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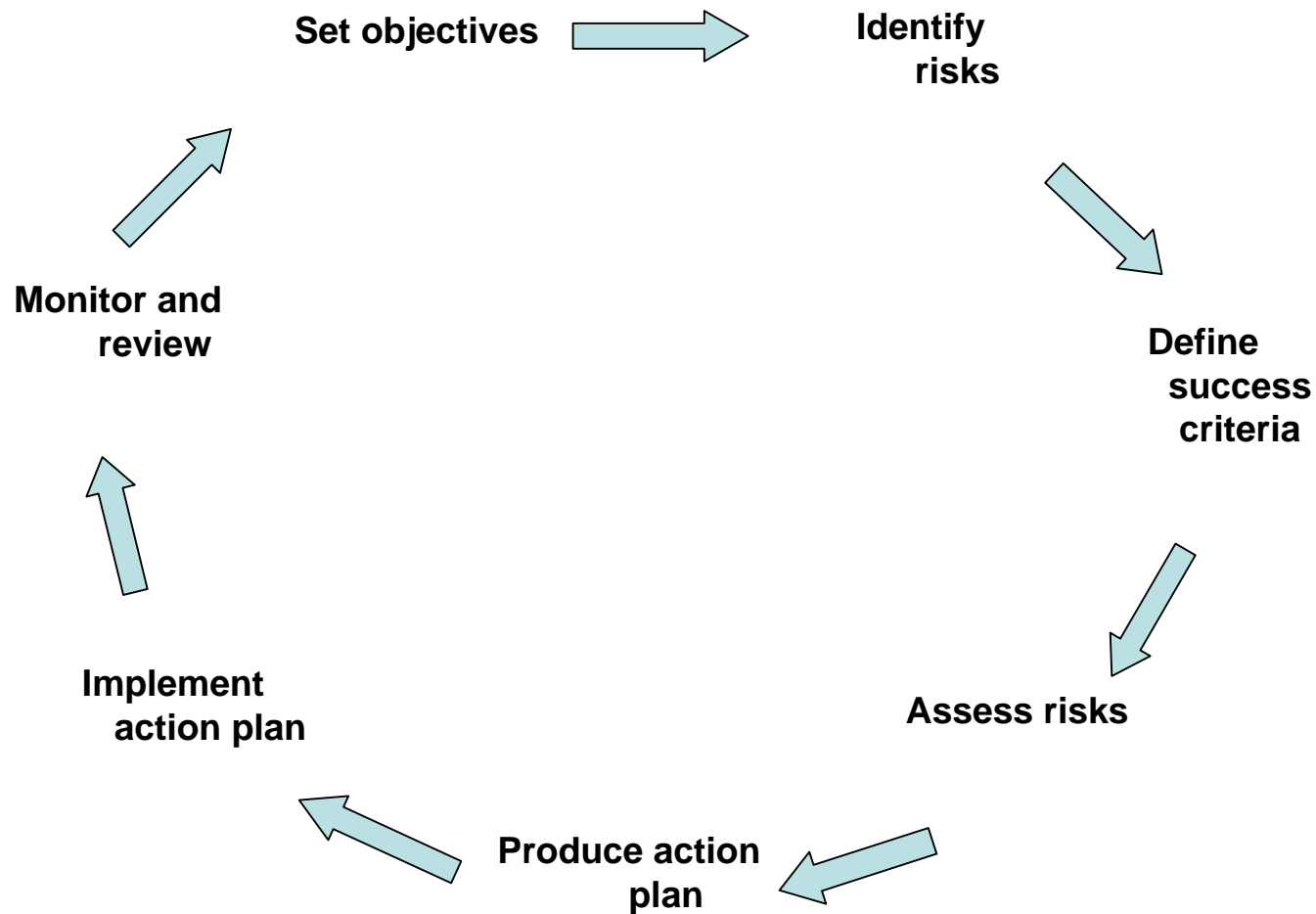


CAA Conference 2007

**Where did risk management of DB Pension Schemes fail?**

Andrew Long  
7 December 2007

# Risk management framework



# The DB Challenge

- Adequate post retirement income, that deals effectively with employer default risk, inflation risk and longevity risk
- Affordability, competitive benefits, no surprises





# Potential risks – UK history, Caribbean future?

## 1960's – 1970's: *First signs of trouble*

- High inflation / pension increases
- Poor equity returns
- Poor DC => move to DB
- Balance of cost
- Introduction of preservation
  
- Valuation of assets using Discounted Cashflow (@ 5.5%)
- Valuation of liabilities using returns (@ 9%) less than gilt yields (@ 17%)
- but....DB Schemes were immature, ie only 10% of GDP versus now circa 90% of GDP

# Potential risks – UK history, Caribbean future?

## 1980's: the **good times?**

- Social change driven by legislation  
NOT cooperation
- Women and part-timers join DB schemes
- Inflation protection for early leavers
- Personal pensions introduced,  
though mis-selling occurs in the 90's
- High equity returns => surplus
- Pension Actuaries allow for equity out-performance, change of  
basis leads to surplus!
- Asset stripping of pension schemes via financing workforce  
restructuring, contribution holidays, benefit improvements, taxation  
of surplus
- Consideration of solvency if bankruptcy happens

Pensions  
~~JAMAICA~~  
NO  
PROBLEM!!

# Potential risks – UK history, Caribbean future?

## 1990's – 2000's: multiple tipping points?

- Maxwell => pension no longer a promise, now a guarantee
- Inflation linked pension increases
- Removal of tax benefits on dividends
- Minimum Funding Requirement
- Longevity improvements
- Lower birth rates
- Discounted Cashflow out of favour, now market value / marked to market
- Accounting disclosures



"He's 104. He always comes back on his birthday - I worked out he'd be gone at 69."

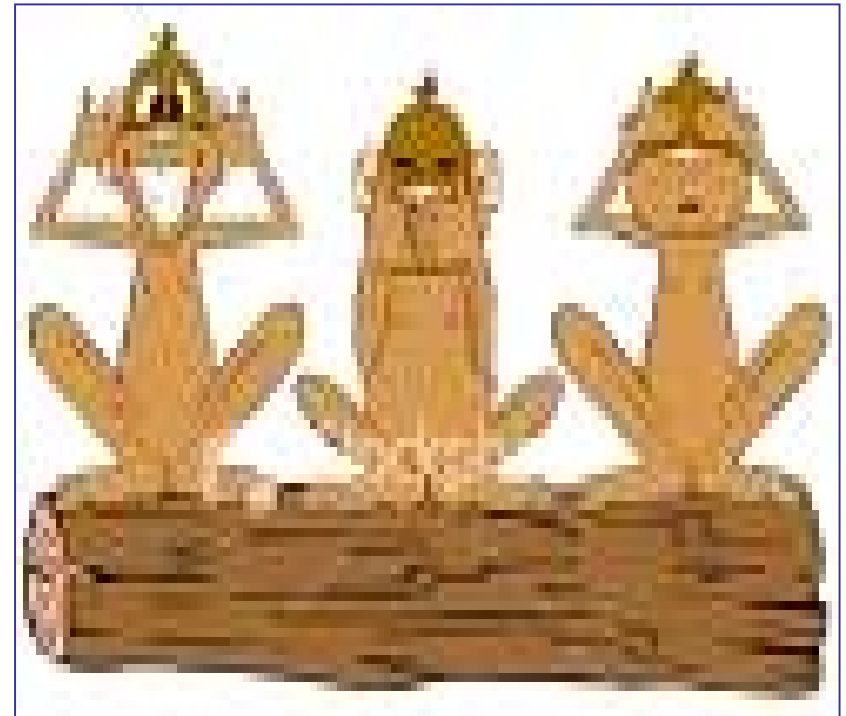
# Potential risks – UK history, Caribbean future?

## **1990's – 2000's:** tipping points and consequences

- 2002 equity market crash, very low bond yields
- Large deficits emerge, onerous contributions required
- DB closures, many members benefits reduced or lost
- DC provision explodes
- Sell equities, buy bonds
- Buy-out market grows, Enhanced Transfer Values
  
- Proactive Pensions Regulator
- Trustees (member nominated, improved standards, act as unsecured creditors)
- Pension Protection Fund and associated levies

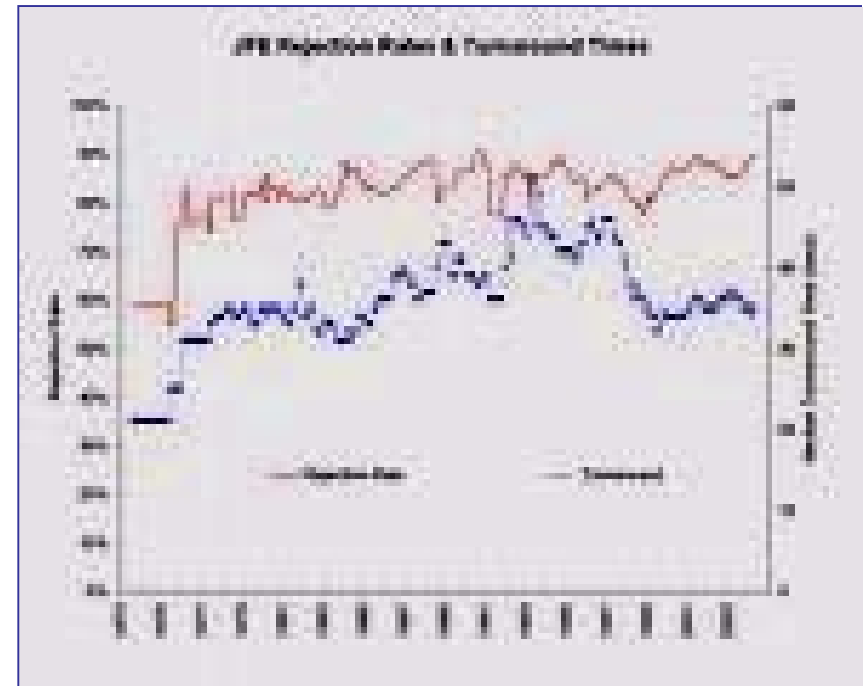
# What did we miss?

- Adequacy of pensions on retirement
- Gearing impact of preservation
- Attention to wind-up position
- Employer covenant
- Social context/political risk
- Change in assumptions (lag between observation and assumptions)
- The lack of clarity of the pensions contract
- Risk measurement techniques
- Lessons from similar entities



# Measurement

- Know the cost of what you have
- How it varies – ie scenario analyses
- Impact on Stakeholders
- Use up to date techniques and tools
- Check the reliability and robustness of tools and assumptions
- Measure impact of changes proactively



# Communication, clarity, transparency

- Understanding of the pensions contract
- What are the risks, faced by whom, and how do we manage them
- who pays, what happens to surplus or deficit, what is the wind-up position
- Show impact of experience not in line with assumptions
- What did we get right, what did we miss?
- Openness to new tools, new thinking
- Employee consultation and education

# Governance

- These are the rules!
- Establish framework for decision making
- Set objectives, how to achieve them monitor performance
- Collective skills of stakeholders (cease silo mentality!)
- Minimum standards of knowledge, training
- Focus on strategy, not operational issues

# Investment

- More effective procedures needed (eg dynamic switching)
- Market value bias versus long term return
- Avoiding herd instinct
- Understand switch from equities to bonds
- Use power as owners of capital to improve governance of companies
- Diversification (exchange controls hurt pensions!)

*“SHOW ME THE  
MONEY!!!!”*

*FAMOUS QUOTE  
BY  
CUBA GOODING JR*

# Political risk + Solvency

- Influence legislation
- Watch national budget spending – more money into healthcare increases longevity!
- The aim of the Plan is to provide adequate benefits
- Buy-out is the end-game, it cannot be ignored
- Journey plan to get there must be in place

# Is DC the answer?

## Behavioral finance foibles

- Too many choices
  - Too little education
  - Fund management fees – poor value for money
  - Longevity risks
  - What pension will members get
- 
- Auto enrolment, dynamically adjust contributions and investment strategy
  - Fewer options (low, medium and high risk)
  - Purchase deferred pensions throughout membership
  - Modeling tools, more creative education tools and media
  - Clarity on target income, expected cost, uncertainties and how to manage these

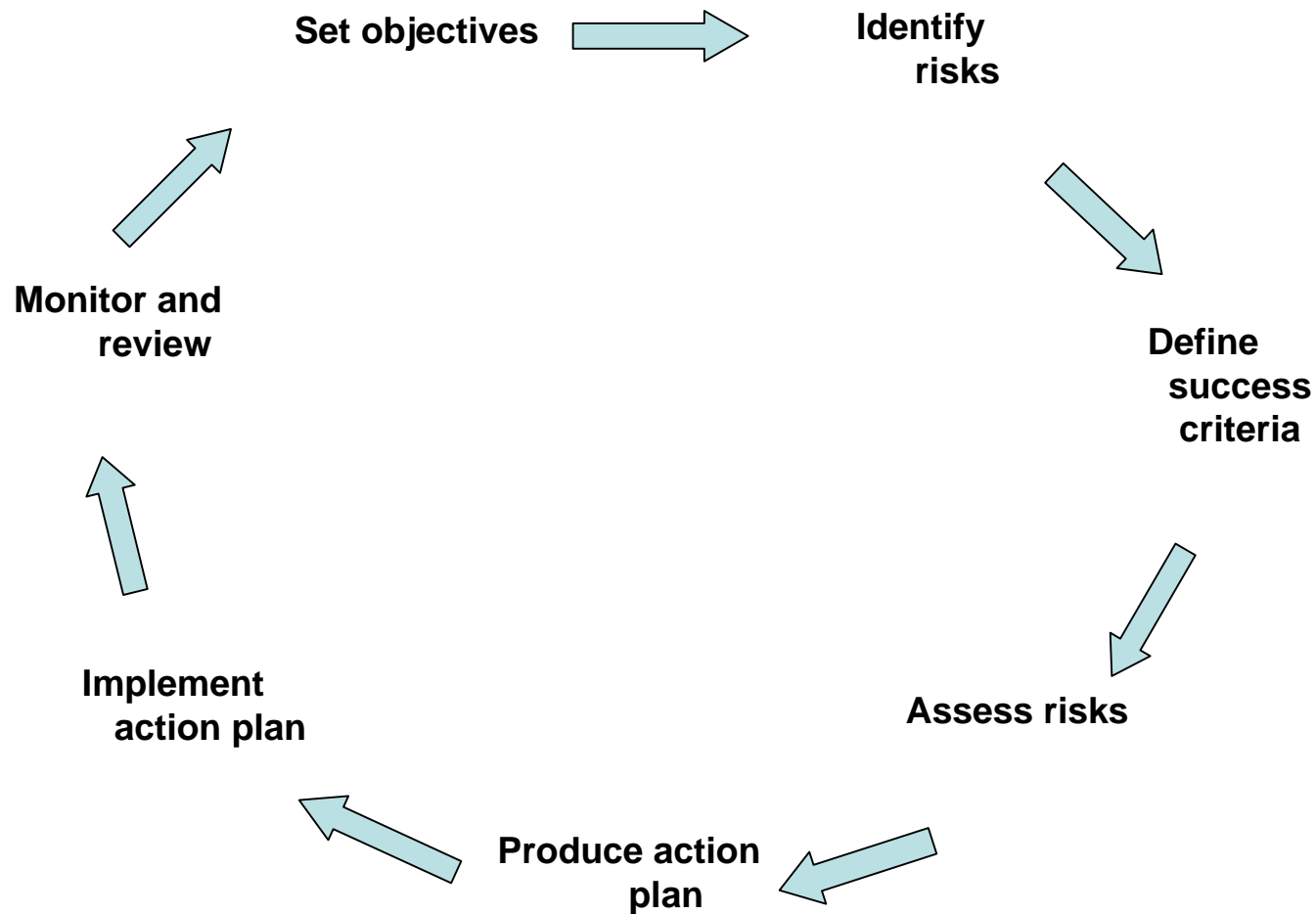
## Other issues

- Large pension coops, with expert leaders have been successful
- Endowment funds / charities have many commonalities and have had years of success
- State provisions and personal pensions also need attention

## Summary of things we can do

Legislation / Regulations	Play active role in drafting, implementing, and critically reviewing
Pension coops	A new business opportunity
Measurement and results disclosure	Use the latest tools and knowledge, undertake in a timely fashion, keep an eye on the assumptions vs reality
Governance	Educate clients on good principles, implement and audit procedures
Scheme design	We haven't cracked it yet – more work needed
Education	Education, Education, Education! A national debate.
Risk management	Set objectives, identify risks....etc
Investment	Long term focus

# Risk management framework



# Discussion

- Your views
- Any questions?

# Useful resources

## Websites:

- [www.trusteetoolkit.com](http://www.trusteetoolkit.com)
- [www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk)
- [www.actuaries.org.uk](http://www.actuaries.org.uk) - area of practice section on risk management

## Books:

- The Pension Fund Revolution – Peter Drucker
- Pension Revolution: A Solution to the Pensions Crisis – Keith Ambachtsheer