatility of a scheme's funding level and any future deficit recovery contributions. From a membership perspective there is no change as the scheme and trustees will remain responsible for meeting pension payments and maintaining the ongoing relationship with members.

### **Longevity Swaps**

Longevity swaps are derivative contracts that offset the risk of a scheme's members living longer than expected. The scheme makes regular payments based on agreed mortality assumptions to an investment bank or insurer and, in return, the bank or insurer pays out amounts based on the scheme's actual mortality rates.

These derivative contracts provide certainty of cashflows and reduce any longevity risk a scheme may have concerns about. Trustees are also able to retain assets (and potentially maintain an aggressive investment stance, employer covenant permitting) while passing some risk to a third party.

Currently, however, it is difficult for most schemes to invest in assets of this nature, as issues of these swaps (to make the attaching fees sensible) would require a minimum liability level of around £50m.

### **Contingent Assets**

Trustees can better control their risk profile if they can obtain certain contingent assets from their sponsors. These can take a number of forms – cash, investments, property or other guarantees – where the trustees benefit from additional assets or funds should certain scenarios occur. This can help give trustees greater confidence that the impact of negative experience will, at least to some extent, be minimised. More details on the forms of contingent asset that might be considered are contained in our TB27.

### **Other Solutions**

There are many other possible actions that can be taken to control risk. These include pension increase exchanges, where members are offered an exchange of uncertain increases for fixed ones, data cleansing, to better control the risks of unexpected liabilities arising, and employer covenant reviews to help manage sponsor risk to name a few.



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### Summary

In uncertain times, the focus on controlling risk and volatility naturally increases. There are a number of strategies that can be considered to help manage these, both for sponsors and trustees. **cprm** are well placed to advise on and implement such strategies. If you wish to investigate any of these further, please contact your usual **cprm** consultant. Alternatively you can telephone Jonathan Black on 0131 338 6127 or email [jonathan.black@cprmlimited.co.uk](mailto:jonathan.black@cprmlimited.co.uk)

May 2010