BROADSTONE™

INVESTMENT RISK MANAGEMENT

HOW MUCH RISK ARE YOU RUNNING?

The recent Pension Regulator's new Code of Practice on defined benefit pension scheme funding is based on a central theme of three pillars that, taken together, form the basis of the Code.

The Code, like a building, recognises that the three pillars need to be well placed, proportionate and accepts the inter-dependency that exists between the three pillars if they are to provide a stable structure. The creation of the Code recognises that these three pillars have not always been in place meaning that many schemes are not as structurally sound as they could be.

The three pillars within the Code are:

1. Integrated Funding
2. Assessment of the Employer Covenant
3. Investment Risk Management.

Previously we have issued guides to the Code of Practice that can be downloaded using the following links.

Pension Scheme Funding – New Code of Practice
www.broadstoneltd.co.uk/page.aspx/Pension-Scheme-Funding-New-Code-of-Practice

A New Approach to Funding – What is Integrated Funding?
www.broadstoneltd.co.uk/page.aspx/BROADSTONE-What-Is-Integrated-Funding

Guide to the Employer Covenant – Assessing Financial Security
www.broadstoneltd.co.uk/page.aspx/Guide-to-the-Employer-Covenant

In this guide we are focusing on the third pillar of the Code – Investment Risk Management.

It is here that the Trustees and employer discuss and set the investment strategy, assess the risks (upside and downside) that a particular strategy will run, and whether it is consistent with the employer covenant.

WHAT DOES THE PENSIONS REGULATOR MEAN BY INVESTMENT RISK MANAGEMENT?

The Pensions Regulator wants Trustees and employers to understand the upside and downside risk of any investment strategy that is put into place.

The Trustees should be able to assess and understand the risks with a particular strategy and how investment strategies would impact on the scheme's funding position. Also they should consider the employer's plans for sustainable growth and, ultimately, the employer covenant.

WHAT DOES THE PENSIONS REGULATOR EXPECT?

SETTING AN INVESTMENT STRATEGY

When setting an investment strategy the Trustees must ensure that the risks associated with the strategy are aligned with the employer covenant. This can involve:

- Stress testing worst case scenarios and best case scenarios to understand the impact on the employer
- Sensitivity testing to see the consequences of changes to the underlying assumptions
- Probability modelling to help demonstrate the funding implications of different outcomes.

When setting the strategy the Regulator also expects Trustees to understand the liability profile of the scheme which should include an assessment of the:

- Maturity of the beneficiaries
- The long-term strategy of the employer
- The end-game of the scheme.

In addition to these factors the Trustees must also be able to:

- Consider and assess their risk tolerance, based on the above information
- Take a proportionate view on diversification and avoid concentrations of investment classes or sectors – especially in the same industry – as the employer where an impact on asset values and employer covenant could occur
- Place the strategy within the confines of the funding objectives
- Understand the liquidity needs of the scheme

With that understanding an appropriate investment structure/strategy can be developed.

HOW MUCH RISK?

This is an area that can difficult to quantify and many Trustees will use Value at Risk (VaR) to assess their risk position. VaR is a statistical technique used to measure and quantify the level of financial risk in the investment strategy over a specific time frame. The VaR is then used by the Trustees in order to measure and control the level of risk which it undertakes. The Pensions Regulator has also started to ask for the VaR number to be included on the scheme return as part of its analysis of the risk in the Defined Benefits world.

From this analysis the Trustees may need to consider strategies to hedge against risks that have been identified.

MONITORING AN INVESTMENT STRATEGY AND MANAGING RISKS

The Pensions Regulator also expects the Trustees and employer to monitor the investment strategy to ensure it remains appropriate in light of potential changes to the employer covenant and scheme funding. However, any potential changes to the strategy should be assessed with proper consideration to any costs versus the anticipated benefits.

It is possible that where there are changes in the funding position that the risk in the strategy becomes excessive. In these cases the Trustees may want to consider:

- Approaching the employer for additional contributions/security
- Exploring options to strengthen the employer covenant
- Changing the investment strategy
- Accepting the new level of risk and maintaining the strategy.

Whatever the outcome the Pensions Regulator expects Trustees to be able to go through an exercise assessing the different options, together with the employer, so that they can collaboratively reach the most appropriate solution. Any solution or investment strategy that is put into place should be appropriate and proportionate to the position of the scheme and employer.

WHAT SHOULD YOU BE DOING NOW?

1. Assess the risks in your existing investment strategy via some scenario/sensitivity testing and VaR analysis
2. Evaluate what can be done to reduce risk without reducing targets for returns
3. Consider strategies to hedge risk
4. Take advice – the Pensions Regulator expects Trustees to use and act on advice from appropriate advisers, there is no expectation that Trustees will have the skills to set and assess their investment strategy without advice
5. Knowledge and understanding – the Pensions Regulator does expect the Trustees to have the appropriate knowledge and understanding and for many Trustees training will be the starting point for investment discussions
6. Consider asset backed contributions – these can be a very useful way of giving schemes access to capital, assets or cash flow previously unavailable to the scheme.

HOW CAN WE HELP?

We are experts in the first and third pillars and have always believed that they should be combined to give properly joined up actuarial and investment advice.

We recognise that many schemes (and their advisers) will need to raise their level of focus. We can provide a bespoke service and work with you to achieve the Pensions Regulator's aims for good scheme funding and appropriate investment strategies.

We will facilitate a collaborative engagement between the Trustees and employer rather than perpetuate a disjointed and passive approach experienced by many schemes in the past.

We provide joined up actuarial and investment advice to achieve the investment structure you need.

We will provide assistance with the governance structure so that the process is handled in a timely manner so all sides consider and respond appropriately.

We work openly and pragmatically with the employer so the position of the employer and objectives of the scheme are aligned.

CONTACT US

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NOVEMBER 2014