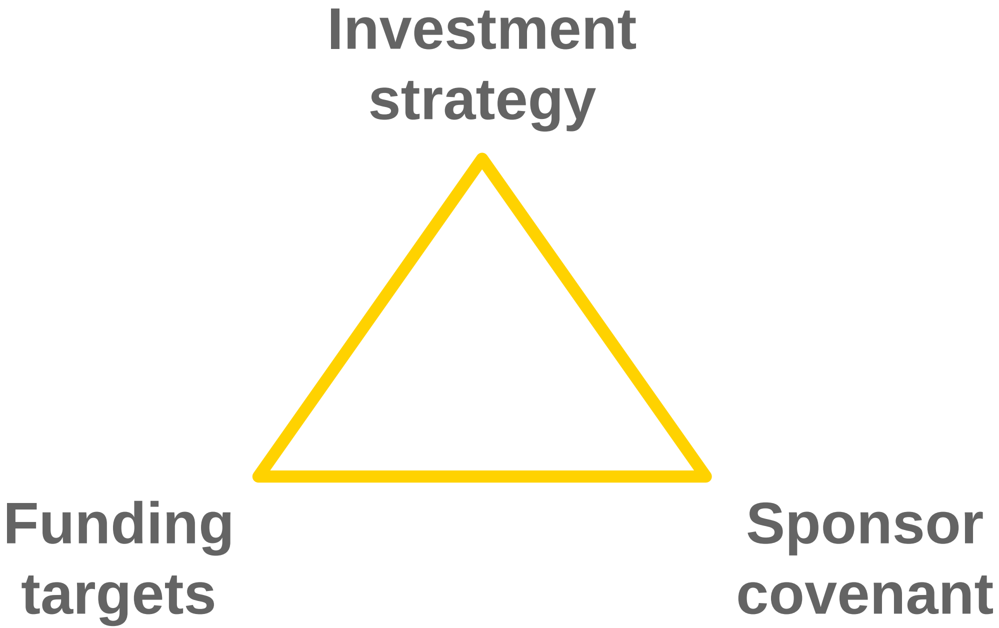
Managing funding and investment risk in defined benefit pension schemes

Robert Heaton, EY

The rear view mirror – What went wrong?



Success depends on risk management

Need an integrated approach to managing key financial risks

What is the Regulator's view?

Pre credit crunch

"The Board continues to be concerned that the investment and funding of too many DB schemes is based on aggressive investment return assumptions and does not take enough account of investment risks and downsides."

Annual Report and Accounts 2007

The current position

"The two greatest concerns of the Board are whether trustees are sufficiently aware of the rates of return they need to achieve to provide benefits for all members, and whether trustees have adequate risk awareness and risk management processes in place.

Such schemes continue to be very vulnerable to falls in equity markets: in the event of any such falls, it is not obvious how they will be in a position to pay all benefits, particularly to younger members."

Annual Report and Accounts 2013

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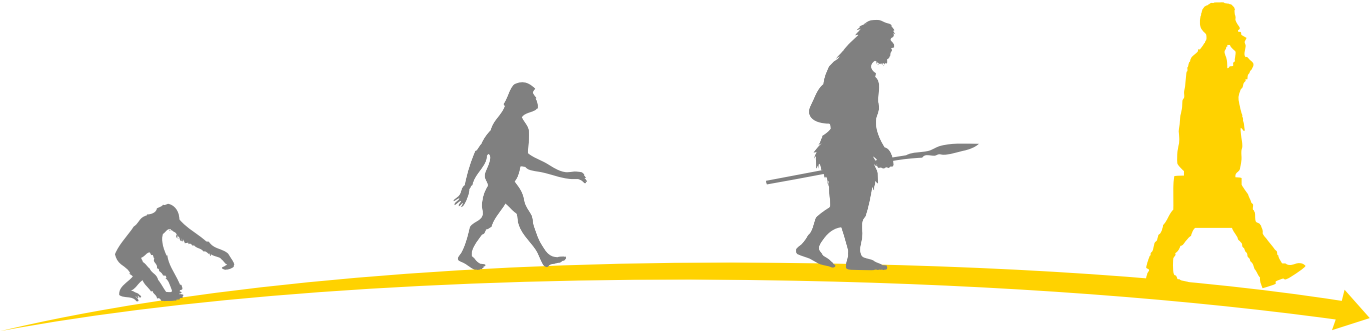
How is regulation evolving?

Recent developments

- Introduction of the Funding Risk Reserve
- New guidelines on Financial Management



Principles in the new guidelines

Two important aspects:

1) Are the contributions adequate to pay benefits in short and long term?
2) How likely is it that benefits cannot be paid because of the risks?

1 **Funding targets**

Trustees should examine the costs of providing benefits under a range of different assumptions.

2 **Sponsor covenant**

Trustees should consider how willing and able is the employer to maintain the contribution rates.

3 **Investment returns**

Trustees should consider whether the required return is reasonable / consistent with investment strategy.

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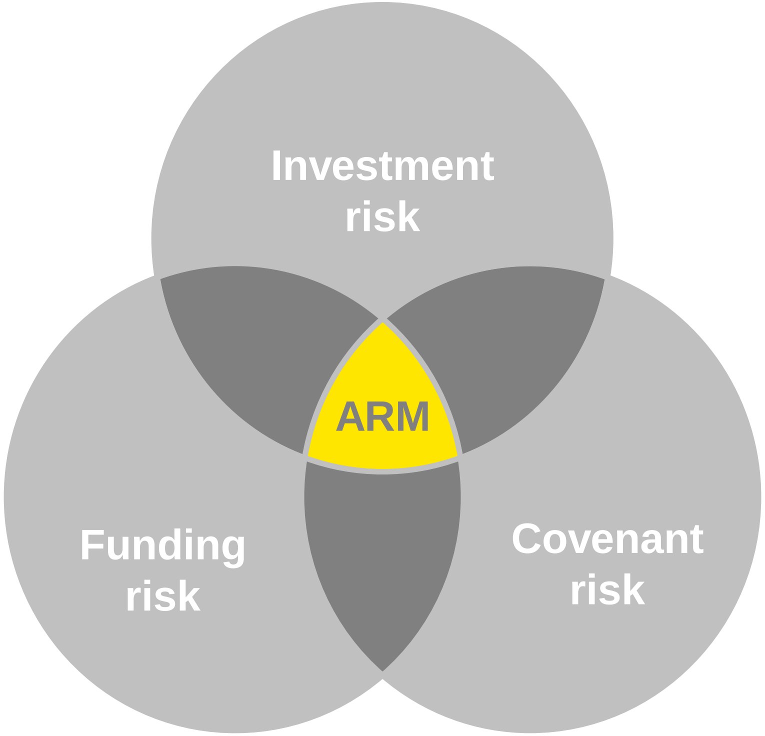
Affordability Risk Modeller

How confident are you that the plan will remain affordable?

What is the risk the existing funding plan will need to be extended?



By how much could the funding position vary at the next valuation?

Is the discount rate consistent with the investment strategy and covenant?

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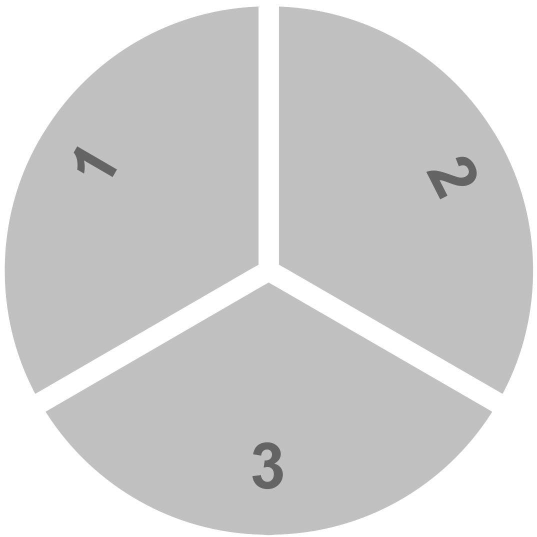
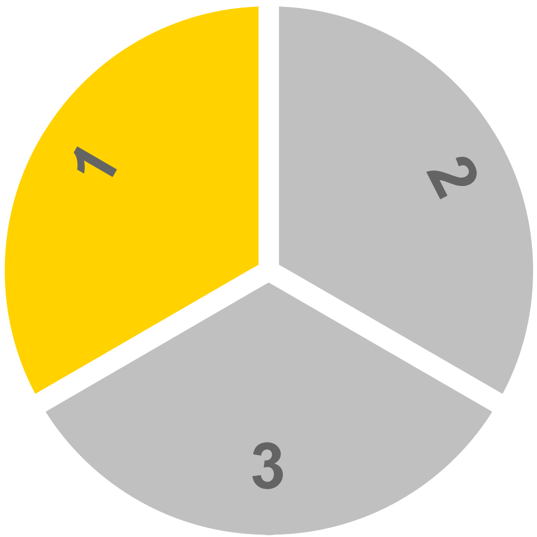
What is ARM?



What is ARM?



1. Covenant assessment

Free cash flow

Balance sheet review

What is ARM?

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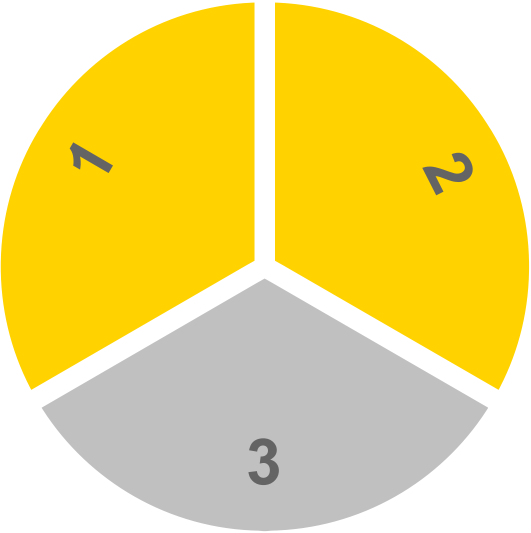
Free cash flow

Balance sheet review



2. Asset liability modelling

Future affordability

Investment strategy

Discount rate

What is ARM?

1. Covenant assessment

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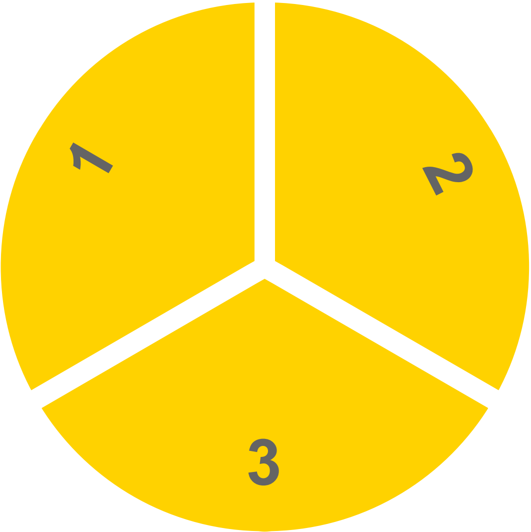


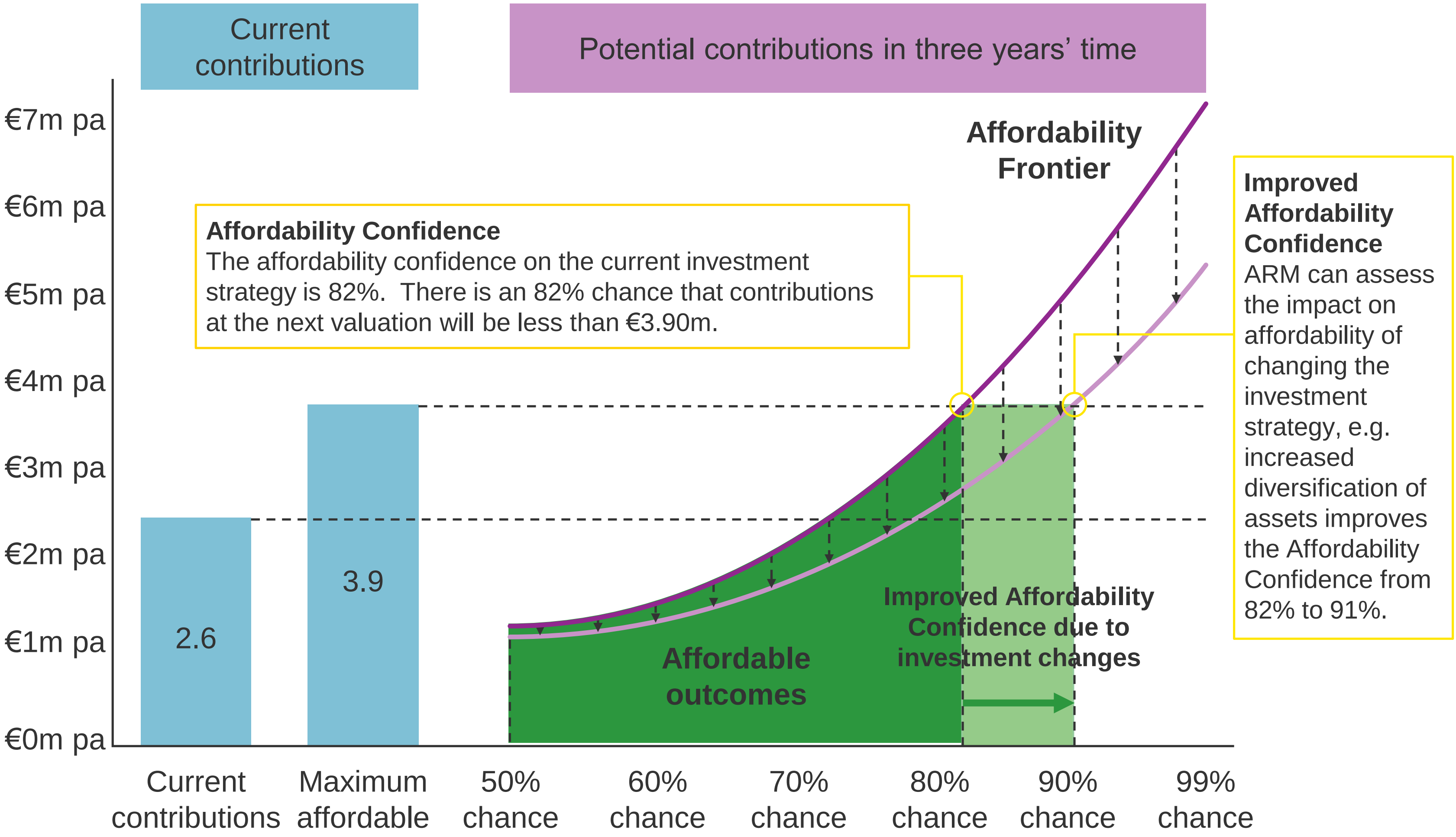
2. Asset liability modelling

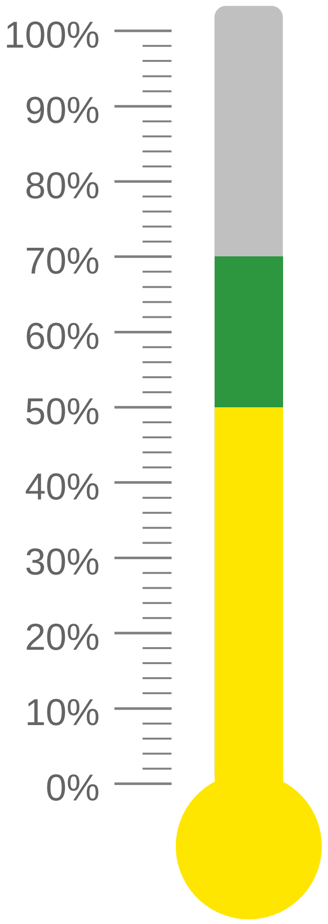
Future affordability

Investment strategy

Discount rate

3. Specific risk analysis


Current contributions
Potential contributions in three years' time
€7m pa
€6m pa
€5m pa
€4m pa
€3m pa
€2m pa
€1m pa
€0m pa
Affordability Frontier
Affordability Confidence
The affordability confidence on the current investment strategy is 82%. There is an 82% chance that contributions at the next valuation will be less than €3.90m.
Improved Affordability Confidence
ARM can assess the impact on affordability of changing the investment strategy, e.g. increased diversification of assets improves the Affordability Confidence from 82% to 91%.
2.6
3.9
Affordable outcomes
Improved Affordability Confidence due to investment changes
Current contributions
Maximum affordable
50% chance
60% chance
70% chance
80% chance
90% chance
99% chance



Discount rate credibility

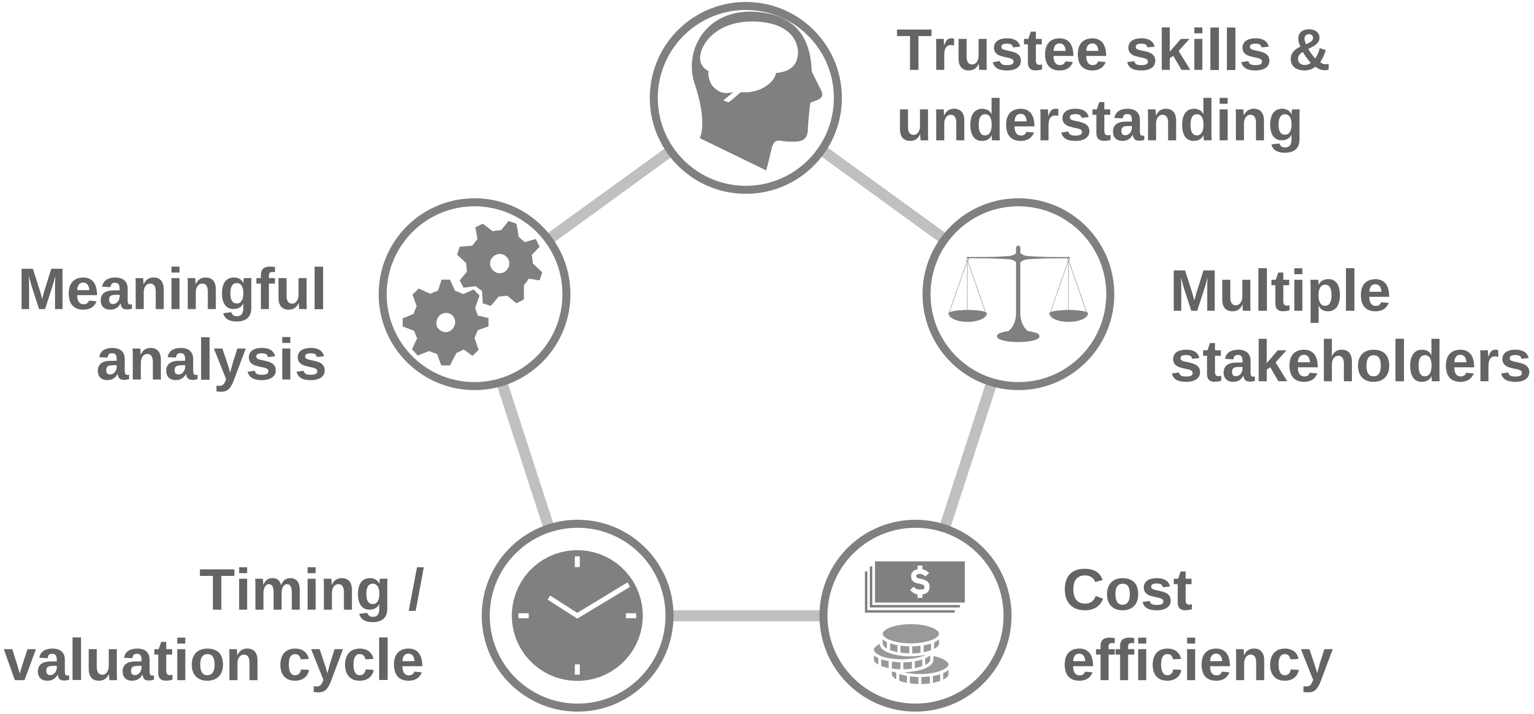
1) What is the chance that the assets will generate returns which exceed the discount rate?

2) What is an appropriate margin for prudence in light of the sponsor's ability to support the scheme?

Identify related risks and manage any correlations

Top business risks	Top funding risks
1. Lower growth in emerging markets	1. Falling gilt / bond yields
2. Higher cost of labour	2. Increasing RPI & CPI expectations
3. Currency volatility	3. Falling asset values
4. Higher interest costs on loans	4. Reduction in land / property values
5. Reduction in land / property values	5. Increasing life expectancies
	6. Lower growth in emerging markets

What are the challenges?



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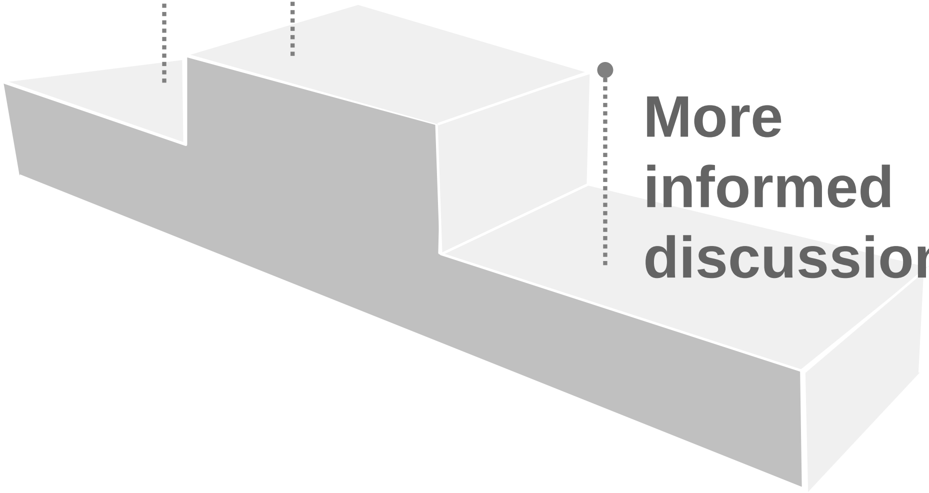
What are the potential rewards?

Improve risk reward profile

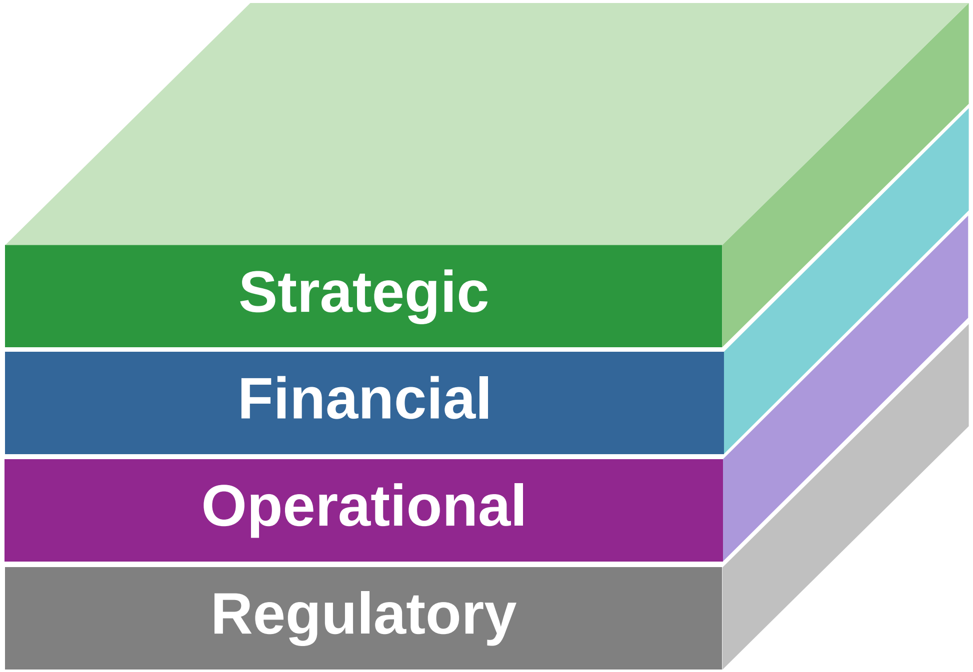
Increase focus on key financial risks

More informed discussions



One more thing…

- Focus today has been on key financial risks
- There is more than just financial risks
- We will be launching a survey with IAPF to explore all areas



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