Risk Management in times of Financial Crisis

Expert knowledge means success

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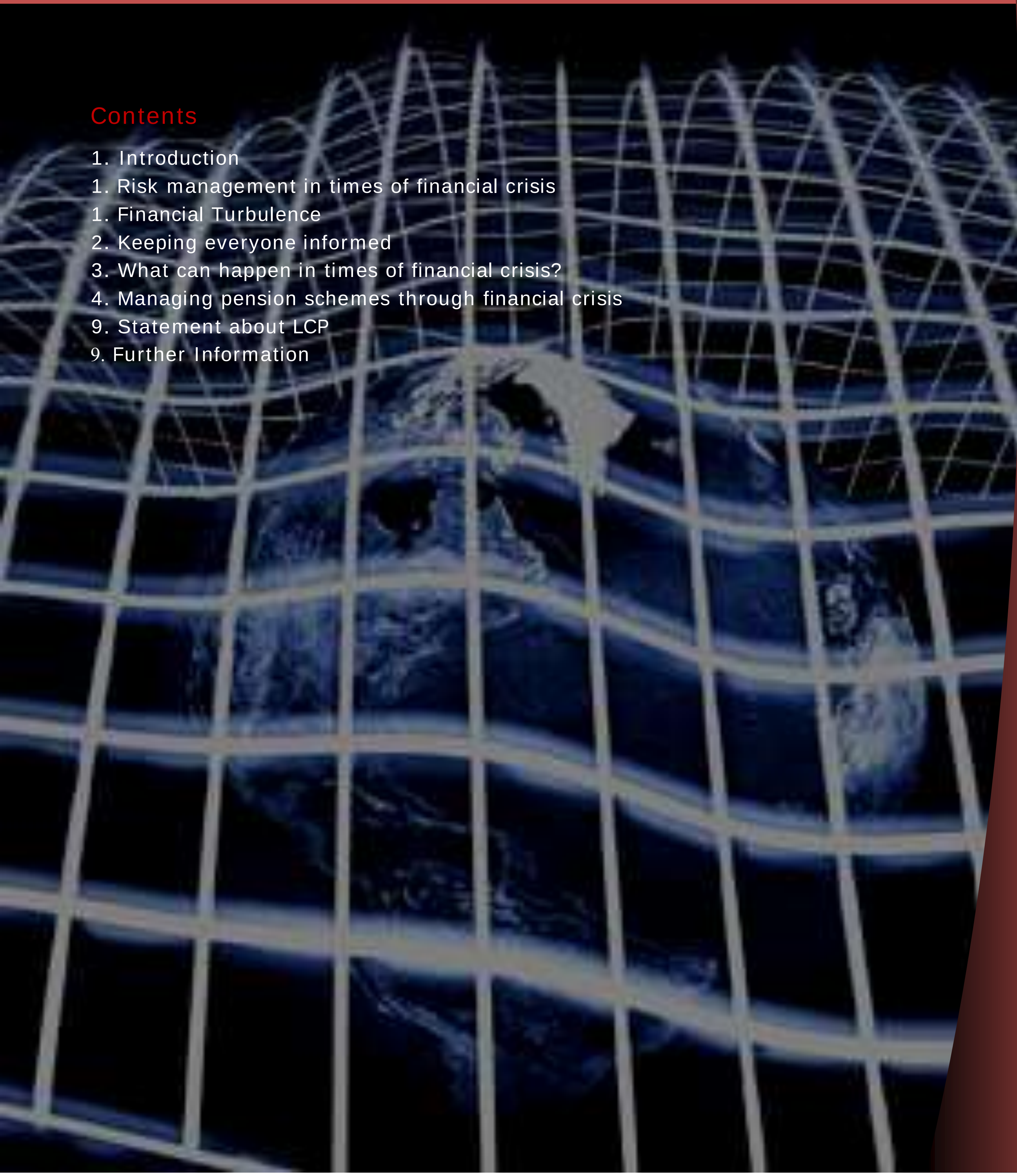

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Introduction

This publication is taken from the document *Risk management in times of financial crisis* published in October 2008 by Lane, Clark & Peacock (LCP) and their copyright is duly acknowledged. LCP is a limited liability partnership offering a full range of actuarial, benefit consultancy and risk services to clients in the UK and internationally through LCP Trustee Consulting, LCP Corporate Consulting, LCP Financial Dynamics Practice, LCP Insurance Consulting and LCP Investment Consulting. LCP's contact details can be found on page 9 of this publication.

Risk management in times of financial crisis

This publication concentrates on the potential issues for UK pension schemes, particularly occupational pension schemes. Clearly, many similar risks apply to businesses and individuals. The note covers issues that are relevant both from a trustee perspective and from the perspective of sponsoring employers. It only covers the risks associated with shock financial events - clearly all the usual risks of running a pension scheme continue to apply and should be managed in the usual way. We make recommendations on next steps in the final section.

Shock bank failures and insurance company rescues. High stock market volatility. What does it all mean for pension schemes?

In dramatic times, dramatic action may be necessary to mitigate against major risks - those who fail to take such action could find themselves in significant difficulties, with capital lost or tied up in all the wrong places. Equally, there are times when the right thing to do is nothing.

Those responsible for managing pension schemes should act now to identify your risks, ensure the key stakeholders - eg trustee and company boards - are aware of them, and identify and implement any appropriate mitigation. Be aware that some actions may be, or may quickly become, time critical.

Financial Turbulence

Recently we have seen events unfold that would have been close to unthinkable just a year ago. Some of the world's biggest banks and insurers such as MG; Lehman Brothers, Bear Stearns and Washington Mutual have collapsed, or had to be rescued.

- What does this mean for the wide range of investment products that are available to pension schemes?
- What does this mean for insurance products, including annuities? What would happen if a large insurer was allowed to become insolvent?
- Does this mean that a large retail bank might fail, and what are the implications if it did?

In the light of the above and other events, investment markets are likely to remain highly volatile and there is the possibility of further shocks to the system, including further failures of financial institutions, entering a recession, significant further increases in inflation and large changes to interest rates. For the time being at least, none of these can be ruled out, even if you think the chances of them are small.

So, at times like this how do you respond? If you do nothing, you may be running some very large risks, and it is easy to see scenarios where the consequences could be material and trustees could be subsequently criticised for their lack of action or their inappropriate actions. On the other hand, there is clearly potential to target limited resources in the wrong places.

The Credit Crunch

The "credit crunch" refers to the overall economic events of the last year, but primarily describes the significant loss of confidence that financial institutions have had in each other since about mid-2007. This lack of confidence has led to their reticence to lend money to each other - and maybe rightly so, as banks began to realise their potential exposure to losses arising from a severe down turn in the US and UK housing markets.

Many banks and other financial institutions rely heavily on their ability to borrow money in order to operate and demonstrate their solvency. Consequently, a number of financial institutions have struggled to demonstrate that they can remain solvent and have needed rescuing by other businesses or governments. Given the global, complex and inter-related nature of the world's financial systems, the impact of such events has been wide ranging. Until confidence and stability returns, there is a material risk that further financial institutions could get into trouble and/or fail, threatening the smooth running of the world's financial systems.

Keeping everyone informed

In all cases, it is important to ensure that the appropriate people are aware that risks exist and, if possible, that action is being taken to mitigate them.

Members

Pension scheme members may be unnerved by reports of a weakening employer covenant, falling asset values, or wider events in the economy. The trustees and employer may wish to communicate to members to assure them that they are aware of the risks and mitigating actions are being taken. Management time may be needed to deal with queries and specific concerns.

Trustees

Trustees need to be kept informed. Where appropriate, urgent meetings may need to be called and sub committees may need to be set up at short notice to deal with urgent matters. Companies will need to work to maintain a strong relationship with trustees, amid other corporate distractions. Trustees also need to keep an open dialogue with their sponsor, as some changes will require consultation. Trustees should also keep clear records of decisions, so that they can be justified when considered in retrospect.

Management

Those with responsibility for pensions within an organisation should consider the extent to which management and company boards should be kept abreast of matters. Key individuals may need to be reminded of legal duties to consider the appropriate involvement of trustees in material corporate change.

Top 10 tips

1. Prepare a list of your key third party exposures - banks, investment managers, insurers etc. Identify the ultimate group company in each case.
2. If you believe there is a chance that your scheme's money on deposit could be at risk, start the process of setting up an alternative account with another bank as soon as possible, as the process is likely to take weeks rather than days.
3. Check that all banking and investment authorisations and signatories are up-to-date to ensure that actions to divest/invest can be completed swiftly if needed.
4. Review all standard transaction procedures for buying/selling assets such as automated switching from one asset class to another; ensure that they remain appropriate in times of market volatility and illiquidity, and that processes are in place to ensure that they are followed.
5. Consider the extent to which material transactions are likely to arise in the coming months and consider whether any should be deferred or phased.
6. Add an agenda item to the next trustee meeting to consider the risks and agree what actions may need to be taken. In particular, we recommend that trustees should update their risk register and in so doing actively reconsider the potential implications of the credit crunch and recession on their sponsoring employer's covenant; if it is believed that the implications could be material to the pension scheme and the security of members' benefits, then decisions should be taken as to how to respond to this.
7. Ensure that business planners and finance departments are aware of the potential consequences of falling asset values on year-end company Ensure that business planners and finance departments are aware of the balance sheets and next year's pension charge and also the potential significant increase in cash contribution requirements that may arise from any upcoming scheme funding valuation if conditions do not improve.
8. If your business suffers redundancies and so there are key personnel changes, consider the impact of these on your scheme's finances and ensure adequate continuity for key roles, such as trustees and pensions staff.
9. Watch out for notifiable events - ie events such as credit rating downgrades and breaching banking covenants - that may need to be reported to the Pensions Regulator at the earliest opportunity.
10. To the extent appropriate, communicate to members to allay any concerns they may have about the sponsoring employer, or about events in the financial world more generally.

"Risk management has been a key theme for pension funds for several years now. For many pension scheme trustees, this could be the first time that your risk management framework will really be put to the test."

Aaron Punwani
Head of LCP
Trustee Consulting

What can happen in times of financial crisis?

Before looking at the consequences for pension schemes, in this section we list a number of possible consequences of the ongoing credit crunch itself. Whilst just a year ago many of them would have been next to unthinkable, some of the most unlikely have indeed already happened.

- Possible failure (or rescue or partial rescue) of an investment bank, a retail bank, a building society or an insurer.
- Flight to quality - government bonds and gold prices may soar, with long term yields on government bonds falling, whilst prices of other, more risky, investments may fall significantly - including equities, corporate bonds and property.
- Normal trading rules may temporarily cease to apply - assets that are normally highly liquid may become unpriceable and / or untradeable (or tradeable but with associated transaction cost being sky high) and therefore may essentially become illiquid for a period of time; stock markets may close for periods and market volatility may be extremely high.
- Commercial contracts may be tested to the limit as businesses struggle to survive or fail - counterparty and collateral contracts for some investment products may be at risk of failing.
- Underlying economic data may change quickly and significantly - eg inflation may take off or fall sharply, interest rates may be adjusted significantly and without warning, unemployment may materially increase.
- Businesses may hold onto cash, may make many people redundant, may close down operations and subsidiaries or fall into receivership - some of these events may occur suddenly and without warning.
- Group parent companies may get into financial difficulties and may seek to move money out of local businesses and subsidiaries; trustees must be alive to these issues.
- Generally, employees and directors are likely to be under more pressure from management and shareholders to identify risks, report them immediately and take urgent mitigating actions. Business risks may be just as likely to arise from over-reaction as from inaction.

Managing pension schemes through financial crisis

There are clearly numerous possible consequences of the above events on pension schemes and it would be impossible to identify all of them. In this section we highlight some of them, but perhaps the most important thing is to always be aware that unexpected consequences could arise and be ready to take any necessary action.

Issue	Description	Comment	Possible actions
Investment			
Asset value falls	The value of a pension fund's assets may fall and may fall significantly over a short period of time. The timing of this may coincide with reporting dates, eg for scheme funding valuations, company accounting or reporting to members (these points are expanded below). Some particular equities or bonds in the portfolio may literally become worthless.	This demonstrates the importance of choosing an appropriate investment strategy, being aware of the extent of the risks for the fund and for the sponsoring employer, and the diversification of assets generally.	Material falls in asset values may make it appropriate to conduct an urgent review of investment strategy, particularly if the sponsoring employers own financial strength has also changed materially.
Counterparty risk	Some investments rely on a "counterparty", eg stock lending, many liability driven investment portfolios, including interest rate and inflation swaps, and other derivative based investments, including equity notes, currency trades and longevity derivatives. Such investments are often further protected by "collateral", ie transfer of ownership of actual assets equal to the face value of the investment, the amount of which is adjusted daily. If counterparties fail, then losses may occur, and other risks and losses may arise during the period that collateralisation ceases to function.	Lehman Brothers was a counterparty to some investments used by UK pension funds.	Be aware of the risks that you are exposed to. Identify the counterparties and ascertain who their group owners are.
Buyout and annuities	In the week of the 15th September 2008, insurers were finding it impossible to price annuities because of illiquid markets. For the time being, many of them have stopped offering guaranteed prices. Some insurers may have exposure to sub-prime losses. All have exposure to a wide range of other financial organisations.	The plight of AIG has illustrated that a very large annuity insurer, with a diversified portfolio and an exceptional brand, can fail, or need to be rescued.	Trustees who are considering a buyout should carefully consider the balance of the risks they are eliminating versus the new risks they are taking on and make informed decisions.
Trading risk	Pension funds routinely buy and sell assets. This may be particularly relevant when there is a large cash flow in or out of the fund (eg a special contribution, transfer from another fund) or the investment strategy is being adjusted, perhaps following an investment strategy review, or implementation of previously agreed de-risking, or simply to maintain the agreed strategy of having a fixed percentage in a particular asset class.		In times of market illiquidity, volatility and high transaction costs it is appropriate for trustees to consider whether the "normal" procedures should still be applied, perhaps choosing to delay or phase certain transactions, and ensuring that any period of time "out of the market" is kept to a minimum.

Issue	Description	Comment	Possible actions
Investment (continued)			
Investment management performance	In times of market shocks and volatility it can be expected that investment manager performance may throw up surprises. For active managers, the impact of being underweight or overweight in financial stocks (for example) could have a very significant impact on their performance. For passive managers, material divergence from their index may become more likely as they struggle to "keep up" with market changes.		Be aware of the risk of underperformance and monitor more closely than in normal circumstances.
Derivatives	The value of derivatives type contracts, that are held to create synthetic or more efficient exposure to underlying assets, eg credit default swaps in place of physical corporate bonds, may not behave as expected. This could be either due to small changes in the pricing basis or due to the legal nature of the contract.		Be aware of the exposure to such contracts and keep a register of them.
Other third party failure	Brokers, advisers and custodians may each be at risk of failure or having assets tied up.	Redundancies may lead to a change in relationships, perhaps at a time of crisis.	Be aware of your exposure to third parties and maintain appropriate relationships with them.
Issuing instructions	Instructions to investment managers or banks need to be issued in a timely manner. There may be the risk that instruction protocols, eg authorised signature lists are not in place or up to date.	There is a risk that a problem is only discovered at a time when a transaction needs to be complete very quickly.	Review authorisation and signatory lists to check they are up-to-date.
Sponsor strength			
Changing covenant	The strength of the employer's covenant to a pension scheme may reduce materially, or the employer may become insolvent. Where the strength of the employer has materially diminished, or is at more risk of materially diminishing, trustees should consider urgent mitigating action, for example using the powers available to them within their rules, seeking additional contributions or contingent assets (perhaps by triggering a valuation), or switching to more secure investments.	Companies should be proactive in engaging with trustees ahead of major changes.	Trustees need to remain vigilant in closely monitoring a company's strength and taking mitigating action sooner rather than later. It may be appropriate to seek special meetings with management to discuss the covenant, to seek additional information, to appoint financial advisers and/or conduct a special review of the covenant.
Unusual events	At times of financial crisis, management may make quick, unexpected decisions which may have significant financial consequences. A group headquarters may put pressure on UK subsidiaries to pass cash further up the group. A business, subsidiary or key assets may be acquired by new shareholders or moved elsewhere within a group.	Normal procedures may not be followed in extreme circumstances and events may develop very quickly.	Trustees need to keep close to the action and perhaps request to be kept closely in the loop if they are aware that their sponsoring companies are under pressure.
Notifiable events	Changes in credit rating, breaches of banking covenants, changes of control and changes to directors or other key posts, can all be events that the employer must generally notify to the Pensions Regulator as soon as possible.	There are some exemptions from this.	Be aware of requirements and compliance.

Issue	Description	Comment	Possible actions
Sponsor strength (continued)			
Change in personnel	In practice, one of the most challenging consequences of financial crisis can be the speed at which personnel and relationships change. Experienced trustees can be made redundant and may need replacing quickly so that the trustee board can cope with the pensions issues. Key management personnel, who have had experience of the pension scheme and long standing relationships with the trustees and their advisers, may be diverted to other management responsibilities and have no time for pensions, or may be made redundant.		It is important for all parties to make urgent efforts to build new relationships between the key decision makers if personnel changes happen at a time of financial crisis.
Financial irregularities and fraud	In times of stress, people can be tempted to act inappropriately.	For example, if trustees are aware that an employer is in financial difficulties and there is a delay in paying an employer contribution to the scheme, this should trigger more urgent action than in normal circumstances.	Be vigilant.
Funding issues			
Increased deficits	Material increases in deficits may trigger the need for an out-of-cycle actuarial funding valuation and a request for additional contributions (or a demand for such contributions if the trustees have that power under their rules).	The trustees' response will be dependent on the strength of the employer's covenant.	Trustees may need to consider if such action is appropriate.
Currently ongoing valuations	Where valuations are currently being completed, the trustees, the company and the actuary should consider the extent to which it is appropriate to take into account "post valuation date" events.		Trustees may need to consider if such action is appropriate.
Transfer values	Increased deficits and changes in investment strategy could lead to a need to review the basis for setting transfer values.	There may be a need to reduce transfer values in respect of underfunding in the scheme.	Trustees may need to consider if such action is appropriate.
Accounting for pensions & internal compliance			
Increased deficits and profit charges	Material increases in FRS17 and IAS19 deficits may emerge before the sponsoring employer's next year-end.	This may have a very significant impact on the company's balance sheet and on the following year's pension charge to profit.	Companies may wish to consider the potential impact on their accounts, the perceptions of their shareholders and other investors including banks, and the impact for 2009 budgeting.

Issue	Description	Comment	Possible actions
Accounting for pensions & internal compliance (continued)			
Funding vs accounting	In times of financial crisis, it should be expected that pension fund liabilities measured for different purposes will diverge. In particular, trustee funding valuations are likely to show much higher deficits than those revealed under FRS17 or IAS19. This is because gilt yields (which drive funding valuations) remain low, whilst corporate bond yields (which drive accounting valuations) increase significantly - this simply reflects the "flight to quality" within investment markets.	Management and shareholders may be surprised to see the combination of very high contribution demands from trustees, but less damage shown in the accounting figures.	Companies who comply with International GAAP may need to book additional liabilities on their balance sheet as a consequence of the new IFRIC14. The expectations of senior management and investors may need to be managed, with the consequent communication issues that arise.
Compliance	Each company will have its own set of internal rules to follow for compliance purposes, potentially based on Sarbanes Oxley.	It is likely that these rules will be tested in extreme financial conditions.	It will be important to follow or amend the rules as appropriate.
Banking and cash flow			
Bank failure	If a UK bank fails, it is quite likely that someone associated with the pension scheme will bank with them. This could be the employer, the trustees, members, or any other third party.		It is very unlikely to be appropriate to pay any money to a failed bank. This may involve swift action to, for example, interrupt a pensioner payroll run.
Diversity	Trustees may wish to consider diversifying their banking facilities away from banks that are perceived to be relatively more risky, especially if the trustees routinely hold a material amount of cash in the bank.		It may be appropriate to do the ground work on setting up new bank accounts sooner rather than later, as this can take time (eg due to anti-money laundering requirements).
Insurances			
Insurance company failure	Pension schemes may have a number of insurances, from life insurance and annuities to trustee indemnity insurance. The employer may also have related employee benefit insurances, eg income protection, special insurances for senior management. If an insurer fails, claims may not be paid, but benefits may have been promised to members.		It is likely to be appropriate to cease paying premiums immediately to a failed insurer, although advice should be taken in that event. Insurances may need to be re-arranged with other insurers very quickly in order to mitigate against further risks.
PPF			
Increased levies	Individual levies and possibly the overall levy in 2009/2010 could be significantly higher. This may arise because of increased deficits in pension schemes and/or the PPF deciding that they need to significantly increase the total planned levy (£700m in 2008/09) because of the increased risk of insolvencies generally and because the PPF's own assets have fallen in value.		Action now may help to mitigate the PPF levy.

Issue	Description	Comment	Possible actions
PPF (continued)			
D&B scores	Sponsoring employers' D&B scores at 31st March 2008 are due to be used to set the 2009/2010 levy. Changes to D&B scores before 31st March 2009 can be expected to impact on 2010/2011 levies.	A material worsening in individual D&B scores can have a very geared impact on levies.	Action now may help to mitigate the PPF levy.
Benefits			
DC Investments	The value of members' DC funds may fall considerably. Complications could arise if the investment manager / insurer becomes insolvent. Complications could arise if DC funds are exposed to derivatives and/or counterparty risk. The performance of passively managed funds may diverge from their index. Actively managed funds may perform particularly badly or well.	Members are likely to be concerned about this.	Understand the risks within your DC funds and consider whether any communications are appropriate.
On-going nature of the scheme	Tough times can lead to tough benefit decisions being taken by companies, in discussion with the trustees.	Some of these may require formal member consultation before they can go ahead.	Cutting back of accrual, redesigning benefits and liability management opportunities may all be considered at these times.
Inflation and pension increases	If inflation takes off, any caps on pension increases may apply – eg 5% or 2.5%.	This may take some pressure off funding, but there may be pressure from pensioners for discretionary pension increases as their standard of living falls.	Take early steps to appropriately manage the expectations of all parties.
Transfer values	In times of high market volatility, there are risks associated with members being "out of the market" between transferring from one pension scheme to another.	For example, being out of the market on 19th September 2008 could have cost a member nearly 10% of their pension savings.	Ensure procedures are appropriate and are followed, and members' expectations are managed.
AVC and other DC benefits and retirement	Likewise, there is a risk at retirement if members' DC funds are disinvested at an inappropriate time. Annuity prices may also change significantly from one week to the next.		Ensure procedures are appropriate and are followed, and members' expectations are managed.

Statement about LCP

Lane Clark & Peacock LLP (LCP) is a limited liability partnership and offers a full range of actuarial, benefit consultancy and risk services to clients in the UK and internationally through LCP Trustee Consulting, LCP Corporate Consulting, LCP Financial Dynamics Practice, LCP Insurance Consulting and LCP Investment Consulting.

The LCP Trustee Consulting practice focuses on providing advice on pensions issues that are of concern to trustees, such as governance, implementing the new pension scheme funding regime, assessing the adequacy of contribution plans, advising on investment issues, assessing the strength of the employer covenant, and advising on the issues surrounding insolvency and the winding up of pension schemes.

The LCP Corporate Consulting practice specialises in advising companies on how best to manage their pension schemes' finances through contributions, investment policy and other approaches. The practice also advises companies on how best to manage the impact of their pension schemes on company finances, how to represent pension schemes in company accounts, ensuring that UK and international benefit plans attract and retain employees effectively, and managing benefit issues in mergers and acquisitions.

The LCP Financial Dynamics practice specialises in offering a new dimension to risk appraisal, business modelling and valuations of companies. The practice uses advanced financial models to give companies a competitive advantage when considering business decisions.

The LCP Insurance Consulting practice provides specialist actuarial advice in the field of insurance and reinsurance. The practice also advises on wider risk management issues for insurance organisations.

The LCP Investment Consulting practice specialises in advising both corporate sponsors and pension scheme trustees on the appropriate investment policy, as well as on the broader areas of risk management. The practice is able to identify the potentially complex and conflicting needs, explain clearly how to address those needs and help with the implementation of the chosen solution.

LCP employs more than 500 staff including over 200 full and part qualified actuaries. We serve a wide range of clients around the world, including some of the largest global multinationals, such as ABN-AMRO, Hilton International, Smith & Nephew and Standard Chartered. They also serve a number of private equity houses, charities and unions.

If you would like assistance on any of these issues, please contact the partner who normally advises you, or call Aaron Punwani on +44 (0)20 7439 2266, Jonathan Camfield on +44 (0)1962 870 060 or Ken Willis on +44 (0)20 7439 2266.

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Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Important Notice

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