Integrated Risk De-mystified

How covenant assessors can work with trustees, sponsors and their advisors

Michael Bushnell
mbushnell@lincolnpensions.com

What Are We Covering?

- What is integrated risk?
- What risks are trustees, sponsors and advisors trying to integrate?
- How exactly *can* you adopt an integrated approach to risk?
- Integrating risk – in practice
- And, so what?

What is Integrated Risk? – *TPR's Code 3*

*"the code encourages trustees to adopt an integrated approach to risk management across the key risk areas to funding plan success – **employer covenant, investment** and **funding** related risks" [p7]*

*"Trustees should seek to **understand the risks across the employer covenant, investment and funding strands**. In particular trustees should understand **the extent of the scheme's reliance on the employer covenant over time** on the basis of a **range of plausible future scenarios**. These scenarios should capture investment risk, the impact of potential or actual maturing of the scheme and the impact of the contribution patterns which are proposed for the scheme (and the risks to those contribution patterns) compared to the employer covenant available under various scenarios. This is because the employer underwrites both the short- and long-term risks to which a scheme is exposed" [para 43]*

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A (non-exhaustive) summary of risks

What are the risks (in this context)?

Investment risks:
- “Return seeking”
- Bonds (corporate and government)
- Interest rates
- Inflation
- Cash flow

Funding risks:
- Longevity
- Demography
- Regulatory
- Benefit changes

Covenant risks:
- Current ability to support scheme obligations and associated funding / investment risks
- Risk that covenant changes

What exactly *is* an integrated approach to risk?

1

Practically integrating advice

- Advisors collaborating to consider covenant, investment and funding issues in their respective advice

2

Considering investment risk relative to the covenant

- Can the employer covenant "as is" support the level of investment risk being run in the Scheme? Potentially tested against a VaR95 or specific economic scenarios

3

Fundamentally integrating investment, funding and covenant risks

- The correlation between investment risk, funding risk, and covenant risk. Potentially tested through:
  - specific economic scenarios;
  - specific scenarios impacting employer covenant; or
  - consideration of random VaR scenarios

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What variables can we flex in any given scenario?

Investment
- VaR95: £500m
- Investments: 75% equity 25% AA bonds

Is everything in balance?

Funding
- TP deficit: £150m
- Gilts flat deficit: £450m
- Solvency deficit: £750m

Covenant
- Free cash flow: £15m per annum
- Asset base (ex-debt): £1.0bn
- Net debt: £450m
- Industry: b2b manufacturing

Integrating advice need not be over-complicated

- Scheme with a solvency deficit of over £200m and a relatively high risk investment strategy (VaR95 of around £80m)
- The employer covenant available to the scheme is “Fairly Weak”, i.e. 7 out of 9 on our scale
- The sponsors’ main aim is to maintain the current investment return profile
- Covenant ratings (1 to 9) mapped broadly against:
  - Reasonable actuarial assumptions (on a scheme specific basis); and
  - Reasonable investment plans
- This made clear that additional support was required to maintain the current risk budget
- **Coordinated advice (and broad support from TPR) resulted in the scheme achieving a material support package worth up to £280m**

A minimum response to the new Code?

- Covenant assessment is a relative process
- The risks being underpinned by covenant are expressed at a point in time by scheme funding levels…
- …but covenant must also be able to support potential risks that may arise in future
- As a minimum we aim to consider the ability of the covenant to support the VaR95 or deterministic scenarios provided by the investment advisor
- Our assessment of covenant already considers broad risks to the sponsors – but we do not (in this scenario) consider the correlation of risks

A practical process for integrating risks

- Employer covenant may be correlated with the investment and funding risks in a scheme – or it may not
- The historical correlation of industries and employers with key financial metrics (such as markets, inflation, gilt yields, etc.) can be modelled
- Professional judgement remains key and modelling cannot be relied upon exclusively (consider a sponsor that has recently increased borrowings, or a company in the midst of moving manufacturing to Asia)
- Adjusted correlation matrices can then be used to consider the ability of a sponsor to absorb scheme risks (stochastic or deterministic)

Why Consider Integrated Risk? – *TPR's Code 3*

"It is useful for trustees to consider how other organisations, which find themselves in a position of being creditors (such as banks), seek to protect themselves against the risk of the non-payment of money owed by counterparties. Applying some of these techniques to the scheme's circumstances could result in the provision of ***adequate and risk-controlled collateral or guarantees*** *(the scheme's actual and contingent assets)* ***and/or the use of controls around employer behaviour*** *(for example, negative pledges and monitoring)."*

Identification of risks is not an end in itself

Output

- Integrated advice should:
  - provide clarity on the most significant events
  - reveal correlated exposure between scheme risks and sponsor risks
  - provide a strong platform for the trustees or sponsor around investment and assumption choices or covenant enhancements
  - help frame recovery plans and 'flight path' lengths

Practical actions

- Consider whether current strategy is appropriate
- Impact of proposed changes in strategy can be considered in context
- Can tailor contingency planning to cover key events – including 'stock' responses to certain conditions (e.g. rapid change in investments or access to contingent support)
- Key risk scenarios can be partially limited in advance (e.g. through structural protections or limits to corporate actions)

What We Have Covered

- What is integrated risk?
- What risks are trustees, sponsors and advisors trying to integrate?
- How *exactly* can you adopt an integrated approach to risks?
- Integrating risks – in practice
- And, so what?

Questions?