# Too late to insure when the house is already on fire!

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We all recognise the futility of calling an insurance company for a quotation after a fire has taken hold of our house. So why do trustees wait until key pension scheme risks have manifested before putting protections in place? Perhaps they do not understand the risks they are running in the first place, and even if they do, getting agreement about how to manage them is often far from easy.

## Key risk management tool

Hedging has and will likely to continue to be a key risk management tool for most defined benefit pension schemes, particularly for unrewarded risks relating to interest rates, inflation and longevity. However, it is frequently a source of disagreement between trustee boards and sponsors, and sometimes within the trustee board itself. We often observe three areas of friction:

- differences of opinion about what risks to hedge;
- the level and pace of hedging; and
- confidence in the trustees' ability to implement efficiently and effectively.

This article sets out how the application of sound governance principles can help trustees and sponsors to frame the issue, identify solutions and agree an approach to implementation. Although we have focussed on hedging, it is an approach that can be used when considering a variety of risk management issues.

## Define your destination and understand the context

As recently emphasised by the Pensions Regulator, it's important for trustees to have a vision for their scheme, and long-term goals for achieving that vision. The long-term vision might include having a low dependency on the sponsor, being wholly self-sufficient, or indeed buying out the liabilities with an insurance company.

In the absence of this context, it will be very difficult for trustees to map out an appropriate journey plan, understand the risks and therefore take appropriate mitigating actions.

## Managing the journey

With a common understanding and agreement about the 'end game' and the journey towards it, trustees need to identify the key risks that might have an adverse impact on achieving it. It's crucial for schemes to understand these risks and their relative materiality before debating the merits of hedging or any other risk management techniques. Unless the question of hedging is framed in the correct context from the outset, it can be very difficult for trustees to prioritise appropriately and ensure adequate momentum is maintained. That context should also take account of the sponsor's circumstances so involve the sponsor early on.

## The importance of training

There are several techniques that schemes can use to manage risk, and hedging is generally considered to be one of the most complex. Before any decisions are made, investing in one or more training sessions to ensure a common and thorough understanding will be crucial. It can also be valuable to include key representatives from the sponsor in this training.


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## Consider scenarios

A common pitfall is for the hedging debate to be side tracked by personal views about the outlook for interest rates, longevity, exchange rates and other key metrics. To help avoid this, time invested early on in clarifying investment beliefs can be very useful. In addition, it can be helpful to focus the discussion on future economic scenarios, and the impact on the scheme should certain of those scenarios play out in practice. This encourages participants to put their own opinions to one side, and instead work collaboratively to identify how they would tackle the less favourable outcomes.

Consider engaging your sponsor in the debate, particularly where there is a link to the covenant and certain risks. For example, some sponsors may have revenue streams that are linked to inflation, providing a 'natural' hedge.

## Implement carefully

Once the nature, desired level and pace of hedging have been agreed, the trustees are faced with the prospect of implementation. Implementation is typically delegated, and it's important the trustees have confidence in their ability to implement efficiently and effectively, as well as to track progress. We recommend agreeing an appropriate set of parameters in advance, for example market and time-based triggers, as well as metrics relating to the impact on funding or other relevant scheme objectives. The trustees may also want to review the experience and capability of advisers and consultants supporting the implementation.

The implementation of a hedging programme can be significantly more complex than other investment strategies, and high-level implementation considerations should form part of the strategy development and approval process. It's also essential to clearly define delegations to third parties.

A trustee implementation oversight group can also be very valuable in providing the trustees with confidence in the implementation process, as well as greater agility. Where such a group is used, the terms of reference and tenure should be clearly defined at the outset. Consider including representatives from the sponsor on any implementation oversight group that is set up.

## Be prepared to review

Most schemes will review their approach to investment strategy at least every three years, considering covenant and funding issues. However, for hedging, where markets can move relatively quickly, and where there is a background of significant trustee and or sponsor debate, a commitment to reviewing the approach in certain circumstances can be helpful in obtaining initial agreement to proceed. It can also ensure a more finely tuned approach is applied than the usual market and time-based triggers alone. It may also enable the early stages of implementation to be delivered, even if there is disagreement about some later phases.

## Conclusion

Trustees should not wait until the flames are licking the eaves. By following a robust governance process, key risks can be identified, quantified and appropriate protections put in place - before it's too late.

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