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Managing risks…

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Emma Watkins discusses risk in funded public sector and quasi public sector pension schemes

Public sector pension schemes are high on the political agenda, primarily as a result of their burgeoning cost in a time of changing demographics and economic turbulence.

First, there was the decision to link statutory rises in public and private pension scheme benefits to the Consumer Prices Index (CPI), rather than the Retail Prices Index (RPI). The Government decided the change provided a more appropriate measure of pension recipients' inflation experiences and was also consistent with the measure of inflation used by the Bank of England. However, for many pension scheme members, this has been viewed as a move to reduce pension scheme benefits, resulting in smaller increases for members because CPI tends to be lower than RPI over the long term.

Then in March 2011, Lord Hutton published his long-awaited report setting out his key recommendations for reform of public sector pensions, handing across the baton to the Government and with it the task of shaping the future of public sector pension provision. Whilst economic concerns about the cost of public sector pensions were the primary driver for the report, the remit was clearly set out to achieve pension reform that was both 'fair and adequate' with any reform not to be seen as a 'race to the bottom'. Shortly after publication, however, warnings from the Trade Union Congress and others that public sector workers would not accept the recommendations were supported when 75,000 public sector workers went on strike in June. The Chief Secretary to the Treasury, Danny Alexander, has since announced plans for talks on reform to continue into the autumn.

In reality the challenges facing public sector pensions in the UK are fundamentally the same as those that all private pension schemes face in the developed world:

- Increasing longevity is making defined benefit pension provision more and more expensive
- Investment returns over the last decade have not been sufficient to meet increasing costs
- Volatility of liabilities depending on reporting standards. Whilst the public sector don't prepare reports in the same way as private organisations, the recent publication of the 'Whole of Government Accounts' demonstrated a similar issue with public sector pension schemes making up the largest portion of all liabilities reported

- The recession has made it harder for employees, employers and the Government alike to be able to afford pension contributions needed to meet defined benefit pension promises

In the private sector, employers and trustees have looked at a number of ways to manage risk within their pension schemes over the last decade. Actions have ranged from increasing employee contributions, benefit modifications, through to liability management and transfer.

A similar trend appears to be emerging in the public sector. The problem of course is that public sector pensions are often discussed as if they are one homogenous group. In reality there is a wide variety of different schemes with different rules, benefit structures and costs.

Unfunded public sector pension schemes, such as the NHS, teachers and police pension schemes, have little option other than to manage their liabilities in a bid to control costs.

However, funded public sector pension schemes have to manage the interaction between their liabilities and assets in an attempt to improve their funding position and thus direct costs. This applies to the Local Government Pension Scheme (LGPS), which is by far the largest public sector scheme with 4.6 million members, but there are also a number of pension schemes associated with quangos – "quasi-autonomous non-governmental organisations" – for which this situation is equally as applicable.

It can be quite difficult to achieve an ideal interaction between assets and liabilities in current market conditions. Stock markets around the world have been extremely volatile in recent weeks hitting a low of 4,944.4 on October 4th 2011 before staging a recovery, having been as high as 6,054.5 on July 7th 2011. Government and corporate bond markets are suffering from an aversion to certain types of sovereign debt and inflation remains well above the UK Government's 2% target, with the Bank of England expecting it to increase further in 2011 due to increases in utility prices.

Of course, pension schemes are not required to formally hedge against investment risks, and due to the perceived complexity and expense, many have not adopted such an approach. And whilst public sector pension schemes are under less pressure than private sector schemes to close pension fund deficits quickly, in this climate of rising inflation, ongoing market volatility and increased scrutiny, the reasons to adopt a de-risking strategy to control volatility is becoming more convincing.

The major thrust of de-risking in funded public sector scheme has been to match assets to liabilities and understand the scheme's risk profile. Critical risks include exposure to changes in inflation expectations, interest rates, credit spreads, and property and equity markets. Liability-driven investment strategies have focused on creating a pool of return-seeking assets that is well matched to the likely cash outflows of the pensions using bonds or swaps. Hedging longevity risk is also something that has been explored, with the Royal Berkshire fund agreeing the first public sector longevity swap back in 2009.

Despite ongoing competition, growth and demand in the bulk annuity market which have provided schemes with genuine opportunities to de-risk all or part of pension scheme liabilities through a buyout or buy-in, these strategies have not been widely considered in the public sector arena.

Both a buyout and buy-in involve the transfer of a scheme's full or partial liabilities to an insurance company and, in doing so, remove or reduce exposure to potential investment, inflation, interest rate and longevity risks. However, there are some fundamental differences between these two approaches to risk transfer:

- A buyout is the full or partial transfer of a scheme's liabilities from the scheme to an insurance company in exchange for a single premium. Members' benefits are secured through the purchase of individual annuity policies. A full discharge in respect of the benefits secured is obtained, and the members gain the comfort of knowing their benefits are protected within a regulated insurance regime. Under a full buyout, all liabilities and associated risks - investment, inflation, interest rate and longevity risk – along with administration costs are removed completely. A buyout is typically one of the final stages of a scheme wind-up.

- A buy-in is the use of an annuity to hedge, or protect, the liabilities of a scheme as part of a strategy to reduce risk. A single insurance policy is secured in the name of the pension scheme, trustees or equivalent body (e.g. a pensions committee) and held as an investment within the continuing scheme structure alongside any other scheme assets. The decision to buy-in is usually part of a phased strategy to reduce risk with the scheme remaining responsible for payment of members' benefits and typically administered as before. In this structure, the scheme obtains a matching asset that produces an income stream equal to the benefits specified to the insurer thus achieving risk transfer without the need for more fundamental changes to the scheme.

With savings required across the board in the public sector it is not unreasonable to assume that the LGPS and pension schemes associated with quangos will also need to demonstrate efficiencies. Where quangos close, pension scheme or section wind-up via a buyout may be a logical option in order to secure members' benefits and remove ongoing costs. However, the scope for ongoing funded public sector pension schemes to utilise buy-ins as a matching asset for their liabilities appears to be an overlooked option. Whilst it may not be suitable in all situations, it should at least be actively considered as part of an appropriate risk management and governance strategy.