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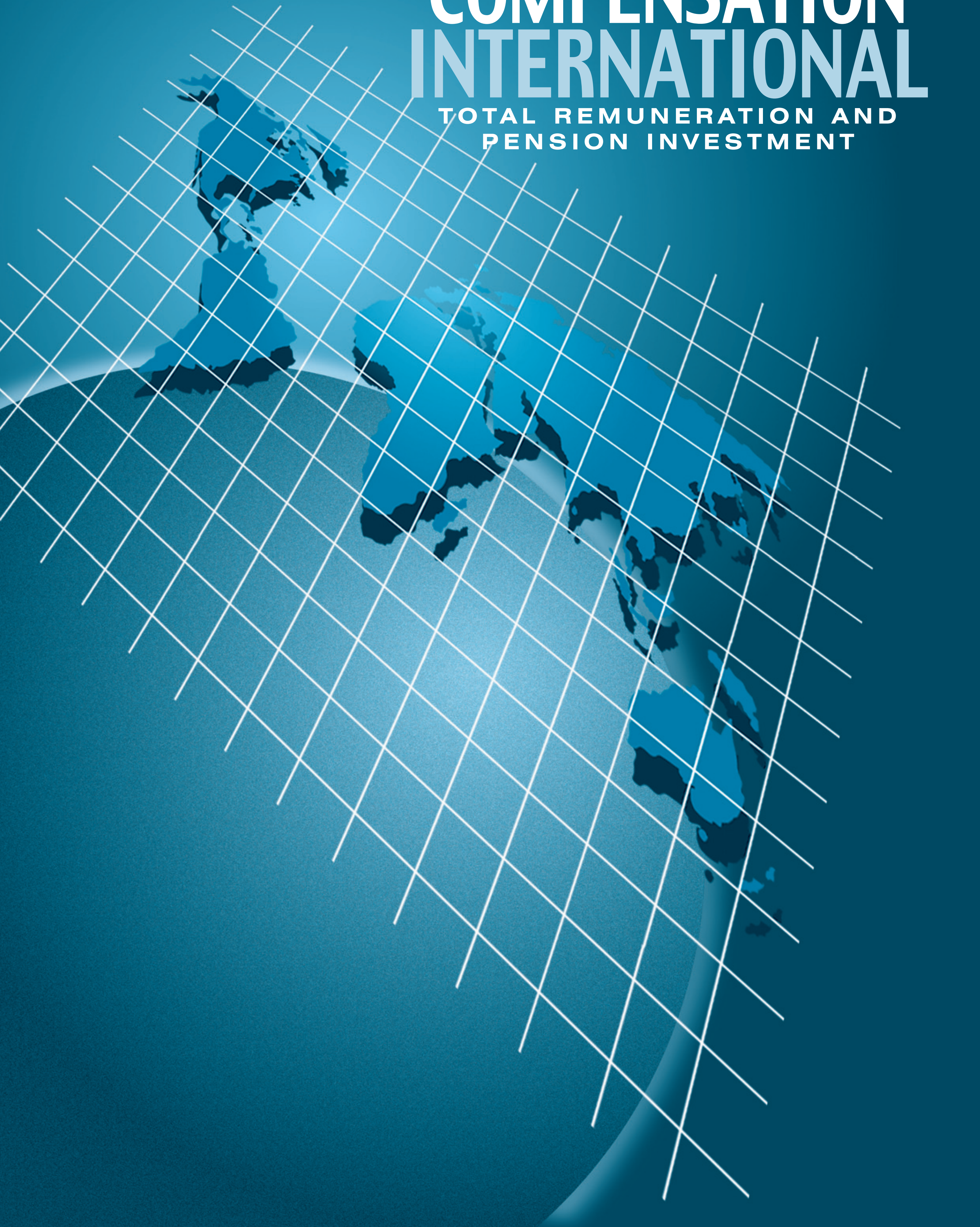

The UK, Netherlands and Switzerland: A Pension Derisking Comparison

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Risk wasn't always a dirty word for pension schemes. When stock markets were running high and schemes were reaping the rewards from high equity allocations, asset risk was little more than theoretical. Likewise, rising life expectancy and interest and inflation rate shocks were yet to dent either funding levels or investor confidence, and few trustee boards or sponsors contemplated the threat of falling into deficit.

Looking back, such fortuitous times are not only a distant memory, they are difficult to comprehend at all. At the end of June this year, the total UK pension deficit for companies in the FTSE 100 stood at £51 billion*, a marked improvement on the £96 billion in the same period last year, but unchanged from the position five years ago. This is despite companies paying £70 billion of deficit contributions over this period. For many trustee boards and their sponsors, risk is something that can no longer be left unmanaged.

The UK has not been alone in suffering the consequences of the financial stresses and strains of the last decade. In Switzerland, high allocations to equity markets cost pension funds dearly at the turn of the century (with funds losing a third of their value between 2000 and 2002) and, in the Netherlands, the catastrophic falls in equity markets and interest rates over the past decade have forced funds to rethink their approach to risk management.

REGULATORY DRIVERS

For financial regulators in the Dutch market, recent funding crises were deemed so severe that regulations have been put in place to help counter the impact of market volatility. In the Netherlands a supervisory framework, the *Financieel Toezichtskader* (*FTK*), has been in place since 2007 that requires a pension fund to be at least 105% funded, i.e. to fully fund nominal liabilities with a 5% solvency buffer. Above this, another mandatory solvency buffer (up to about 30%) should be in place, based on the risks facing the pension fund. Trustees are obliged to carry out regular risk assessments covering both financial and non-financial elements and, where funds carry high levels of risk, they will be expected to have a larger buffer in place. However, the *FTK* has not been designed to force Dutch pension funds away from growth asset classes or hedge out all risk exposure. Risk and return continue to play a role, particularly as the Dutch system operates conditional indexation where members receive pension increases only where assets have performed well enough to pay those increases. Rather, the role of the *FTK* is to encourage trustees to manage risks more effectively. Regular asset / liability management studies, which are obligatory every three years but are often conducted annually, are a key part of this process.

Meanwhile, in Switzerland, where funds wish to exceed the limits imposed by the legislation, they must demonstrate in their annual statements that they have appropriate risk management, including well-diversified portfolios supported by asset/liability studies. As with the Dutch *FTK* framework, the Swiss regulations are not motivated by a desire to eliminate all growth assets from portfolios, but to improve governance and encourage a more thorough understanding of a fund's investment risk.

In the UK, however, investment regulations remain broadly unchanged and, while trustees are bound to behave prudently and have liability valuations and recovery plans approved by The Pensions Regulator, they are not obliged to restrict investment choices and, in stark contrast with the Netherlands, they are not

* €1 = £0.83; US$1 = £0.65 as at 10 September 2010

required to hold larger reserves when holding riskier assets. The UK's pension schemes have so far escaped the kind of solvency legislation that governs insurance companies and are seen as very much a different kind of animal. In the Dutch market, however, pension regulations are seen as a precursor to the latest Solvency II legislation which sets stringent rules for insurers across Europe.

REACTING TO RISK

Liability-driven investment (LDI) has been in evidence in the Dutch pension market for a number of years. The obligatory ALM studies have forced trustees to have strategies for hedging those risks viewed as unrewarded, while profiting from others. For some Swiss funds, tactical asset allocation is a popular strategy, allowing trustees to take high-level views on inflation and interest rates, and adjusting their portfolios accordingly.

These kinds of derisking solution have been gaining ground in the UK market but the use of interest rate and inflation hedging, while common among larger schemes, is still less common for smaller schemes due to governance requirements and potential implementation costs.

Where the UK does lead the derisking market is in the use of insurance, e.g. buy-in and buy-out arrangements*, and, more recently, longevity hedging. According to our firm's figures, over £6 billion in risk transfer deals was completed in the first half of 2010, so the market is on track for £10 billion to £15 billion by the end of the year. A significant contributing factor in the surge of buy-out deals comes from the longevity swap market with one deal completed by the BMW pension scheme worth £3 billion alone. While the BMW deal is the largest to date, it was indicative of the potential size of longevity transfers being considered in the UK. Schemes of all sizes are anxious to remove or reduce the risk of growing life expectancy but, for schemes with less than £250 million in pensioner liabilities, longevity hedging remains impractical for the time being.

The Dutch and Swiss markets, however, are just waking up to longevity hedging. Of course, pension funds in the Netherlands and Switzerland are acutely aware of growing life expectancy and, in the past year, Dutch funds had to increase liability valuations by, on average, 5% to account for rising longevity. However, private market solutions have yet to manifest themselves in either country as they now have in the UK.

As with longevity hedging, buy-in arrangements are unheard of in the Swiss and Dutch markets, although both countries have witnessed notable buy-out deals. For Dutch pension funds, however, buy-out is driven not by the need to derisk but by onerous governance demands which have made running a pension fund prohibitively expensive and time-consuming for some companies. In fact, the number of corporate pension funds in the Netherlands has halved in recent years as more sponsors hand their funds over to insurers.

In Switzerland, buy-outs have happened where corporate sponsors have become so weakened financially that they can no longer support the pension fund, though this is largely restricted to the smaller end of the market.

FINDING THE RIGHT STRATEGY

Irrespective of a pension fund's location, the size of its deficit or any preconceived ideas the trustees or sponsors may have about preferred strategies, the first step on any derisking path is to identify and quantify the risks the scheme is carrying.

Assessments need to cover both the assets and liabilities and strategies need to incorporate both sides since they are intrinsically linked. For example, there is a diversification benefit in holding a number of risks that are only partly correlated, such as equity market and interest rate risks. So, where a pension fund is looking to reduce its equity exposure it may also look to balance the equation by reducing interest rate risk, say through interest rate hedging.

Finding the right time to implement a derisking strategy is also critical. Some exposure may pose more of a threat to schemes at different times, and trustees need to take a tactical view about when to remove certain risks and when they might profit from leaving others on the table. For example, where trustees have a positive view on interest rate movements, does their strategy allow them to retain some exposure while tackling another unrelated risk such as longevity?

Going beyond the mandatory monitoring obligations and assessing risks on a more frequent basis can help trustees manage a dynamic derisking strategy that best reflects their unique portfolio profile. For example, summarizing and reviewing the asset and liability risks every six months can help trustees systematically assess immediate threats to funding levels and eliminate those accordingly.

DERISKING CHALLENGES

Regular monitoring can be instrumental in reducing costly frustrations that can arise during a derisking process. Ahead of the last financial crisis, many Dutch pension funds believed they were fully hedged against severe falls in interest rates. However, many were only 60% hedged and, when the markets crashed in 2008, millions of euros were wiped off funding levels. A more thorough review of how the hedge was implemented and what it involved could have helped insulate Dutch schemes from the worst of the impact.

In the UK, challenges arise from the relationship between the sponsor and the trustee. Trustees control investment strategy in the UK and are not required to negotiate strategy with the corporate sponsor, although they must

* A buy-out is a transaction where liabilities and legal responsibilities are transferred to an insurance company. A buy-in is a transaction where a pension scheme purchases an insurance annuity contract to match pension liabilities, but the pension scheme retains legal responsibility for the liabilities.

consult with it. Given the riskier asset mix typically found in UK schemes, the sponsor will often be concerned about the implications of the scheme's investment strategy and may have a very different view from the trustees about the appropriate level of risk to bear. Disagreement over investment strategy (where the sponsor has no direct say) can therefore spill over into other areas, such as funding negotiations, where the sponsor does have a say. In contrast, Dutch and Swiss trustee boards are made up of individuals representing both the sponsor and the employee sides and decisions made will, by default, reflect positions that are generally acceptable to the sponsor. Consequently, once it has been agreed by the board, an investment strategy will normally go ahead.

For UK schemes wishing to avoid potential conflicts between trustee and sponsor, the key is for the two parties to reach agreement at an early stage about the objectives of a derisking exercise, and iron out all the details before proceeding. For example, if longevity hedging is the priority, are there any providers with which a corporate or trustee board would not be comfortable working? Only once the strategy is clear on both sides is it worth approaching providers and putting solutions in place.

Another largely UK-specific issue arises because pension strategies have become far more complex in recent years – compare LDI, with its reliance on financial derivatives, with the typical mix of equities and bonds held by most UK schemes 10 years ago. This new complexity places additional demands on trustees looking to move pension strategies forward, particularly in the UK where the majority of board members are lay people with a limited amount of time available to dedicate to the role. Equally, in the Swiss market, it takes time for particular tools and techniques to filter through. Certain dynamic derisking approaches that have long been prevalent in the Dutch and, to a lesser degree, the UK markets involving options have yet to take hold among Swiss pension funds. In the Netherlands, however, where governance rules are now more stringent, pension fund board members must operate in a rigorous framework which requires a higher standard of knowledge. As such, Dutch pension schemes are often seen as market leaders in the derisking market.

IDEA SHARING

Since pension schemes across Europe share so many of the same threats to their funding levels, much can be learnt from examining approaches and solutions taken by neighbouring countries.

Each nation's regulatory framework will be driven by specific legacy issues and their own unique circumstances, but this should not preclude the possibility of copying laws that have proved particularly effective.

By the same token, successful providers should be able to take their solutions across borders and develop new markets throughout the continent, as has already been the case with LDI strategies. In the case of longevity hedging and buy-ins, markets outside the UK offer huge potential for insurers and investment banks offering these solutions and we may yet see growth in cross-border activity.

As the derisking market becomes more sophisticated the potential to reduce volatility and get funding levels under control becomes more real. Trustee boards need to work with their advisers and sponsors to ensure they understand their risk exposure and put the best strategies in place to tackle the most dangerous threats. The range of products now available means that pension schemes, irrespective of country or profile, can find a strategy to suit them. Ω

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