Pension Risk Management

9th Pension Law and Litigation Course

June 11, 2013

Amanda Darrach

CAVALLUZZO

Risky Business

- Insurance companies often describe themselves as “in the business of managing risk”
- So are pension plans
- Pension sponsors and administrators face and must address enormous risk, no matter the size of the plan

How risky?

- Mercer’s Pension Health Index (January 2013):
  - 60% of Canadian pension plans were less than 80% funded as of January 1, 2012
  - 94% of plans have some solvency deficit
  - Only 1 in 20 plans would have had enough assets to fund benefits if wound-up

Why risky?

- Record low interest rates
- Poor equity performance

What is the effect?

- Showing up on the bottom line in financial statements
- In the UK, companies that had de-risked pension plans experienced an increase of 10.2% in share price (Source: DB Pension plan de-risking, Grant Thornton UK LLP)

What is risk management for pension plans?

- Three steps:
  - Analyze and define risk factors
  - Decide on acceptable level of risk
  - Measure and control

Enterprise Risk Management

- Consider pension risk management as part of enterprise risk management

What are the risks?

- 4 major risk areas:
  - Litigation risk
  - Investment Risk
  - Funding Risk
  - Everything else

Litigation Risk

- You will hear a lot about litigation risk in the next 2 days
- Administrative and other decision making open to challenge by plan members, retirees, unions…
- Difficult to reduce the likelihood of a challenge
- Less difficult to reduce the chance of success

Litigation Risk

- Mitigators include:
  - Early identification of decisions likely to come under scrutiny – plan conversion, reduction of benefits, increase in contribution, changes to indexing
  - Clear, early, and (perhaps) frequent communication

Investment Risk

- Interest rate risk is one the most, if not the most, largely cited risk factor
- Long term interest rates used to determine pension liabilities
- 1% decline in interest rates = 10-15% increase in liabilities
- Long term interest rates are the lowest in 60 years
  - (Source: Pension Risk Management Issues for CFOs)

Investment Risk

- In the past 14 years, equity returns have bounced from over 30% (1999) to -30% (2008)
- Even more as a problem because “diversification” was often diversity in flavours of equity

Investment Risk

- Why's that a problem? Plans typically have about 55% of assets in equities
- Mismatch!
  - Liabilities sensitive to interest rates
  - Assets sensitive to changes in equity markets

Funding Risk

- Pension plans are greatly underfunded
- Interest rate risk and investment risk are combining to create large solvency deficits
- Recognized by governments in solvency funding relief
- May not be enough

Other risks

- Regulatory risk:
  - Changes in standards can lead to changes in risk and funding levels
  - You’re required to comply – but you may not have (or your service provider may not have) seen it coming

Other Risks

- Inflation risk
  - For indexed plans in particular
- Longevity risk
  - People are living longer, and mortality tables can't keep up
- Reputational Risk, Liquidity Risk, Credit Risk, Market Risk, Demographic Risk…

Risks

… not being able to meet the pension promise.

What to do, what to do…

- Two options:
  - manage the risk,
  - …   or get rid of it

Ridding yourself of risk – get rid of the pension plan

- Get rid of it all – close the plan and annuitize everyone!
- Not practical for a number of reasons for most plan sponsors:
  - Annuity market is tight, and costs are high
  - Plan will have to be fully funded
  - Will have employee relations consequences

Managing the Risk – Investment

- Consider asset/liability matching
- Reduce exposure to equities, increase long bond
- Risk that the market experiences a large gain
- Deficits will be locked in and must be addressed through contributions

Managing Risk - Investment

- Other strategies – “risk parity” – allocation of risk, rather than capital
- Each asset class has the same potential for losses
- Longevity insurance/swaps

Managing Risk - Investment

- CAPSA recommends that you identify risk tolerances in your investment policy

Managing the Risk – Plan Design

- Reduce benefit formulas, indexing, ancillary benefits
- Increase contribution rates
  - Be cautious! This could increase litigation risk

Managing the Risk – Plan Design

- Plan conversion – convert your DB plan to a DC plan
- Reduces investment risk for the plan sponsor
- Reduces, but does not eliminate, litigation risk
  - High potential for litigation re conversion process
  - Lower potential (but nothing approaching zero) for litigation re administration

Managing the Risk – Plan Design

- Plan conversion is the trend in Canada and elsewhere
- Plan sponsors are considering “hard” and “soft” conversions
- Difficult to convert in a unionized environment
- Target benefit plans?

Managing Risk – Funding Policies

- Developing funding policies will allow for known and consistent responses when risks materialize
- Consider use of letters of credit
- Funding policies can function as contingency plans:
  - Build up reserves when times are good
  - Call on reserves when times are not

Managing Risk – Funding Policies

- CAPSA funding policy guideline
- Why have one?
  - "Improves the identification, understanding and management of risk factors that affect the variability of funding requirements"
  - Leads to predictability in funding and reducing volatility

Managing Risk – Other Issues

- Consider your governance structure – who meets to discuss pension issues and how often?
- How is pension risk management incorporated into sponsor-wide processes?

Questions?