

Road map to peace of mind – Trustee Handbook 2012

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For many trustees, the ultimate goal of buying out their scheme is being impeded by funding deficits. Emma Watkins examines de-risking strategies to overcome this challenge

Removing risk from pension schemes has become one of the most important action points for trustee boards over the last few years, as trustees seek shelter from the volatility of markets.

'De-risking' can take various forms, but the ultimate objective for many pension schemes is a full buyout where an insurer takes on all the assets and liabilities of the scheme, including credit risk, inflation risk, interest rate risk, mortality risk and risk associated with the employer covenant.

To achieve this goal, a pension scheme must be fully funded or have an employer able to make up the difference at the time of buyout. However, for many schemes this is not the case. While a fully funded position might not be achievable immediately, planning a 'roadmap' to reach that point over a period of time is a constructive exercise.

Identifying obstacles

The role of the sponsoring employer in planning a route towards buyout is key. While trustees remain responsible for the scheme's investment strategy and paying the pensions of members, the decision to proceed to buyout is typically taken by the sponsor. Sponsor and trustees need to work together to ensure a shared view of the risks associated with the scheme and that the parties set mutually agreeable goals. Indeed, in the area of risk management, research carried out by MetLife Assurance¹ found that both groups' views of risk importance appears to be converging.

The inaugural 2010 survey found that both groups placed greatest importance on the risks for which they were responsible; trustees said investment risk was most important while sponsors rated longevity, employer covenant and scheme governance as critical. However, in this year's survey both groups agreed funding deficits is the most important risk factor facing schemes. This is not surprising since many schemes have witnessed significant fluctuations in their funded status recently.

Employer covenant was selected as the second most important risk in this year's survey. Tumultuous market conditions have left schemes susceptible to major fluctuations that they are not necessarily able to control, leading them to appreciate the importance and examine the viability of their sponsor as ultimate guarantor.

Planning a route

Within the de-risking roadmap, investment strategy will be key in enabling schemes to reach the goal of fully-funded status and allowing the execution of other de-risking activities along the way.

The investment strategies that each scheme uses on its de-risking roadmap will vary according to the employer's financial position, the profile of its membership and size of scheme deficit.

However, any scheme considering a path towards full or partial buyout will need to monitor investment risk and reward frequently. Establishing a regular forum where trustees and sponsor can discuss the investment management risks of the scheme, taking any changes in employer covenant into consideration, can help ensure both groups are comfortable with the level of risk in place and how that risk will help achieve ultimate funding goals.

Getting buy-in

For schemes in deficit, where a full buyout is not achievable in the short term, a more common approach is a buy-in, an annuity policy covering a selected portion of the scheme membership, most commonly pensioners. Buy-ins allow trustees to continue to manage the scheme, but with transfer of risk for the insured membership. A buy-in policy additionally offers flexibility to trustees in the event the scheme winds up in deficit; the insurance policy typically contains provisions to redistribute benefits, thereby preserving member equity.

Be prepared

When contemplating investment strategy in advance of a buy-in or buyout, obtaining advice on portfolio assets or structures that can easily be transferred to an insurer will be valuable. It is likely the insurer will prefer to accept assets which they would hold themselves, such as corporate or government bonds. Many insurers are also likely to hold derivatives to hedge risks such as interest rate and inflation risk. In the case of a partial buy-in or buyout, it is equally important to identify in advance the assets that will remain in the scheme and the appropriate investment strategy to support the remaining liabilities.

¹ As part of MetLife Assurance Limited's second UK Pension Risk Behaviour Index, 89 respondents (42 scheme sponsoring employers and 47 trustees) were surveyed between December 2010 and February 2011.