Integrated risk management
Why it's important for employers and trustees

The Pensions Regulator (tPR) will issue new guidance shortly on the funding of defined benefit schemes. This updated guidance will build on the themes flagged in tPR's May 2013 annual funding statement meaning that the old valuation triggers (e.g. ten-year recovery plans) will be officially abandoned. The focus will be much less on recovery plan length and much more on funding and investment strategy – by taking into account the level of risk that the sponsoring company can support and the contributions that it can afford to pay.

If you're an employer, integrated risk management is likely to be a familiar process – consistent with the way you run other parts of your business. For trustees, the focus will be on the employer's ability to support return-seeking investment strategies, and downside mitigation in the event that things turn out worse than expected.

In this *Pension Focus* we look at what integrated risk management is, why you need to take action and how you can make sure you get the right outcome.

What is integrated risk management?

The term 'integrated risk management' came out of tPR's May 2013 annual funding statement. In it, tPR flagged that trustees should consider investment strategy, employer covenant and funding approach in the round and be able to provide evidence that they'd done this.

In practice, this means trustees need to be able to justify:

- how they've assessed the sponsor's ability to support the scheme now and in the future
- how this has impacted on the investment strategy – i.e. can the sponsor cope with the downside risk being run, and
- how this relates to the funding plan – for example, tPR will be keen to examine the balance between cash contributions and investment out-performance in the recovery plan and how these relate to the strength of the employer and affordability of contributions.

We believe this is a step forward in promoting better pension scheme governance, potentially leading to improved outcomes and less future management overhead for employers who engage in the process. Having a clear plan is likely to be more efficient than reinventing decisions without context each time an issue comes up.

Why action is needed

Trustees will increasingly be looking for joined-up and strategic actuarial and investment advice that incorporates a clear understanding of the employer's covenant, future business plans and the key risks to covenant.

If, as an employer, you engage in integrated risk management, you're more likely to get the result you want in an efficient way. And you'll substantially reduce the risks that the scheme poses to the business. Some of the potential benefits of a proactive approach are:

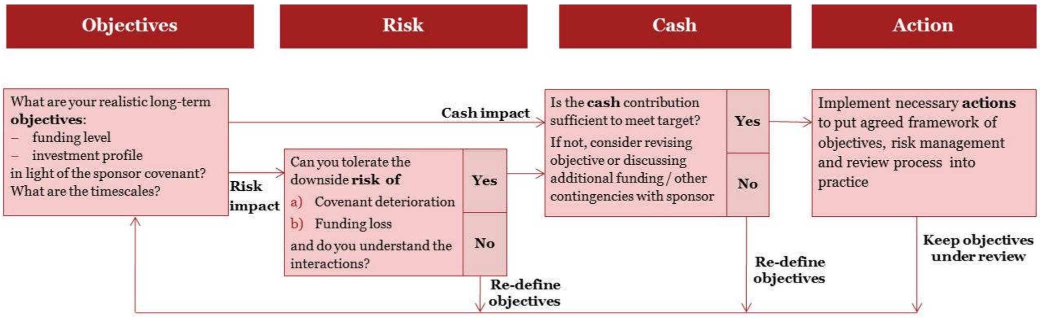
- higher expected future investment returns by avoiding a premature move to de-risk the pension scheme assets
- lower future cash contribution requirements
- optimised use of security (in the form of company guarantees or charges of particular corporate assets) – provided only where necessary or mutually advantageous
- greater clarity over the long-term objectives and better alignment with future business plans, and
- a more collaborative relationship between employer and trustees.

Let's think about it a different way. If the pension scheme were a subsidiary entity of the business, what would you expect of its management? A business strategy would be a good starting point. How will management improve the entity's financial position and over what time period? What funding would they need from the parent? What risks would you be comfortable with them taking? And what contingency planning is in place? It's very unlikely you'd leave the subsidiary to its own devices and be prepared to fund any underperformance against budget. Why is the pension scheme any different?

Articulating the long-term strategy

Integrated risk management is all about setting a long-term strategy for the pension scheme that's consistent with the objectives of the employer and its ability to continue to support the pension scheme, and consistent with the trustees' obligations. Strong employers, in particular, often don't deploy or present their covenant strength effectively; so integrated risk management is an opportunity to run pension schemes more effectively.

Whether you're an employer or a trustee, our ORCA framework – which stands for Objectives, Risk, Cash and Actions – can steer you through a consistent series of decisions to help you join up your objectives and actions on financing and risk management.



Integrated risk management in practice – what to expect

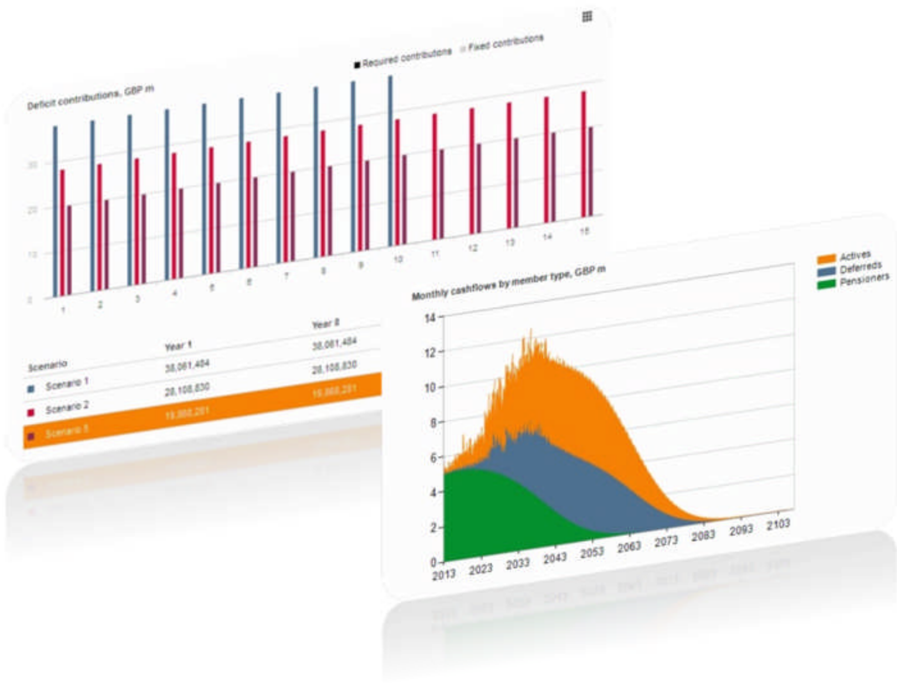
In the longer term, we believe this will lead to a number of interesting developments in the funding and risk profiles of defined benefit pension schemes.

- Increasing desire by trustees for strategic advisers, who are able to join up the elements of a plan in a way which the scheme actuary and investment consultant can't always do by themselves.
- Integrated risk analysis – for example, how does investment risk interact with covenant risk?
- Increasing use of external covenant advisers by trustees.
- Funding discount rates that are more explicitly linked to investment strategy and covenant strength – our asset-led discount rate methodology is an example of this.
- Increasing use of trigger point mechanisms for important risks – employers will need to think carefully about what triggers are appropriate whilst retaining flexibility.
- Greater use of technology platforms that help you to monitor your funding positions and risk profiles more accurately and speedily and with the ability to quickly carry out 'what-if' analyses instantly. Read about Skyval on the following page.
- Greater focus on contingency planning – what mitigating actions are appropriate if things start to go off-course? What's the employer prepared to offer the trustees and what will they ask for in return?

Using Skyval - turning data into decisions

Our online pensions modelling tool, Skyval, can be used to set integrated risk management plans and to monitor them going forwards. Skyval allows users to perform in real-time:

- updates of funding and accounting actuarial valuations
- risk management analysis
- sensitivity testing under a variety of economic scenarios and what-ifs
- ability to drill down into detailed scheme and market information, including cashflows, and
- summary dashboard reporting on key pension scheme metrics.



Critically, you can use Skyval for formal reporting purposes, e.g. signing off actuarial valuations or pensions accounting disclosures. Once you've set up Skyval for one purpose, all the other functionality is available – it's a single, consistent platform which can be used for sponsors and trustees alike, across all their advisers.

Skyval

- Helps companies and trustees understand and manage their defined benefit pension liabilities quickly and efficiently.
- Can be used directly in-house by selected employers and trustees.
- Contains analysis to support decision-making in an intuitive and readily accessible format.

Find out more

For a further discussion on any of the issues raised in this bulletin, please contact your usual PwC pension adviser or:

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