

Business risks posed by defined benefit pensions

[Business](#), [Management](#)



Introduction

“ Occupational pension funds are financial institutions that manage collective retirement schemes for employers in order to provide benefits to employees.” (European Commission, No Date), The DB pension funds offer a type of pension that’s more predictable, is based on a percentage of your earnings and basically, the greater your salary and length of service the bigger your pension should be. (Corporate finance institute, No Date). DB pension funds over time proved to be increasingly risk takers and not just because investment returns are uncertain. There is a string of risks associated with them which must be appropriately managed by the fund trustees and managers especially after the less risky period of the 90’s (Introduction to pension Accounting, 2018). New accounting standards and increased spotlight in the media on companies with huge pension deficits have forced many to switch to DC pension, avoiding some of the risks detailed in this essay.

Discussion

At the inception of the DC pension funds as a second pier to state pensions and during its golden age of the 80’s and 90’s the majority of risks related to them were grossly overlooked in the management process due to surpluses from cautious funding, favourable economic climate, high long-term interest rates and higher inflation. A combination of factors like management negligence, rising life expectancy, falling investment returns and unfavourable inflation amongst others have pushed fund managers and

trustees to look into the DB funds related risks a lot more carefully and thoroughly (Franzen, 2010).

Assuming and retaining risk is a main characteristic of DB pension funds unlike the DC funds which push these risks upon participant members and let them contend with the ups and downs of the share and equity prices. The importance of liabilities and the long-term investment horizon make these funds long-term investors assigning pension money in asset classes such as equity that are subject to higher volatility in the short-term but usually reward higher returns in the long-term (The Actuary Exploring pension risk, 2018).

The risk least susceptible to hedging is longevity risk and has met increased attention by managers in order to understand the accuracy of life expectancy assumptions and more importantly to assess the value for money of a longevity hedging deal. Since the 1970s the life expectancy charts were highly inaccurate but large prediction errors proved less financially significant because the central banks' discount rates were higher and getting longer term mortality predictions wrong had relatively less impact on liabilities. But more recently, with the fall of discount rates, the longevity risk became something to reckon with (Hewitt, 2016).

Many DB pension funds have come under pressure from ultra-low gilt yields since the financial crisis of 2008 due to the interest rate risk and that's because the promised pension benefits have not been covered by money from fixed-income securities (Baxter, 2017). The drop in interest rate following the Brexit vote in 2016 for instance caused an increase in liabilities

and a decline in the funding ratio. The recent small rise of the Bank of England interest rate and news of a further increase should be good news for hard pressed DB funds however the slow pace and value offers only limited relief and furthermore, the uncertain outcome of Brexit adds a further twist to the interest rate issue and a headache to DB fund managers.

Closely related to the interest rate risk is the investment risk which measures the financial impact when the actual investment experience differs from that expected. It is generally accepted that the best assets for pension fund liabilities are conventional and index-linked bonds even though they have a lower return in the long run than equity. Index-linked bonds combined with inflation derivatives are a good choice to meet appropriate funding levels because the income is adjusted for inflation (Shane F. Whelan, 2004, p. 36).

In a DB pension scheme low interest rates and low inflation have increased the value of the payable pensions contributing to fund deficits reducing member security (Mycompanypension, and Dnb. nl, 2018). Inflation risk as well as interest rate risk need to be managed by fund managers by defining both a nominal and an inflation related benchmark. Inflation risk is very important in the long term for the UK due to continued uncertainty and should be advisable for fund managers to set up an inflation hedge similar to interest rate hedges, also they should replace government bond exposure with inflation-linked bonds (Preesman, 2017). High inflation would reduce the cost of benefits making fund managers happy but the government has often stepped in with regulations to prevent member benefit decreases.

The last few years have seen a huge amount of pension related regulation rolled out mostly in order to improve value for money for scheme members, make DB schemes more sustainable and alleviate some of the risks for DC members (Moss, 2015). For pension fund managers the regulatory risk has steadily increased in the past decade with several rounds of regulations forcing them to make compulsory adjustments to the way they operate. These changes being unforeseeable and mandatory made fund managers more aware of the importance to factor in regulatory risk during decision making.

Regardless of size and complexity operational risks exist in every organization including pension funds and is viewed as the risk arising from the execution of business functions. These include risk of loss resulting from inadequate internal processes, people and systems or from external events. Capital allocation was the main reason for measuring operational risk but in recent years the focus shifted towards managing operational risk making sure it's taken into account when predictions are made regarding expenses and liabilities.

New government regulation, low interest rates and market dynamics have affected many institutional investors but pension fund face the biggest pressure because finding and maintaining appropriate liquidity is very important for many DB pension trusts, especially the ones closed to new members. The risk that a firm is not able to settle a position at market values due to liquidity disruptions in the markets is also known as a funding crisis.

The introduction of the FRS17 accounting standard and calls for greater transparency in pension funding and company accounts was the government's response for the aforementioned situation. The new accounting standard is used to assess the balance sheet impact and pension costs associated with the operation of pension schemes (Collins, 2018).

Accounting for liquidity risks became an important part of pension scheme risk management as cash is an important investment enabler and in the current business environment returns on cash positions can be very low or even zero if inflation is factored in as well.

For a pension fund's financial health, the funding ratio is a very important indicator and the 2008 crisis signalled the need for a much improved risk management. The surplus risk was focused upon previously but the funding ratio risk serves risk management a lot better in case of DB pension funds. The steep fall in pension funding during the most recent financial crisis, tougher regulations, difficult business climate and the real threat of additional contributions to repair underfunding have pushed many DB pension plan sponsors to take an increased interest in DC or hybrid DB/DC schemes to transfer some of the risk burden onto employees (Woters, 2018). Improved risk management with the Liability Driven Investment (LDI) approach should have been deployed since this technique is more effective and the assurances made to employees and pensioners are the liabilities this technique must target (CIMA, The Pension Liability, p. 28). It involves effective risk management and is far more acceptable for fund members

since it sidesteps the unpopular risk transfer between employer and employees.

The possibility that a pension funds' documents filed with The Pension Regulator contain false information is financial reporting risk and usually the higher this risk is the higher the pension fund deficit. If there is any significant mismatch of assets and liabilities where risk is being taken on to try and achieve higher returns, the Value at Risk (VaR) concept is a very useful approach. These techniques were originally developed by the major banks and insurance companies for assessing the risks in their own books of assets and liabilities and can be adapted to suit the needs of troubled pension funds thus reducing the financial reporting risk.

Every important financial decision within a pension fund must be taken with an established strategy of risk-return trade-off making sure the moves are put in practice by the book. Risk management is about recognizing the relevant risks before every decision controlling and adjusting measures if expected or unexpected risks are surfacing. The risk management of pension funds should equally focus their attention on the risks to avoid as well as on risks deliberately taken to achieve the goals of the fund members. The early and proper recognition of risks and the appropriate measures taken to mitigate them is the hallmark of pension funds that have a proactive attitude regarding risks and have a culture of risk management at each level of its organization (Hoogdaem et . al, p. 3). The board of a pension fund is expected to take market risk in order to realise the strategic goals of the organisation and a good distribution of the assets across issuers and

countries makes is more resilient to various risks also removing the need to pay a hedge fund to take on the risks. The balancing of contributions, ambition and risk is the main task of the fund trustees thus figuring out the risks that are rewarded and making informed decisions about the maximum allowed exposure to the involved risks (Hoogdaem et. al, p. 4).

A well-structured pension fund has multiple layers with the top level making the risk-return trade-off and setting out the investment strategy and the bottom level receiving individual investment mandates. The business risks are present at every level to a certain degree but a solid strategic risk management culture can make a big difference between successful funds and those in liquidation.

Conclusion

The issue of risks within pension funds has become more visible in recent years and with it has come a hurried reaction to switch from DB to DC. Changing the investment strategy remains the quickest and most effective method of changing the risk exposure (company risk in a DB arrangement, member risk in a DC account) by pension fund managers, however switching from DB to DC is essentially a risk transfer from company to employee, not one that reduces cost. Pure DC is only one of a broad range of solutions and, even here, the switch needs to be properly managed and communicated if it is to achieve its objective of reducing risk. It is vital that scheme sponsors not only understand the nature of risks within their schemes but are also aware of the tools available to manage them. From accounting point of view the workload with DC pensions is significantly less than with DB pensions

due mainly to less complex risk factors however, there's more room for improvements and streamlined solutions.