

Integrated Risk Management

Delivering improved outcomes



The issue

The Pensions Regulator's (TPR) guidance on Integrated Risk Management (IRM) is relevant for all pension scheme trustees and their sponsors. TPR has encouraged trustees and employers to implement an IRM framework as soon as possible, regardless of where they are in their valuation cycle.

IRM is not, however, about ticking boxes. It is crucial that each scheme has a process in place that is proportionate, works with the scheme's governance structure and reflects the particular circumstances of the scheme and its sponsor.

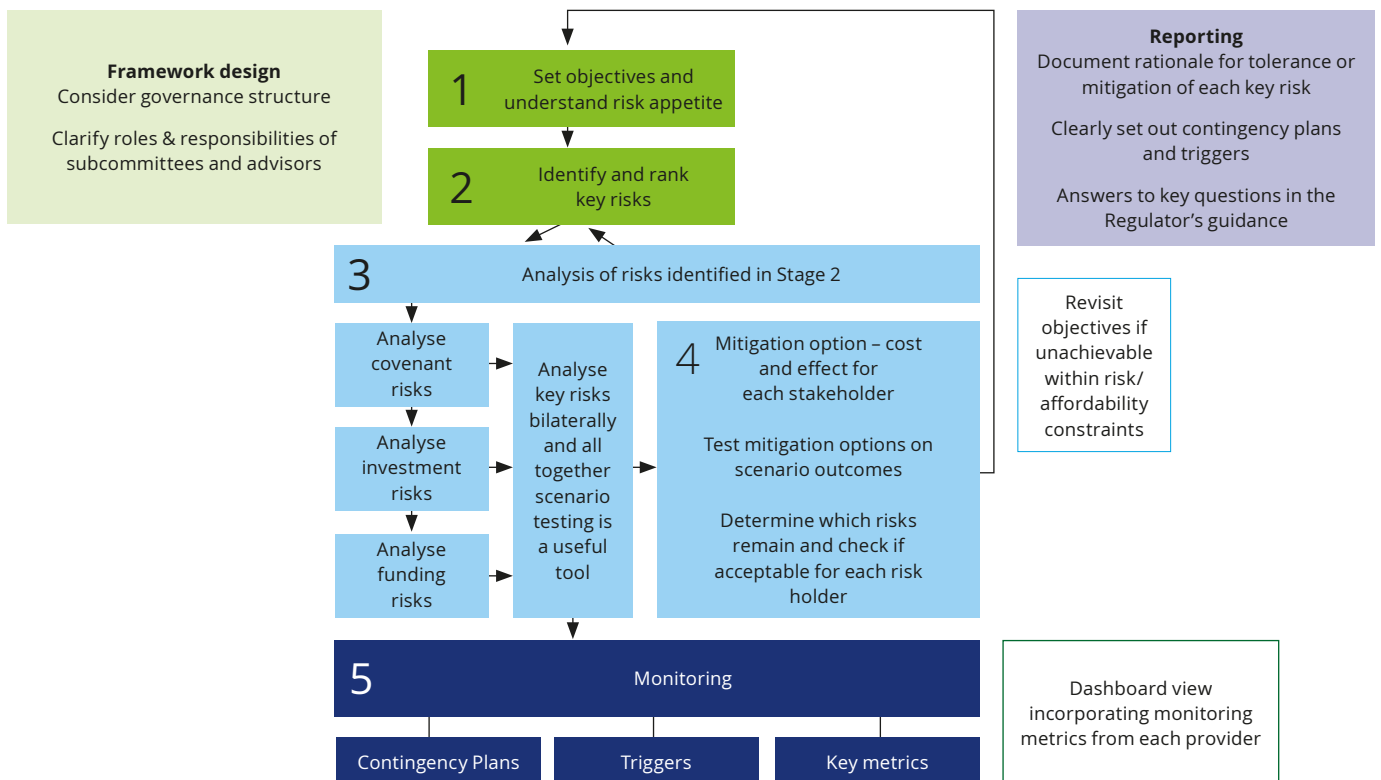
What is Integrated Risk Management?

In practice, this is the process by which most schemes are already managing their investment and funding decisions, IRM is a formalisation of this integrated approach. IRM acts as a framework for ensuring that the key risks facing the scheme have been clearly understood and that they have been considered in conjunction with other key risks, rather than in a silo.

Where to start?

IRM is an iterative process and it may therefore be difficult for those managing pension schemes to determine where to start. We have set out, below, an example process map which may provide a useful guide. However, the key objective of implementing a good IRM framework is to deliver improved outcomes for the pension scheme.

This should not, therefore, be a tick box exercise or a process which is followed and then filed away. The intention of IRM is to ensure that each scheme has a decision making structure in place which is useful, referred to regularly and is appropriate to its own circumstances.



Step 1 – Objective setting

Most schemes will already have a view of their objectives, both in terms of funding levels and the timescales needed to achieve them. There may be secondary objectives, such as securing the benefits for the scheme with an insurance company. All scheme objectives should be measurable, clearly described and set with direct reference to the circumstances of the scheme and its sponsor.

The reason why each objective has been selected should also be examined. This will help to determine the extent to which the objective can be flexed if the level of risk and/or employer contributions required to achieve the objective is unacceptable. The objectives should be tested against the trustees' and sponsor's ability to take risk, at their risk appetite.

One of the key principles of IRM is collaboration. It is important that the sponsor is involved in discussions around the objectives for the scheme and understands the impact that these objectives will have on its business.

Output

A documented set of objectives, and the rationale behind the objectives, which can be communicated to all advisors and used as a basis for recommendations and risk analysis.

Example

A scheme has set an objective to achieve full funding on a self-sufficiency basis by no later than the date on which a large cash generating contract that provides a significant proportion of the sponsor's revenue comes to an end. Unless there is additional security in place or the employer secures an extension or replacement to this contract, it will be important for the trustees to achieve their funding objective within that timescale.

On the other hand, achieving full buyout over a period of ten years because the sponsor would prefer to remove the pension scheme risk from its balance sheet may be a more flexible objective. This could be altered if the risk or contribution levels required to achieve this are too high.

Step 2 – Risk identification

Again, most trustees will already have information about the risks facing their scheme. There is no need to re-invent the wheel but most trustee boards would benefit from a review to test that they understand and have identified the key risks to which their scheme is exposed.

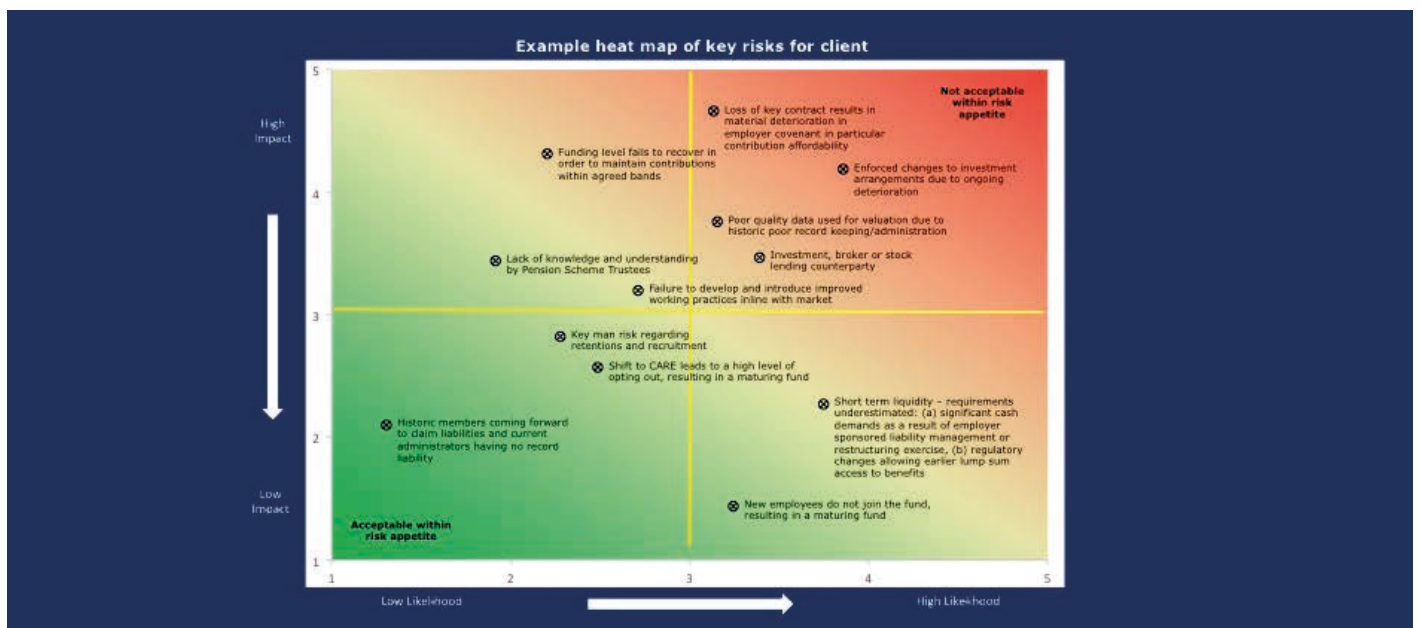
As well as risks, opportunities should be identified such that these can be incorporated into the design of the monitoring framework. Opportunities might include additional contributions if the sponsor generates significant additional profits or the ability to secure benefits for certain groups of members if annuity pricing shifts.

Output

Some risks are more relevant for the employer, some for the trustees and some affect both. It may, therefore, be helpful to produce a risk matrix or 'heat map' showing each risk, the perceived likelihood vs impact, the extent to which each risk is rewarded and who is responsible for monitoring/managing the mitigation process associated with that risk.

Format

The objective setting and risk identification steps are often best undertaken as a workshop with the sponsor, trustees and key advisors present. Tools such as the voting output illustrated below allow views of all parties to be captured and stored for instant visibility of the results emerging from these discussions.



Step 3 – Consider the risks individually, bilaterally and all together

Individually

Access to an assessment of the individual risks facing each scheme is normally available from the most recent covenant analysis, investment review and funding report. These are typically the risks set out in the square boxes in the diagram at the bottom of the page.


Bilaterally

Covenant and funding risks ➤ Assessing the ability of the sponsor to weather changes in the funding position of the scheme will help to identify the risks that fall outside of the risk appetite of the sponsor and/or trustees.

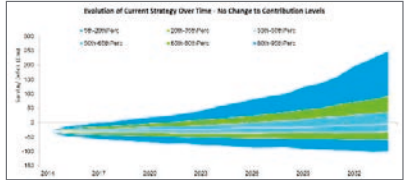
Investment and funding risks ➤ Using funding level projections, stress scenarios, and Value at Risk analysis, trustees can assess those funding and investment related risks that impact most on the probability of achieving the scheme objectives.

Investment and covenant risks ➤ Consideration should be given to those risks which impact both the strength of the employer and the performance of the asset portfolio of the scheme. This analysis can be used to determine unacceptable concentrations of risk.

Risk interaction

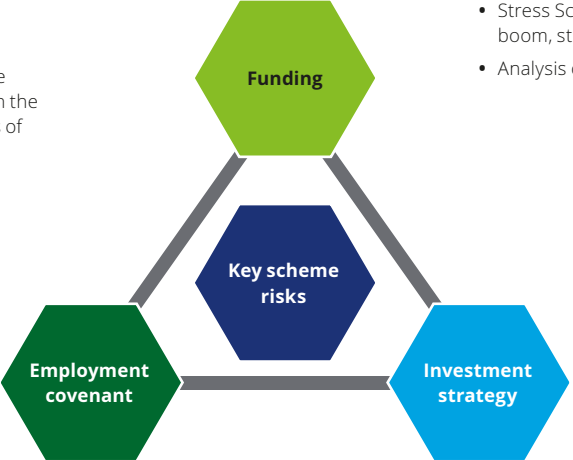


- Longevity risk
- Inflation risk
- Demographic/cashflow incidence risk
- Concentration of risk
- Legislative risk
- Quality of data



Interaction
Consider drivers for change in employer covenant. Use these drivers to determine the likely impact of those economic scenarios on the funding position. This helps to identify areas of risk concentration.

- Horizon scanning and future outlook for industry sector and sponsor's business
- Competitive environment
- Current financial performance and cashflow generation
- Cost pressure affecting the business and/or industry sector
- Leverage & exposure to interest rate rises
- Balancing priorities with other stakeholders e.g. shareholder dividends
- Regulatory risk/opportunities



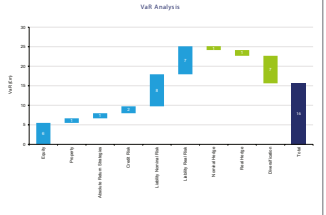
Interaction
• Strategic risk
– Insufficient returns
– Volatility of returns
– Diversification

• Mismatching risks
– Duration of liabilities
– Inflation linked/fixed liabilities

• Liquidity risks

• Tactical risks
– Stock/manager risks

Interaction
Compare funding level projections and stress testing with view of employer covenant to assess whether the employer retains the ability to address downside funding/investment risk in a range of scenarios.



Bringing it all together

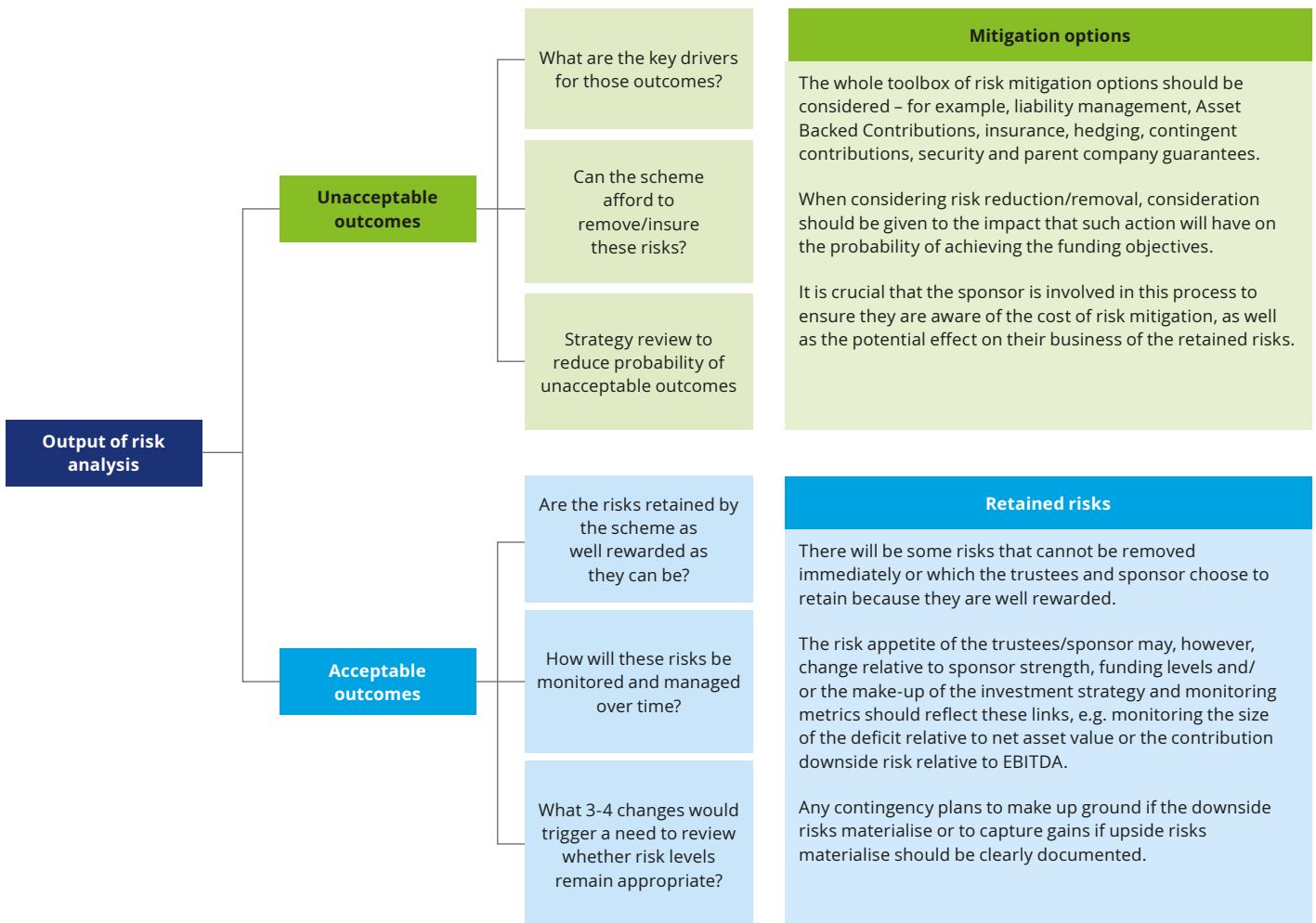
By undertaking the process set out on the previous page to assess the key risks to the scheme and their impact on the funding position, investment performance and covenant strength, trustees will be able to work with their advisors to answer the questions posed in the Regulator’s guidance:

- What are the material risks the scheme is exposed to, taking account of their impact and probability?
- How do these material risks impact on the scheme separately and together in qualitative terms and, where proportionate, quantitatively?
- Which are the highest priority risks?
- What does this analysis reveal about the totality of the risks that the scheme is running?
- What does this analysis reveal about the scheme’s and the employer’s risk capacities?
- What does this analysis reveal about the scheme’s and the employer’s risk appetites?
- Is any individual risk or the totality of risk greater or less than the trustees’ and/or employer’s risk appetites?

Step 4 – Mitigation options and revisit strategy/objectives

For the vast majority of pension schemes and their employers, risk removal is either not affordable or not desirable. The returns generated from taking risk are, in most cases, expected to contribute towards achieving the scheme’s objectives. IRM is not, therefore, about risk removal but rather about facilitating an intelligent approach to risk taking.

In considering which risks should be reduced or removed, the trustees, sponsor and their advisors can use the output of the risk analysis in Step 3 to identify the priority risks and ways in which these can either be removed or managed:

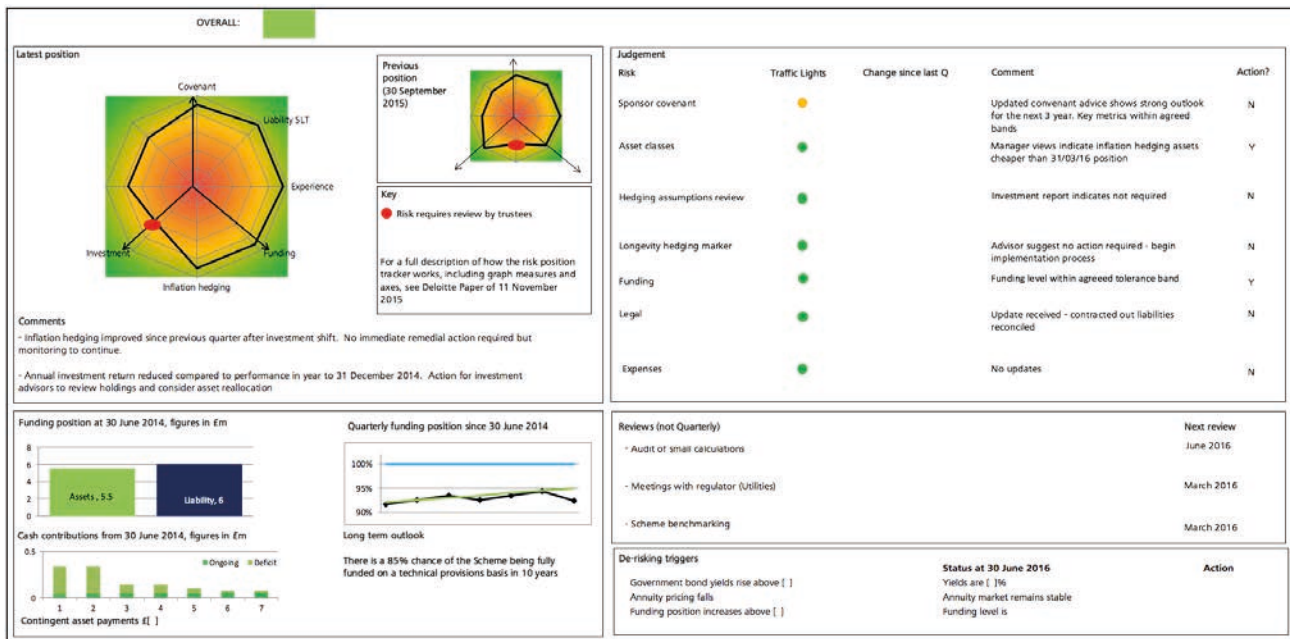


Check that reduction of risk does not impact negatively on objectives. If risk reduction to the agreed risk appetite means that objectives are not achievable; timescales, objectives and risk appetite should be reconsidered

Step 5 - Monitoring

Whilst any analysis process is useful, it is based on the view of the trustees and sponsor at a single point in time. By far the most important aspect of IRM is monitoring the position in order that appropriate action can be taken in light of scheme experience. In order to do this effectively, trustees should avoid burying the key issues in reams of information. Any monitoring process should be designed to monitor those key drivers identified in Step 2 and 3 which would cause a review of the strategy to be taken outside of the valuation process or which would signal the need to implement any contingency plans agreed.

Metrics provided should set out clear triggers for action in an accessible format and incorporate the highest priority investment, covenant and funding risks.



Reporting

Following the IRM process should allow trustees and sponsors to answer the key questions posed in TPR's guidance.

Output

An output from the IRM process should include the trustees' and sponsor's current response to each of these questions. This document can be kept at the front of the scheme management documents and, in designing their IRM framework, trustees should consider how often to review and refresh the answers to these questions:

For both the sponsor and the trustees:

- What are the scheme risks to the overall strategy for meeting the scheme objective(s)?
- What are the probabilities of these risks materialising?
- What are the relationships between the risks?
- What are the capacities of the scheme and employer to put scheme funding and/or the employer position back on track should the risks materialise? What steps would that involve taking?
- What are their risk appetites?
- If the risks are greater than their risk appetites, should the overall strategy for meeting the scheme objectives be changed?
- What monitoring should be put in place for scheme funding and/or the employer position?
- What options are available should scheme funding and/or the employer position improve?

For the trustees

- What is the potential impact for both the scheme and employer of the risks they are taking (or proposing to take) in their funding plans?
- Having discussed with the employer the resources it has available, are the trustees comfortable that the scheme and the employer have sufficient risk capacities to manage that impact?

For the sponsor

- Is it aware of the impact managing the risk could have on its finances (both in the short and longer term)?
- Is it able to manage the potential impact of the current (or proposed) scheme risk?
- How well does it understand the options available to manage those risks and the costs and benefits of those different options?

Practical issues and governance

An appropriate structure for a trustee board looking to implement an effective risk management strategy may be as follows, although this will depend on the size of scheme and resources of the trustees. The important point is to ensure that the lines of reporting are clear and that the roles and responsibilities of each advisor have been communicated and agreed.



The elements of a successful IRM framework include:

- Trustees adopt a broad outlook and governance of risk and integrate risk considerations into strategic decision-making
- Capable processes, systems and trained people act on both risks and opportunities in a timely and coordinated manner
- A consistent risk assessment approach is used to manage all classes of risk consciously and effectively

Clearly, building a successful advisory team will rely on collaboration. Trustees and their advisors should discuss and agree who will lead the risk analysis work, the cost and timescales involved, as well as the extent to which advisors are able to rely on analysis provided by third parties when presenting their advice. Any non-reliance or non-disclosure documents should be agreed and signed at an early stage to avoid delays later on in the process.

Conclusion

Most trustee boards are already taking an integrated view of their investment, funding and covenant risks. IRM represents an opportunity to formalise this process and streamline the monitoring of the key risks facing the schemes, so that appropriate action can be taken where needed.

Turning a risk management framework into better outcomes depends not only on analysis but, perhaps more importantly, on action. Once the scheme's objectives and key risks are understood, it is crucial that the sponsor and trustees put clear funding, contingency and risk mitigation plans in place.

It will not always be possible to remove or mitigate all the risks facing the scheme. The point is to reduce the likelihood of being caught unaware and to have a process in place that enables trustees to easily monitor, understand and react to changes in the funding position and strength of the employer covenant over time.

Contact us

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us please feel free to make contact using the details below or directly through your usual Deloitte contact.



Paul Geeson
London
 020 7303 0878
 pgeeson@deloitte.co.uk



Richard Slater
Edinburgh
 0131 535 7602
 riclater@deloitte.co.uk



David Robbins
London
 020 7007 2810
 drobbins@deloitte.co.uk



Tony Clare
Manchester
 0161 455 8392
 tclare@deloitte.co.uk



Marian Elliott
London
 020 7007 0978
 marielliott@deloitte.co.uk



Mark McClintock
Belfast
 028 9053 1429
 mamclintock@deloitte.co.uk



Tom Partridge
London
 020 7007 4011
 tompartridge@deloitte.co.uk



Andrew Mewis
Birmingham
 0121 695 5071
 amewis@deloitte.co.uk



Greg Morris
Birmingham
 0121 695 5507
 grmorris@deloitte.co.uk



Richard Jarvis
Leeds
 0113 292 1619
 rijarvis@deloitte.co.uk



Mark Shimmons
Belfast
 028 9053 1041
 mshimmons@deloitte.co.uk



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte Total Reward and Benefits Limited is a subsidiary of Deloitte LLP, the United Kingdom member firm of DTTL.

Deloitte Total Reward and Benefits Limited is authorised and regulated by the Financial Conduct Authority.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte Total Reward and Benefits Limited would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte Total Reward and Benefits Limited accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2016 Deloitte Total Reward and Benefits Limited. All rights reserved.

Registered office: Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Registered in England No 3981512.

Designed and produced by The Creative Studio at Deloitte, London. J6211