

Moving Forward with Confidence

Wednesday 24th November 2010

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Structure of Presentation

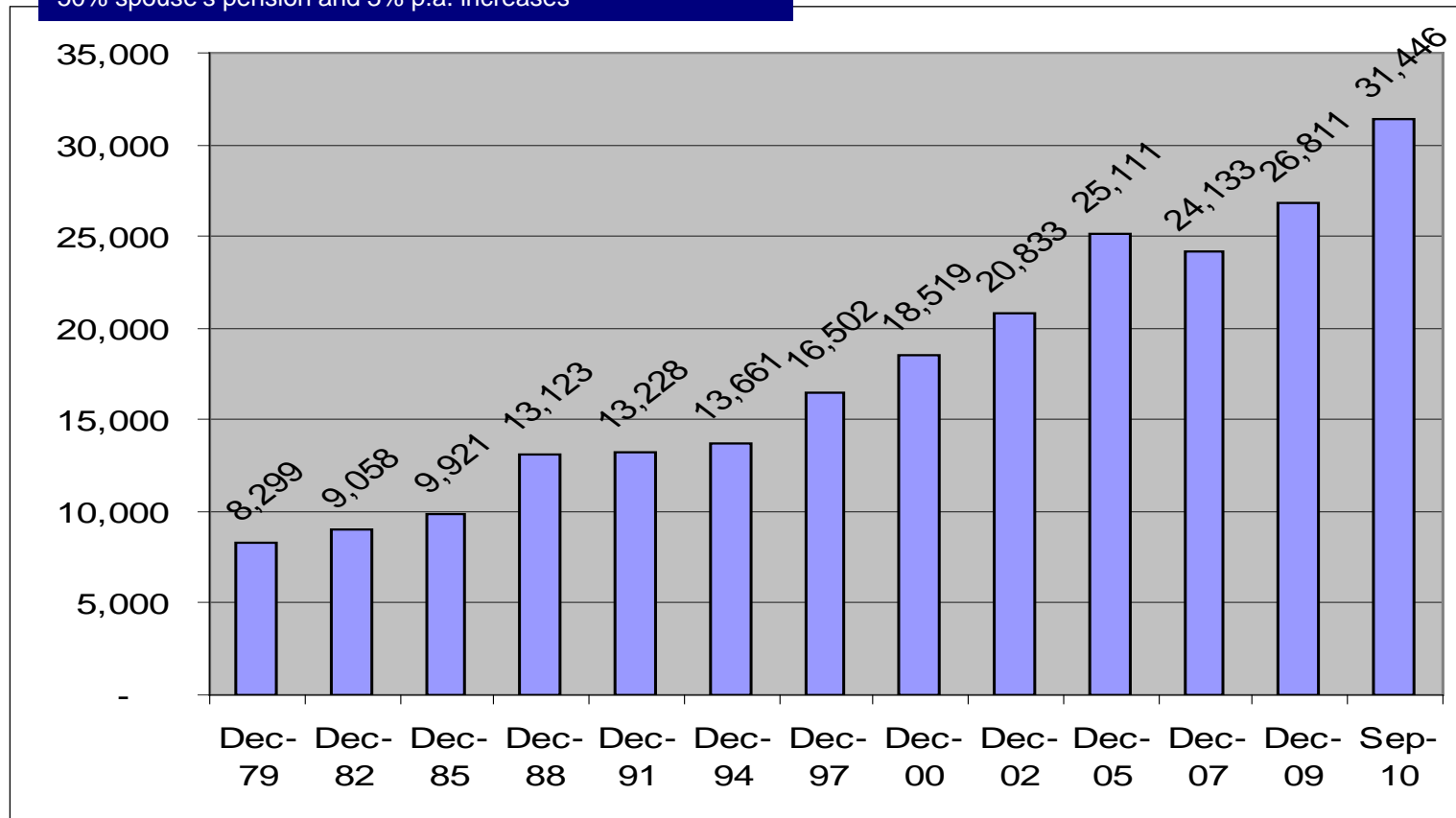
- Context – Understanding the Problem
- Tackling the Problem
- A Better Risk Management Framework

Context

Dramatic Increase in Cost of Pensions

Cost of €1,000 p.a. pension at age 65

50% spouse's pension and 3% p.a. increases



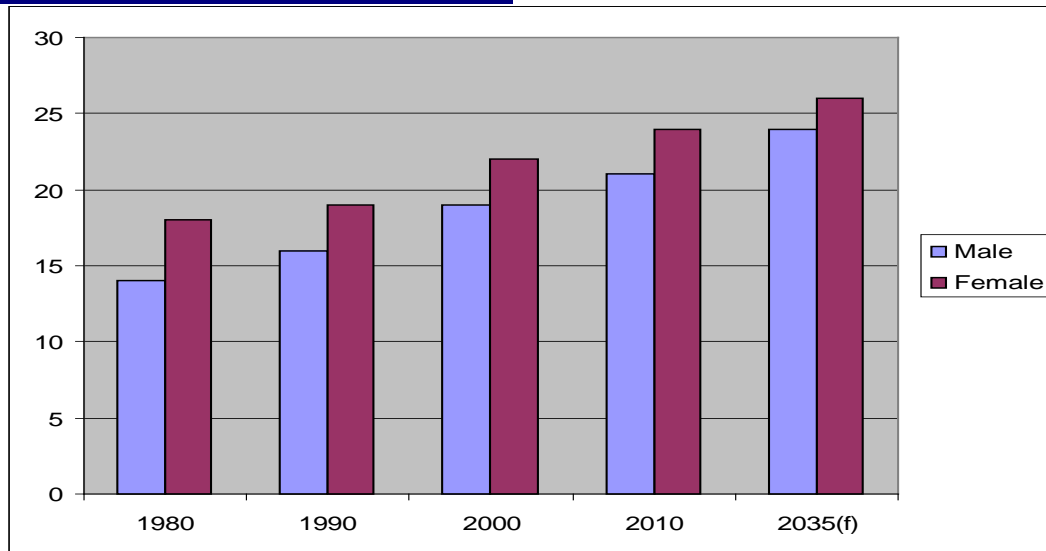
Source: Society of Actuaries in Ireland

Why?

1. People living longer

Source: Society of Actuaries in Ireland

Life expectancy at age 65

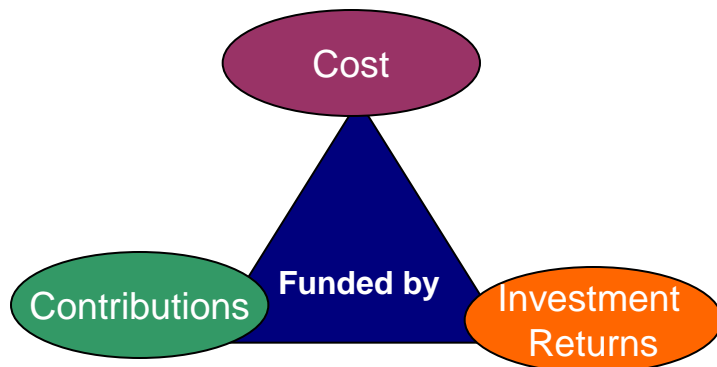


2. Lower interest rates

Period Jan 1990 to Nov 2000



Funding Decision Impacts Risk not Cost

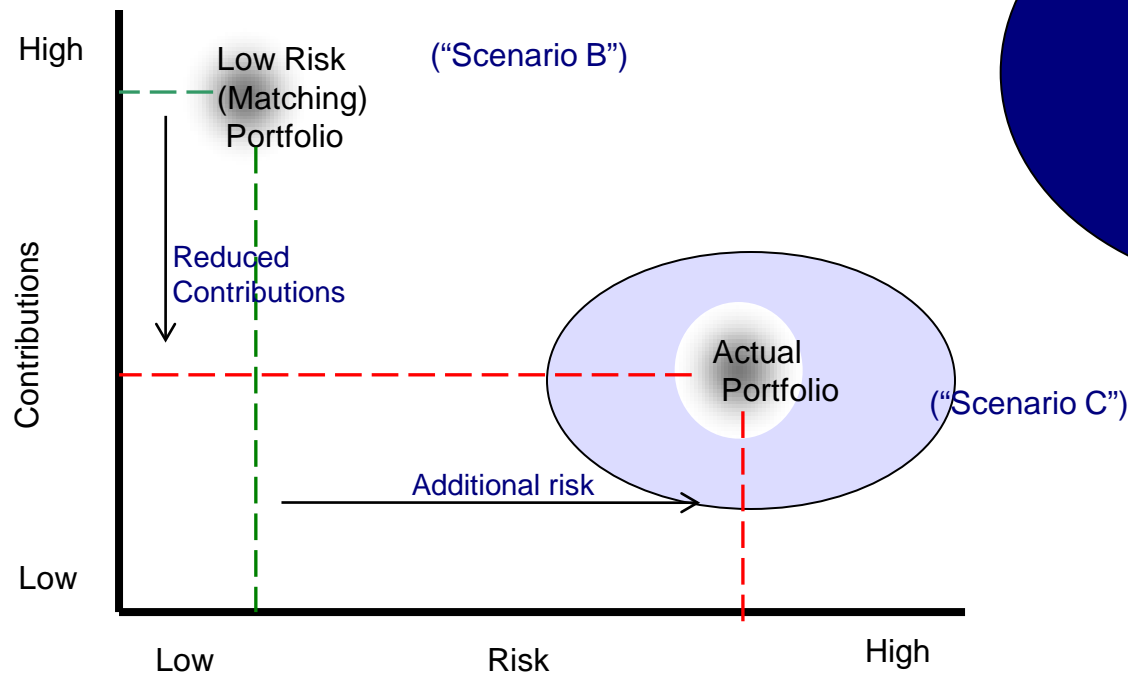


Scenarios	A	B	C
Expected Cost	€32,000	€32,000	€32,000
Expected Investment Return			
(i) Time value of money	0	€4,000	€4,000
(ii) risk assets	+ 0	+ 0	+ €8,000
Contributions	€32,000	€28,000	€20,000
Risk	+/- €1,000	+/- €1,000	+/- €14,000
Risks:			
Longevity	✓	✓	✓
Accounting	✓	✓	✓
Regulatory	✓	✓	✓
Investment	X	X	✓✓

Numbers shown are for illustration purposes only.

Scheme Funding Decisions Added Risk

- Aspirations of part funding the Cost from investment returns led to people taking risks.....

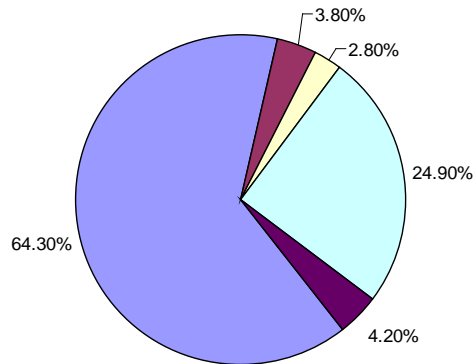


Quantum of risk decision not always well explained to Trustees

How Much Risk Did We Take?

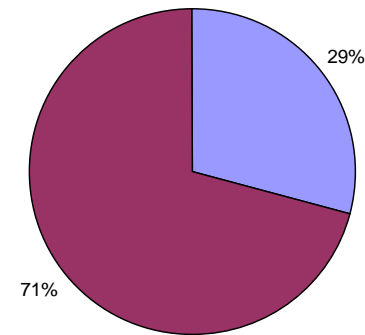
Average Asset Mix at end 2009

IAPF Pensions Investment Survey 2009



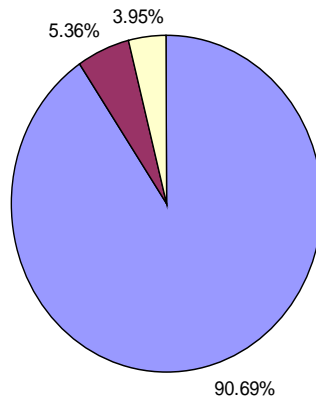
■ Equities ■ Property □ Alternatives □ Bonds ■ Cash

Represents Significant Move
Away from Matching Assets



■ Matching Assets ■ Return Seeking Assets

No Diversification within Return Seeking Assets

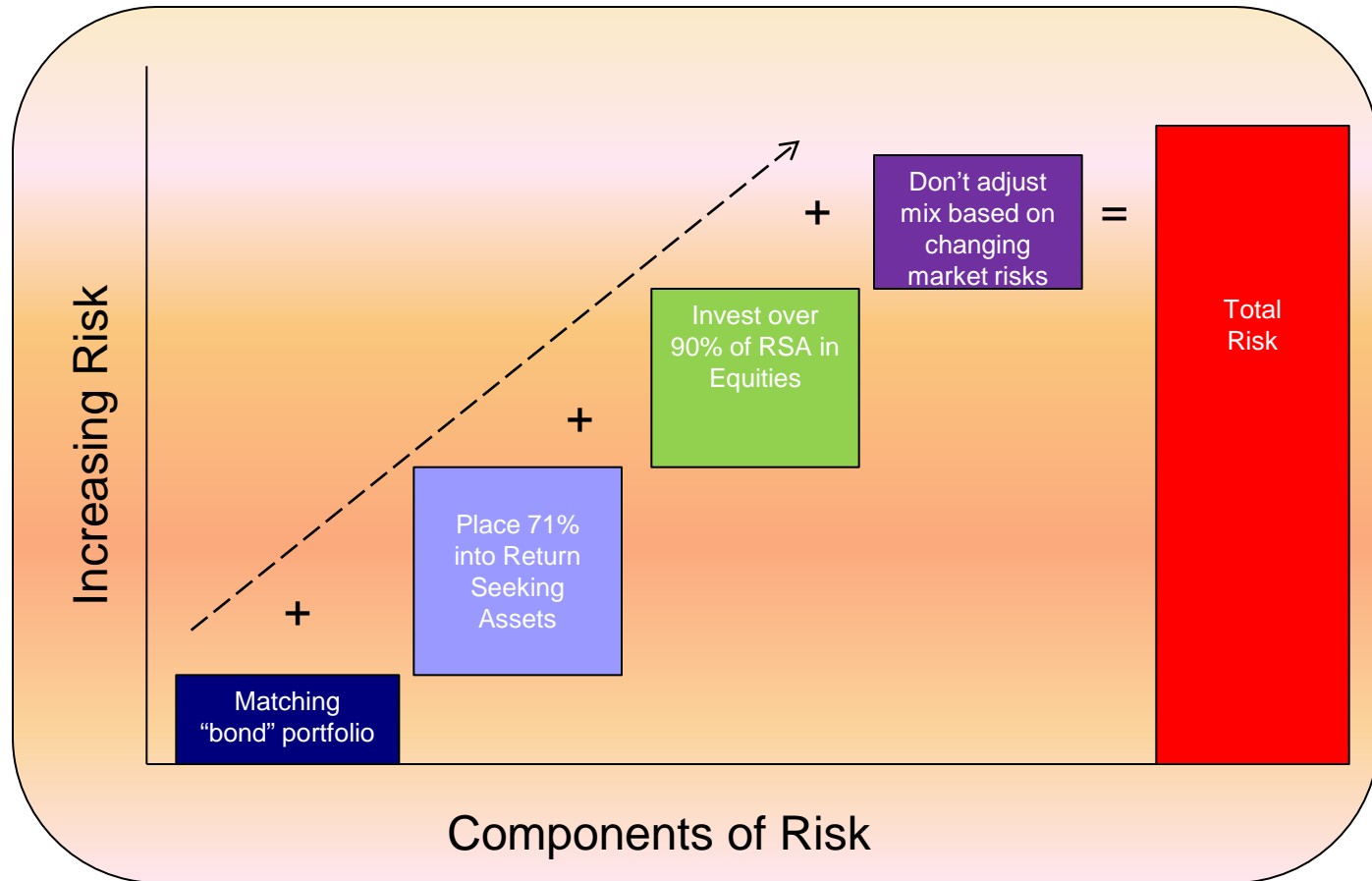


■ Equities ■ Property □ Alternatives

Significant shift into Return Seeking (Risk) Assets

No diversification where it matters i.e. within Return Seeking Assets (RSA)

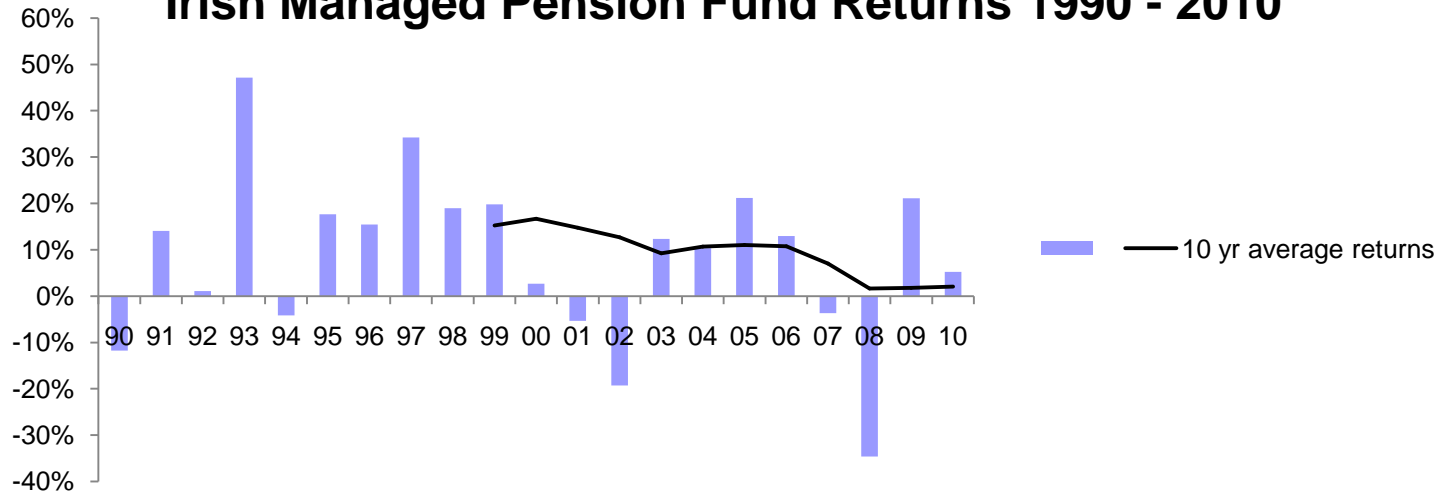
How Much Risk Did We Take?



.....and it now turns out those risks were not well managed.

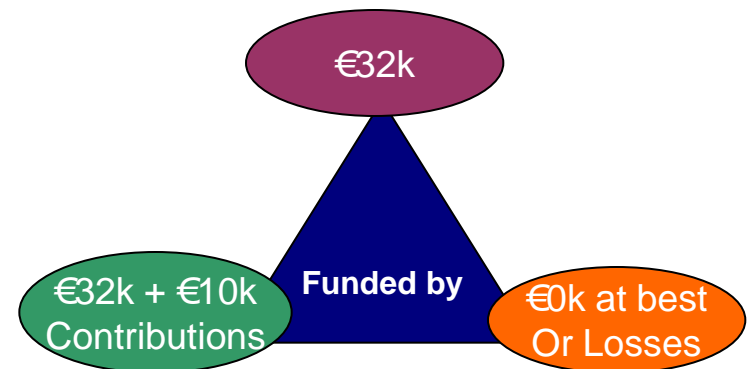
So has this Additional Risk Delivered?

Irish Managed Pension Fund Returns 1990 - 2010



Result:

1. Investment returns did not materialise
2. Contributions must bear the cost (€32k) PLUS Fund the past service deficit – another €10k.



Numbers shown are for illustration purposes only.

Structural Deficiencies

- **Managing a pension scheme is like managing an insurance company.**

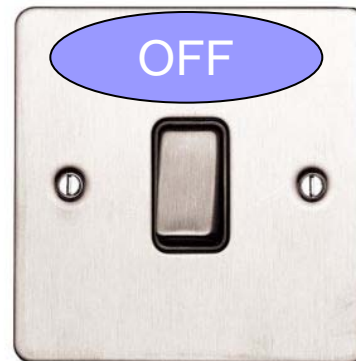
- **If an insurance company generated significant losses accountability is clear:**
 - Chief Executive and Board have ownership and responsibility for the problem:
 - Have the expertise;
 - Have the authority over all of the decisions.

- **But who has ownership and responsibility for pension scheme deficits?**
 - Trustees?
 - Company?
 - What about the central role of the Scheme Actuary?
 - Investment managers and advisers?

Is it possible there is a flaw in the current governance system?

Other Issues

- **Having at least 4 different way of measuring liabilities and funding is not helpful.**
 - Low risk portfolio (aka “Liability hedged portfolio”)
 - Ongoing valuation
 - Minimum Funding Standard
 - Accounting (IAS19)
- Low Risk Portfolio - i.e. Bond based portfolio with **investment risk switch turned off** - is the right starting point.



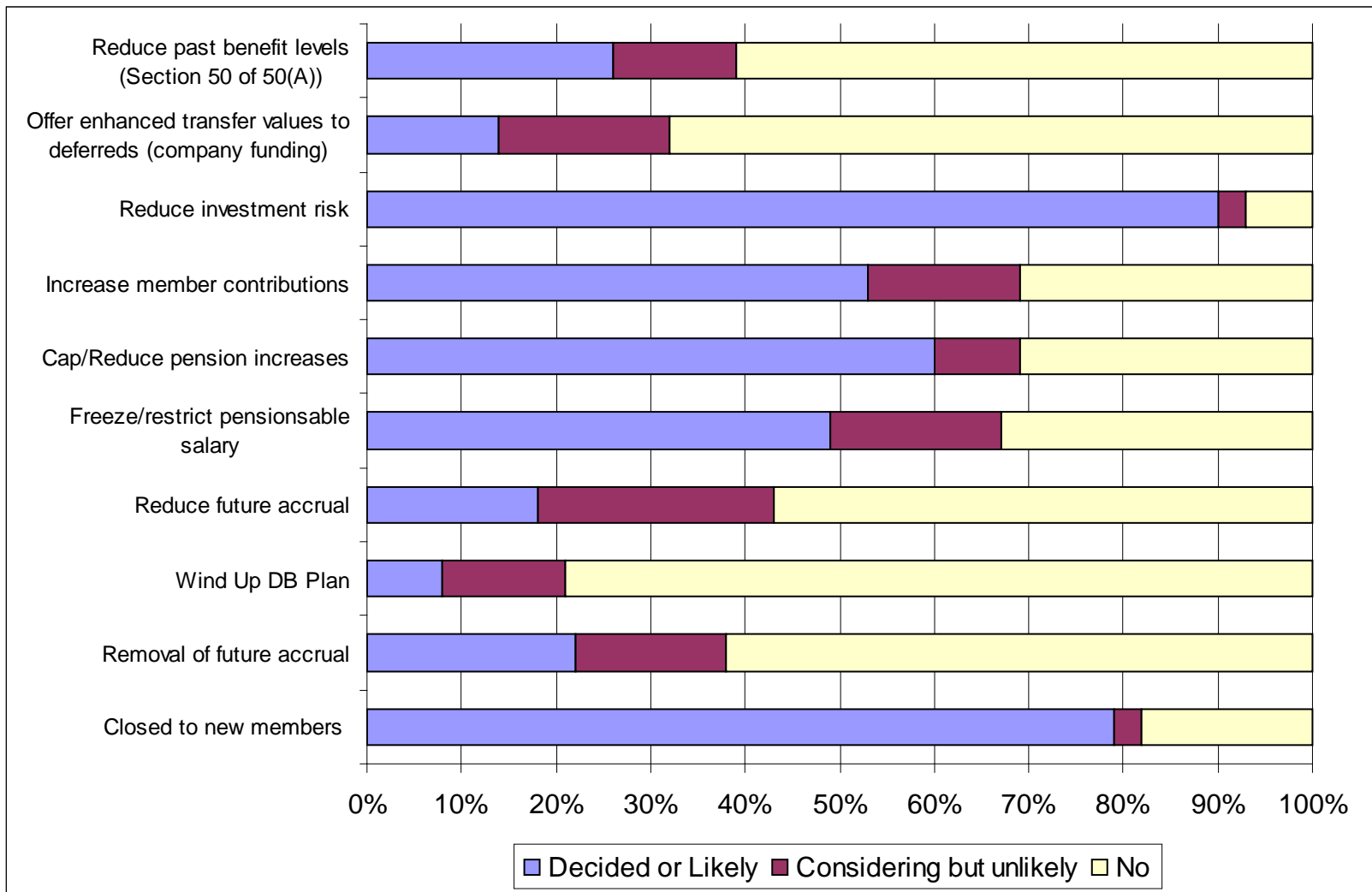
Tackling the Problem

4 Pronged Approach

1. Changing the benefits
2. Increasing contributions
3. Changing the rules
4. Developing a more effective risk management framework

All the time and effort going into 1, 2 and now 3. Regardless of outcome of these schemes still need to do 4.

Changing Benefits & Contributions



Source: IAPF DB Short Survey, September 2010 (133 respondents)

Changing the Rules

1. National Pension Framework – New DB Model
2. Sovereign Annuity Proposal
3. Changes to Minimum Funding Standard

All once off in nature and have potential to reduce the estimated cost. In our illustration this means the cost estimate could reduce from €32,000.

- However, regardless of changes in the Cost companies and trustees still need to:
 - Determine how to fund that Cost (mix of contributions and investment returns); and
 - Manage the residual risks
 - Longevity
 - Accounting
 - Regulatory
 - Investment

A Better Risk Management Framework

Pensions Management Framework

- **Trustees are responsible for the Scheme**, though without an executive management team, have to outsource the technical and operational functions:
 - Actuarial advice and valuations
 - Investment advice
 - Accounting and Administration
 - Investment Management
- **The Sponsor Company is significantly exposed** to the consequences of any adverse events within the scheme
 - Additional contributions
 - Reduction in benefits
 - Impact on company balance sheet

The Management Solution must recognise the asymmetry of responsibility and consequence and align the objectives of the two key stakeholders.

The Management Solution - Hypothesis

A Comprehensive and Robust Management Structure / Framework:

1. A “**Baseline**” or “ideal” against which to measure .



- The low risk portfolio.

2. A **single management** group.



- To include company management and Trustees

3. A Framework to systematically manage **Inherent Risks**.



- Risk Register
- Reporting to Trustees and Company

4. A disciplined approach to management of **assumed risks** (investment risk).



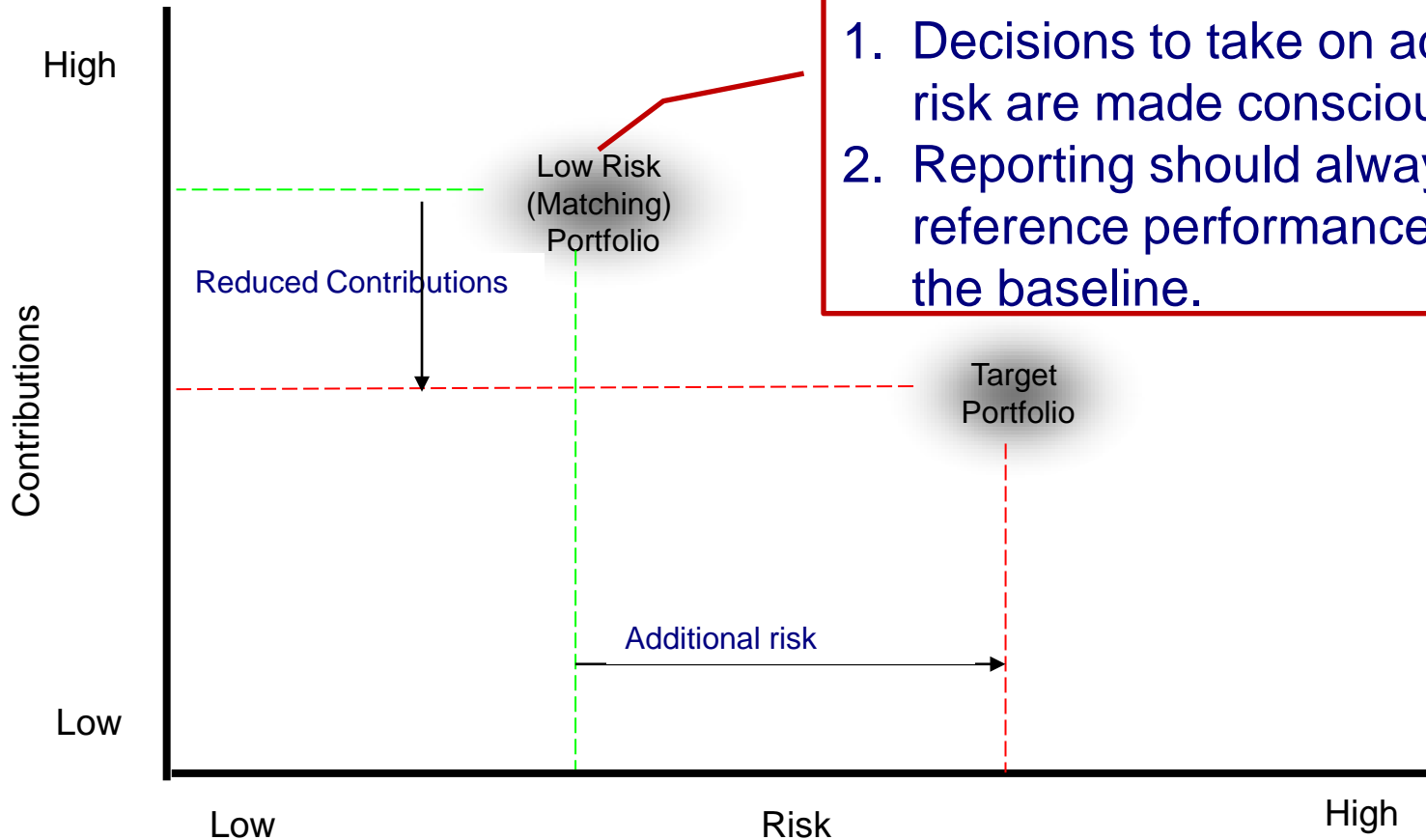
- Effective risk diversification
- Consequence management for both good and bad outcomes.

Collaboration will be required between the two key stakeholders.

1. Agreeing the Baseline

Setting this as the baseline ensures that:

1. Decisions to take on additional risk are made consciously.
2. Reporting should always reference performance against the baseline.



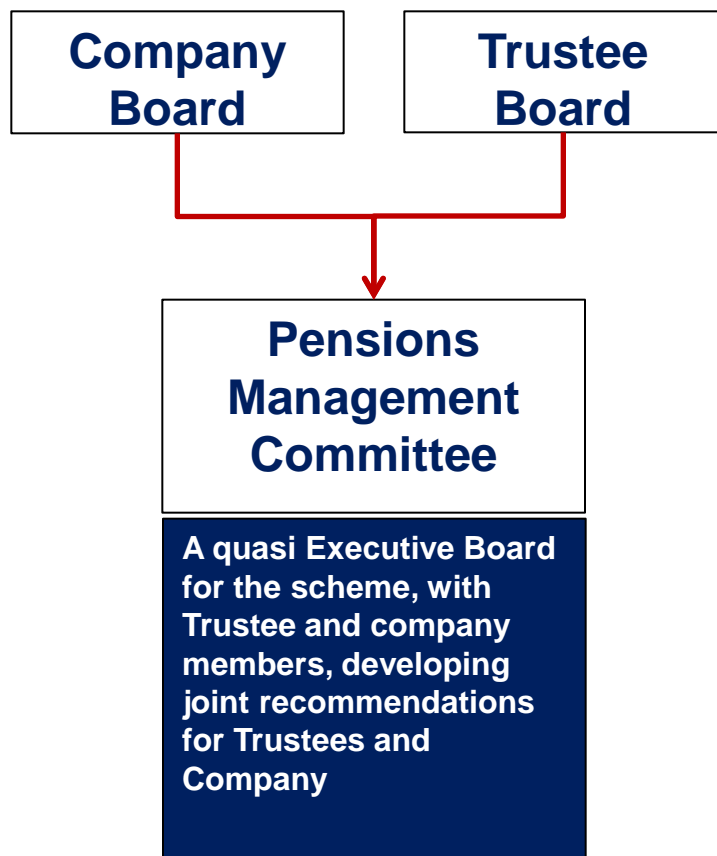
2. Combined Approach to Management

Recognise the asymmetry of responsibility and consequence and align the objectives of the two key stakeholders :

Key Issues / Decisions	Ownership & Responsibility		Impact	
	Sponsor	Trustees	Sponsor	Trustees
Level of Investment Risk		✓	✓	✓
Management of Longevity Risk	?	?	✓	✓
Accounting	✓		✓	✓
Regulatory		✓	✓	✓

Collaboration will be required between the two key stakeholders.

The Pensions Management Framework – A Hypothesis

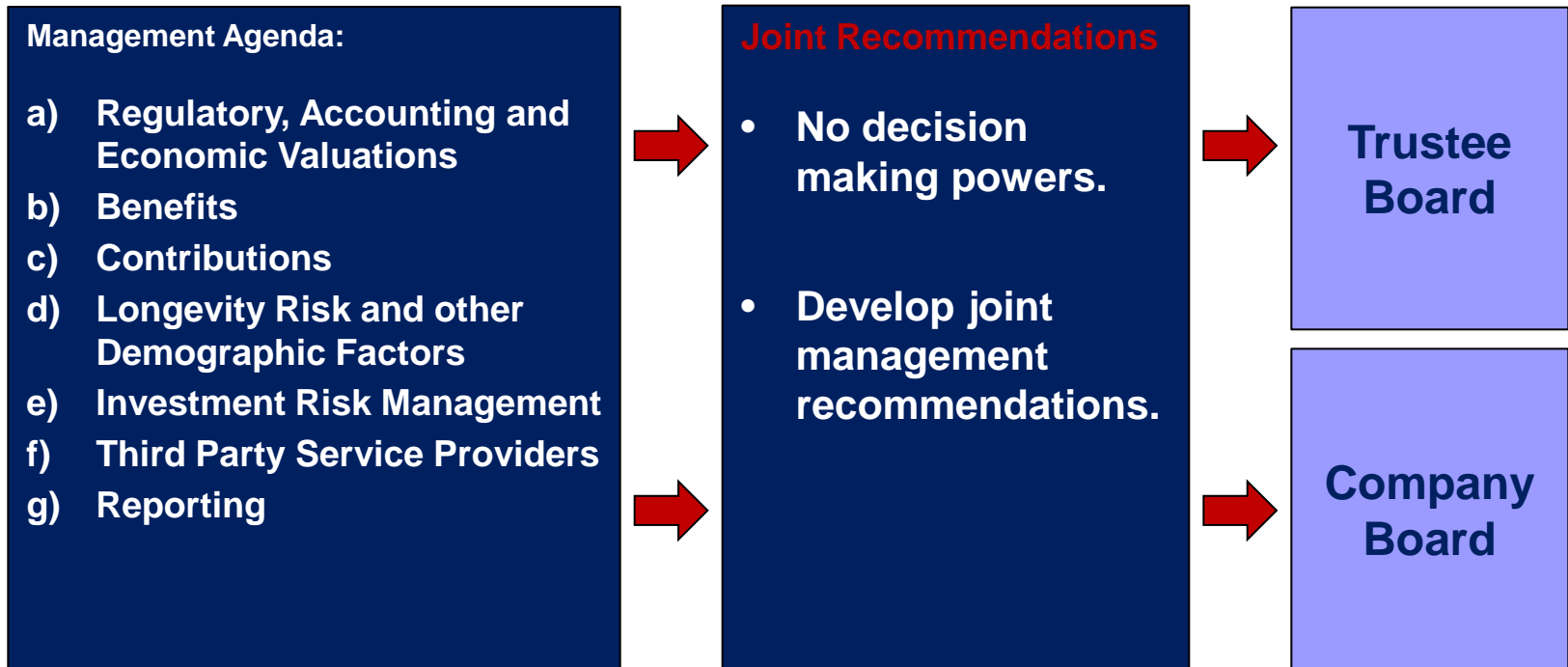


- When the interests of the company and the members become unaligned (through the emergence of a funding deficit or affordability issues etc) there is a need for joint discussions
- Likewise, proactive management of the potential for these adverse scenarios developing should be carried out jointly

Members interests are best served through positive collaboration of the Trustees and the Sponsor Company

The Hypothesis Developed

The Pensions Joint Forum Agenda



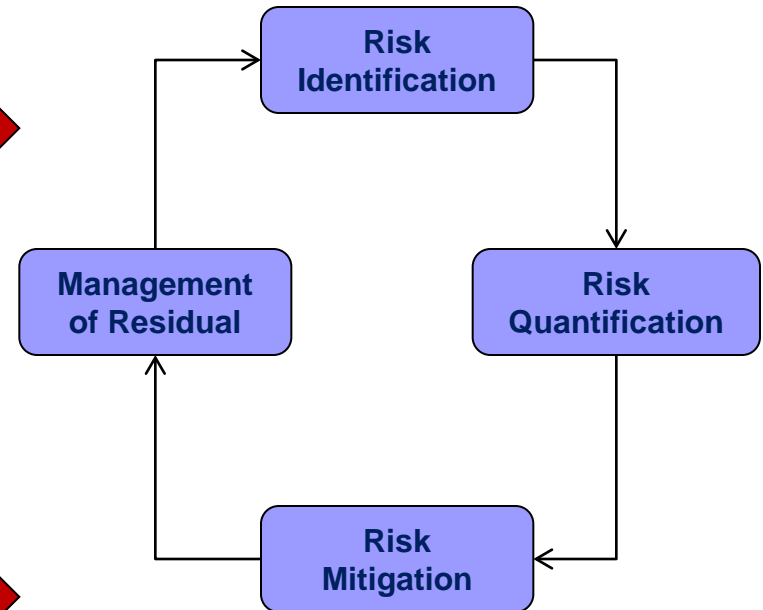
Greater support to Trustees and Company when making decisions.

3. Risk Management

- Risk means being exposed to the possibility of a bad outcome



- Risk Management means taking **deliberate action** to shift the odds in your favour – increasing the odds of good outcomes and reducing the odds of bad outcomes.



Deliberate action is supported through the formalisation of the process.

Key Risks

Risk	Score
Strategic	<ul style="list-style-type: none">• The fund is unable to meet the committed benefit levels in the future• Risk of member litigation
Investment	<ul style="list-style-type: none">• Growth assets underperform in the short term• Matching assets fail to achieve their objective
Environmental / Economic	<ul style="list-style-type: none">• Longevity experience deteriorates, driving up liabilities• Interest rates remain low for long periods
Regulatory & Accounting	<ul style="list-style-type: none">• Accounting rules change, impacting the sponsor affordability• The minimum funding standard is not achieved

Risk Identification is the first step to risk management.

Risk Register Extract

Risk	Score	Mitigation	Effective	Residual	Owner	Actions
Strategic a) The sponsor company is unable to contribute at the required level	Prob: 1 Impact: 5 Score: 5	a) Increase exposure to growth assets to bridge the gap b) Reduce benefits	Partial	Exposure to additional investment risk		

List all of the scheme risks and categorise (Strategic, Investment, Financial, Operational etc.)

Score / prioritise the risks in terms of probability and impact

Set out the mitigation strategies – management control, insurance etc.

Consider the residual risk retained and plan corrective actions if realised

Assign owners and actions to all risks

Risk Register is reviewed at each Pensions Management Committee Meeting with an annual workshop to identify additional risks.

4. The Investment Risk Decision

The Trustees' Appetite for Investment Risk

The
Appetite



- The baseline is the 'low risk' matching portfolio.
- There is no capital in the fund to support the taking of investment risk.

The
Decision



- Moving away from the matched strategy, by investing in return seeking assets, requires the explicit support of the covenant and therefore must be a joint decision.

Manage-
ment



- For the same reasons, management of this assumed risk must be explicit and joint.

Taking and Managing Investment Risk must be done jointly.

Managing Investment Risk

1. What is the Risk



1. Growth assets do not deliver expected outperformance

2. Quantifying the Risk



2. The impact on the deficit of a 1% under or over performance against expected

3. Mitigating the risk



3. The risk mitigation options open are:

- a) Diversification across asset classes
- b) Dynamic asset allocation
- c) Derivatives to protect against the downside by sacrificing some upside
- d) Systematic de-risking

4. Managing the Residual



4. Plan for consequences of adverse scenario (additional contributions, reduction to benefits etc)

The Management Solution - Summary

The hypothesis is that the management framework must have:








1. A “Baseline” or “ideal” against which performance and decision making are measured
2. A management forum which aligns the objectives of the Trustees and the Company
3. A Framework to systematically manage all risk within the scheme
4. A collaborative, risk management approach to the assumption of investment risk and the proactive management of that risk.



Appendix

Framework Health Check!

Key Questions for Trustees and Sponsor Company Executives

1.	Are the Trustees and Company aware of the surplus / deficit in the fund based on a fully matched (i.e. 100% bonds) valuation approach and is this the baseline against which risk decisions are made?	
2.	Is there a forum where Trustees and Company decision makers work together, to develop solutions to scheme financial issues and bring recommendations to the Trustee and Company Boards?	
3.	Is there a risk register maintained for the scheme which identifies all of the potential risks to the scheme, scores and ranks them, assigns mitigating actions and owners, and reviews the residual risk regularly?	
4.	Has the scheme taken on investment risk? If so, has this been done with the explicit approval of the sponsor, and with future actions agreed in the event of adverse investment scenarios?	
5.	Does the scheme make appropriate use of investment risk management tools such as diversification across and within asset classes as well as dynamic asset allocation?	

A decorative graphic on the left side of the slide consists of a grid of overlapping squares in various shades of blue and purple, creating a stepped, staircase-like effect.

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