Publication

Derisking insight

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Risk ranks top of sponsors' agendas

The financial crisis has shattered the funding status of many UK and international pension funds. According to the Pension Protection Fund, the estimated aggregate funding status of about 7,400 defined benefit funds was at a deficit of £158.1bn at the end of July 2009. A year ago, the deficit was £18.8bn.

While capital markets have partly rebounded since the beginning of 2009, volatility remains and continues to drive the need for ongoing pension risk management. From a plan sponsor perspective, a checklist should be in place to verify if the prudent person principle has been translated into risk management processes:

- Is there a clearly defined investment and risk policy in place?
- Are all risks transparent, monitored, and actively managed?
- Is there a consistent investment and risk management strategy in place?

Pension risk management needs to be integrated and must address the risk factors that impact liabilities and pension assets. A discretionary approach builds on ad hoc, situation-driven actions. There is an inherent behavioural risk in this approach. Rule-based risk management is built upon disciplined and systematic actions triggered by preagreed rules and budgets. This approach has the advantage of working more seamlessly compared to an ad hoc approach.

All strategies should be customised and must take into account the sponsor's specific liability structure, risk preference, liquidity and regulatory needs. Unprecedented events, such as the extreme financial distress in 2008, have caused many sponsors and boards to rethink their fiduciary responsibility and approach towards risk. The review process may ultimately focus on a classic make, buy, or sell decision. In other words, plan sponsors may reconsider whether pension risks should be managed in-house or by an external risk management specialist, sold to or shared with third parties. Risk transfer and restructuring instruments such as interest and longevity swap transactions, pension buy-ins or buyouts may be considered.

Naturally, there is no straightforward answer to these questions. Affordability, availability, price, and timing of these options will differ, but one thing is for sure: prudent risk management remains a top priority for pension boards and plan sponsors.