December 2010

MetLife
Assurance Limited

Comparing Pension Risk Attitudes and Aptitude
in the United Kingdom and United States

EXECUTIVE SUMMARY

The recent global market events have underscored the need to better understand and effectively manage risk exposure in order to protect the benefits of current and future pensioners and deliver on the promise of a secure retirement. As both the United Kingdom (UK) and United States (US) begin to emerge from what has arguably been the most turbulent and difficult economic environment in many decades, how well pension risk is managed in each country takes on increasing importance.

MetLife in the US and MetLife Assurance Limited in the UK recently commissioned research of defined benefit (DB) pension schemes in their respective countries to assess the current state of risk management. Both studies surveyed respondents on 18 investment, liability and business risks to which their schemes are exposed. Data from each survey were used to assess respondents' attitudes toward and aptitude for managing pension risk. Respondents in the UK were comprised of sponsoring employers (scheme sponsors) and trustees; in the US, sponsoring employers (plan sponsors) were surveyed.

The results show that:

- The Index scores in the UK and US are virtually identical, indicating that scheme sponsors on both sides of the Atlantic do a comparable job overall, albeit as a result of different drivers.

- Collectively, the five risk factors ranked highest in importance in the UK were Measurement of Technical Provisions/Liabilities, Longevity Risk, Employer Covenant, Investment Management Style and Funding Deficits, whereas in the US the "most important" risk factors were Liability Measurement, Underfunding of Liabilities, Plan Governance, Asset Allocation and Advisor Risk.

- There are some notable differences in the importance rankings between the UK and US. For example, Longevity Risk is much higher in importance in the UK (tied for second); whereas in the US, it's only ranked tenth in importance; Plan Governance ranks third in the US while its UK counterpart, Scheme Governance, is ranked twelfth.

- Both groups of respondents gave themselves very high marks for successfully managing risk overall. In the UK and US, respectively, 79% and 80% of the respondents believe they are successfully managing risk.

- In each country, there is a misalignment of pension risk management importance and success for at least a handful of risk factors.

In this report, MetLife will compare and contrast the findings of the UK Pension Risk Behaviour Index (PRBI) and the US PRBI studies. However, before doing so, it's important to understand the similarities and differences in the pension risk markets in both countries.

Pension Risk Markets Across the Atlantic: Similar But Not the Same

There is a widely held assumption that the US and UK pension markets are virtually identical and that whatever happens in one country will inevitably be followed in the other within a few years. While this is an easy and popular view, it misses key underlying characteristics that are behind both markets.

There are, of course, similarities between the UK and US pension markets. Both markets have a long and deep DB history, they represent some of the largest DB pension markets in the world, and both are among the first to recognise the growing importance of managing liabilities for the lifetimes of today's and tomorrow's pensioners. Both have also witnessed a shift from DB schemes in favour of defined contribution plans.

Now for the differences. Until recently in the US, assets rather than liabilities had been the main focus of pension scheme management for many years, and focus on the liabilities had typically centered on reporting rather than analysis. The UK is generally recognised as being slightly ahead of the US in considering liabilities as centric to asset allocation decisions.

A second crucial difference between the two markets is the framework and structure of their regulatory regimes. Market participants in the UK will recognise the difference between the role of the scheme trustees and the role of the scheme sponsor, with its clear separation of power between the fiduciary and financial roles. This is a key structural difference from the US, where the plan sponsor has both responsibilities, and US regulation is built on this foundation.

In the US, the Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that protects the assets of millions of Americans so that funds placed in pension plans during their working lives will be there when they retire. Since fiduciary and financial responsibilities typically rest with the same body, the corporation, it was critical for ERISA to set forth certain fiduciary standards to address and protect against the potential conflict of interest.

Turning to member protection, although member protection has existed for some time, the Pension Protection Fund (PPF) in the UK is in its infancy when compared to the Pension Benefit Guaranty Corporation's much longer history in the US. Asset allocation, investment policy, risk premiums, opt-out provisions, and how rules and policy decisions have affected plan sponsor behaviour in the US may offer insights for the UK as the PPF develops and begins to address problem UK pension schemes.

Finally, in the US the Pension Protection Act of 2006 has ushered in a new era of discipline and transparency for DB plans. The UK has also seen new pension laws that seek to do the same for UK Defined Benefit pension schemes, such as the 1995 and 2004 Pension Acts in the UK.

In addition, new accounting requirements have been adopted by both countries. While these vary in their specifics, both seek to increase the transparency of pension reporting. The combined effect of new legislation and new pension laws has brought about a new focus on liabilities, one that many in the industry believe will open up new solutions for DB pension schemes.

PENSION RISK ATTITUDES AND APTITUDE: COMPARING AND CONTRASTING THE FINDINGS OF BOTH STUDIES

Index Values: Virtually Identical

In each study, an Index was calculated to calibrate the importance that the survey respondents ascribed to managing each risk, their perceived success at implementing comprehensive practices to manage each risk and the consistency between the two, effectively measuring both attitudes toward, and aptitude for, managing pension scheme risks. The calculations are fairly complex, but in essence require an average success rating to be calculated for each respondent, which can be used to produce an equal-weighted industry average success rating across all respondents. This industry average success rating can then be converted into a final index value.

The PRBI Index in the UK (78 out of 100) is virtually identical to the US (79 out of 100) indicating that trustees in the UK and sponsors in both countries do a comparable job overall, albeit as a result of different drivers, and indicates that they report to be successfully managing the risk factors that they deem most important. Of course, the Index score by itself does not tell the full story. In both the UK and US, there are very different priorities ascribed to particular risks.

Importance of Managing Pension Risk

In order to understand how trustees in the UK and sponsors in both countries prioritise and then act on various DB pension related risks, both surveys measured the relative importance ascribed to 18 risk factors by respondents. The risks were identified in consultation with leading industry experts. The descriptions of the risk factors were designed so that they were germane to each country, while maintaining generally comparable phrasing to allow for directional comparisons between the two studies.

The table opposite shows the rank order of the risk factors by importance. The descriptions of the risk factors that were included in the UK and US versions of the studies, respectively, are functionally equivalent in the large majority of the cases. An N/A indicates risk factors which did not have comparable counterparts.

Table 1: Importance Ranking UK vs US

	UK Ranking	US Ranking
Measurement of Technical Provisions/Liabilities (UK) / Liability Measurement (US)	1	1
Longevity Risk	2	10
Employer Covenant (UK)	2	N/A
Investment Management Style (UK) / Negative Alpha (US)	4	16
Funding Deficits (UK) / Underfunding of Liabilities (US)	5	2
Asset and Liability Mismatch	6	6
Investment Valuation	6	13
Inflation Risk (UK)	8	N/A
Investment Risk Profiling (UK) / Ability to Measure Risk (US)	9	8
Meeting Investment Return Targets (UK) / Meeting Return Goals (US)	9	14
Mortality Risk	9	17
Scheme Governance (UK) / Plan Governance (US)	12	3
Inappropriate Trading	13	7
Adviser Risk (UK) / Advisor Risk (US)	13	5
Decision Process Quality	13	10
Asset Diversification (UK) / Asset Allocation (US)	16	4
Quality of Member Data (UK) / Quality of Participant Data (US)	16	17
Litigation Risk Exposure (UK) / Fiduciary Risk & Litigation Exposure (US)	18	9
Accounting Impact (US)	N/A	15
Early Retirement Risk (US)	N/A	10

Most Important US Pension Risk Factors

As revealed in the second annual US PRBI, during a year of extraordinarily volatile market conditions, plan sponsors' attitudes toward pension risk management, and the importance of individual risk factors, changed dramatically from the inaugural MetLife study. In 2009, plan sponsors focused almost exclusively on a handful of risks, and ranked investment related risk factors consistently ahead of liability related factors. Today, sponsors in the US are focusing more significantly on the liability side of the equation and looking at the full spectrum of risks in a more holistic way. This year, in fact, the two risk factors rated as "most important" were Liability Measurement and Underfunding of Liabilities. The remaining top five risk factors by importance were Plan Governance, Asset Allocation and Advisor Risk.

Last year, MetLife had hypothesised that plan sponsors' heavy weighting on asset related risks would likely decrease as market conditions illustrated the need to protect schemes against additional risks. Today, we see strong evidence that this shift is well underway.

Most Important UK Pension Risk Factors

The result of this year's inaugural UK PRBI demonstrated that scheme sponsors and trustees are collectively taking a broad, yet not necessarily integrated, view of pension risk management. Collectively, the top five ranked risk factors, by greatest importance, included Measurement of Technical Provisions/Liabilities, Longevity Risk, Employer Covenant, Investment Management Style and Funding Deficits.

While there are some interesting similarities, there are also notable differences in ranks between the UK and the US.

Similarities in importance rankings:

- Measurement of Technical Provisions (UK) and its US counterpart, Liability Measurement, both rank 1 in importance.

- Funding Deficits (UK) and its US counterpart, Underfunding of Liabilities, both rank among the top 5 risk factors in their respective countries.

- Quality of Member Data (UK) and its US counterpart, Quality of Participant Data, both rank near the bottom of the rankings in terms of importance.

Some risk factors ranked higher in importance in the UK:

- Longevity Risk is much higher in importance in the UK (tied for second); whereas in the US, it's only ranked tenth in importance. Longevity risk is defined as follows: distinct from the risk that our members will die before obtaining benefits, we implement and regularly review the effectiveness of procedures to mitigate, transfer or actively manage the risks associated with increasing longevity among scheme beneficiaries.

  While both countries are grappling with the challenges posed by increased longevity, the effect is more significant and the awareness more advanced in the UK. This is probably the result of the UK's more common inflation adjusted pension structure, as the cost of indexed pensions is much more susceptible to changes in life expectancy than a fixed nominal pension.

- Employer Covenant (tied for second), which can cover both the sponsor's financial strength as well as its commitment to support the scheme, ranked high in importance in the UK. This risk factor, which has received quite a bit of media attention in the UK, should be particularly important to trustees since they need to ensure that the financial strength of the sponsoring employer can meet the promises of the scheme. It's worth noting that no comparable risk exists in the US, given plan sponsors' dual fiduciary and financial role.

Similarly, in the US some risk factors are deemed more important than in the UK:

- Plan Governance, defined as "those responsible for plan governance exercise effective, independent oversight, supported by internal controls within all areas and at all levels of plan management", ranks third in the US while its UK counterpart, Scheme Governance, is ranked twelfth. Scheme Governance is defined as: we ensure good governance of the scheme through effective evaluation of risks and appropriate risk mitigation measures, such as through the use of a risk register and plan management tools that are regularly reviewed and updated to reflect changes in risks and their impact on the scheme.

  In the US, the volatile economic environment over the past few years, coupled with legislative and accounting changes, has brought several issues to light, including the importance of funded status, the investment challenges inherent in managing funded status effectively and a greater emphasis on appropriate levels of plan liquidity. It's not surprising, then, that US plan sponsors are paying more attention to those responsible for plan governance — ensuring that they're providing effective, independent oversight that's supported by internal controls.

- Adviser Risk is ranked 5 in the US but only 13 in the UK. Advisor Risk is defined in the US as follows: Plan trustees and internal plan managers have sufficient knowledge, experience and training to assess the quality of advice and the effectiveness of services provided by third parties.

  With pension scheme management being viewed more broadly, some plan sponsors feel that they may not be able to — nor want to — rely on their consultants and advisors to the same extent they once did when consulting assignments were more standardised. If they do, then they need to be able to demonstrate to their governance committees that more care is being taken effectively to select and manage their plan advisors and consultants, in addition to carefully evaluating the advice given.

- Asset Allocation is ranked fourth in the US, but its UK counterpart, Asset Diversification, ranked only sixteenth. In the US, Asset Allocation is defined as follows: We use disciplined rebalancing to implement a documented strategic asset allocation policy. The UK definition is similar, but adds that the policy is documented in the Statement of Investment Principles and investment manager mandates.

In the US, although Asset Allocation still ranks high in importance, it's actually down from the top spot in importance when compared to 2009. This may be a by product of plan sponsors realising that more attention needs to be paid to the liability side of the pension risk management equation, and less to the asset side of the equation.

Perceived Success in Managing Pension Risk

Survey participants were asked to indicate the extent to which they agreed that they managed each risk factor successfully. Both groups of respondents gave themselves very high marks for successfully managing risk overall. In the UK, 79% of the respondents' ratings were either 4's or 5's, meaning that they either somewhat or strongly agreed that they successfully manage the risk factors. In the US, 80% of respondents believed they are successfully managing risk. The median success score in the UK was 4.23 (out of a maximum of 5), while in the US it was 4.27.

Respondents in the US gave themselves higher success ratings (albeit by small margins in most cases) in two thirds of the 18 risk factors than did their UK counterparts (see Table 2).

US higher success ratings than UK:

- US respondents gave themselves higher marks for Ability to Manage Risk (4.06) than UK respondents gave themselves for managing the comparable risk; Investment Risk Profiling (3.53).

- US respondents rated their success in managing Fiduciary Risk & Litigation Exposure (4.00) higher than UK respondents for the management of the comparable risk, Litigation Risk Exposure (3.63).

- More US respondents believe that they are successfully managing Asset Allocation Risk (4.36) as compared to UK respondents when managing the comparable risk, Asset Diversification (4.02).

- Finally, US respondents' self-described successful management of Adviser Risk (4.57) is higher than UK respondents (4.28).

UK higher success ratings than US:

- UK respondents gave themselves higher marks for successfully managing Mortality Risk, (4.34), than did US respondents (3.98), as well as Measurement of Technical Provisions/ Liabilities (4.84) vs. Liability Measurement in the US (4.72). Mortality Risk is defined as follows: distinct from the risk that our pensioners will live longer than expected, we have modelled and understand how the expected mortality of our scheme members affects our scheme's cash flows and funding requirements.

Table 2: Perceived Success in Managing Pension Risk: UK and US

	UK Average Success Rating	US Average Success Rating	Difference: UK Minus US
Measurement of Technical Provisions/Liabilities (UK) / Liability Measurement (US)	4.84	4.72	0.13
Employer Covenant (UK)	4.63	N/A	N/A
Scheme Governance (UK) / Plan Governance (US)	4.48	4.58	-0.09
Inappropriate Trading	4.46	4.56	-0.10
Mortality Risk	4.34	3.98	0.36
Quality of Member Data (UK) / Quality of Participant Data (US)	4.33	4.29	0.04
Investment Management Style (UK) / Negative Alpha (US)	4.33	4.39	-0.07
Adviser Risk (UK) / Advisor Risk (US)	4.28	4.57	-0.29
Investment Valuation	4.24	4.45	-0.21
Meeting Investment Return Targets (UK) / Meeting Return Goals (US)	4.22	4.44	-0.22
Asset Diversification (UK) / Asset Allocation (US)	4.02	4.36	-0.33
Asset and Liability Mismatch	3.97	4.06	-0.09
Funding Deficits (UK) / Underfunding of Liabilities (US)	3.94	3.89	0.05
Inflation Risk (UK)	3.92	N/A	N/A
Litigation Risk Exposure (UK) / Fiduciary Risk & Litigation Exposure (US)	3.63	4.00	-0.37
Decision Process Quality	3.58	3.74	-0.16
Investment Risk Profiling (UK) / Ability to Measure Risk (US)	3.53	4.06	-0.53
Longevity Risk	3.49	3.48	0.01
Accounting Impact (US)	N/A	4.25	N/A
Early Retirement Risk (US)	N/A	3.57	N/A

All figures shown, including the calculation of differences between the UK Average Success Ratings and the US Average Success Ratings, were rounded to two decimal points.

Pension Risk Importance and Success

Ideally, individuals who are responsible for managing pension schemes should be highly successful at managing the most important risk factors. However, based on the self-reporting, this may not always be the case.

In the UK, there were six risk factors that were classified as high importance, low success category (where the names of the risk factors are different, the first name listed is the UK name, followed by the US name of the factor).

- Meeting Investment Return Targets (Meeting Return Goals)
- Asset & Liability Mismatch
- Funding Deficits (Underfunding of Liabilities)
- Inflation Risk (not asked in the US)
- Investment Risk Profiling (Ability to Measure Risk)
- Longevity Risk

Three of the six risk factors listed above for the UK, also appear in the high importance, low success category in the US, indicating that inconsistency is a problem for both sets of respondents.

- Asset & Liability Mismatch
- Funding Deficits (Underfunding of Liabilities)
- Investment Risk Profiling (Ability to Measure Risk)

An additional risk factor appeared in the high importance risk, low success category in the US:

- Litigation Risk Exposure (Fiduciary Risk & Litigation Exposure)

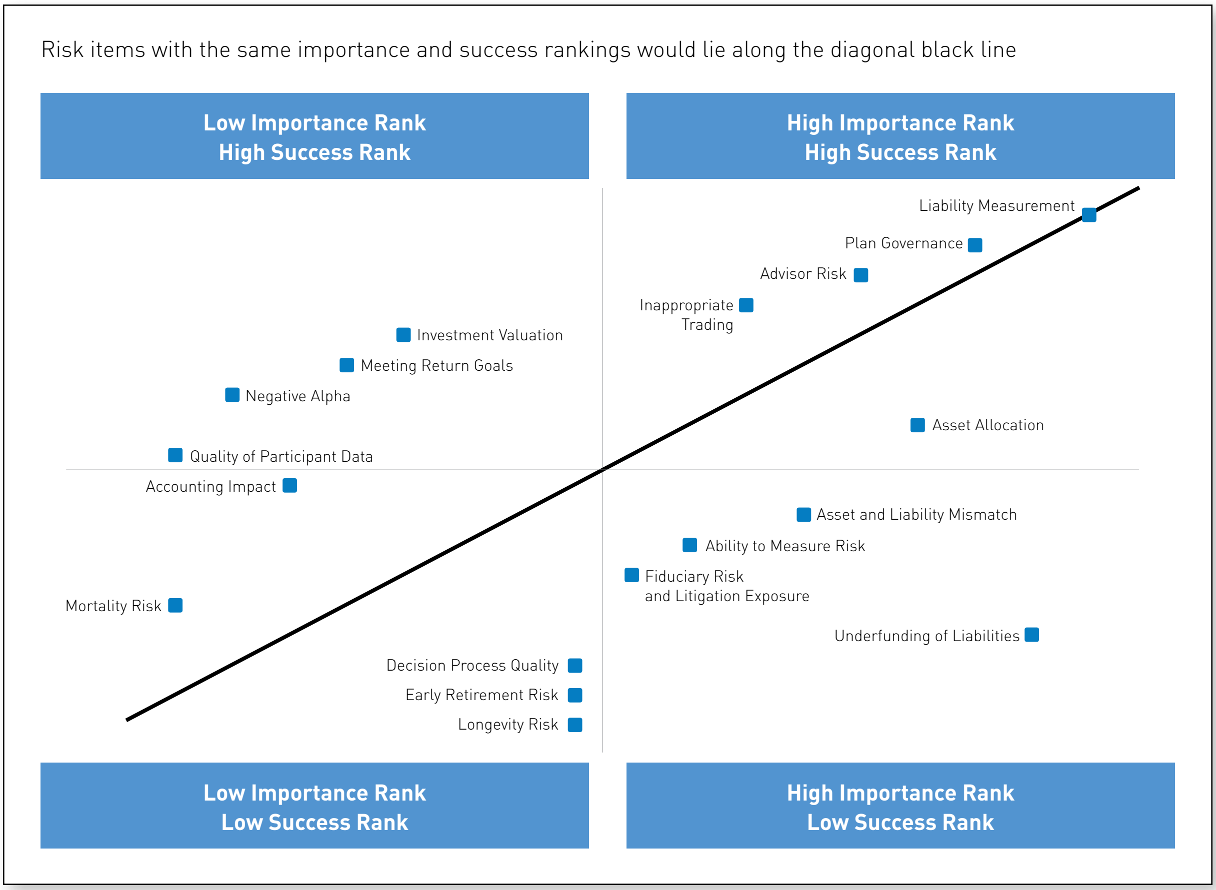
Finally, looking at the low importance risk, high success category for both studies, points to a potential problem area in both countries with regard to Quality of Member Data / Quality of Participant Data. While the study findings suggest that this risk is generally thought to be of low importance and high success in both countries, experience with plans involved in pension risk transfer transactions suggests that, as a matter of common practice, participant data for ongoing plans is typically not sufficient to complete a plan termination or a change in plan administrators without additional and potentially costly expense.

One explanation for this may be that this may be managed on an exception basis (e.g., fixing complaints as and when they occur). If so, when trustees / sponsors seek to transfer risk or change administrators, they may potentially find they have an expensive problem on their hands. Less than optimal recordkeeping can lead to significant additional costs in a number of areas including administration, inaccurate actuarial valuations and even claims from disgruntled members.

US Consistency Chart

The chart below shows a scatter plot of the Importance Rank and the Success Rank for each risk item. The vertical distance from each point to the line represents the mismatch between the rankings. Unfortunately, in the US, only Liability Measurement lies on the consistency line, and just five of the 18 risk factors fall cleanly within the High Importance / High Success quadrant. Underfunding of Liabilities, which falls in the High Importance / Low Success quadrant, is a risk factor to which US plan sponsors may want to pay more careful attention.

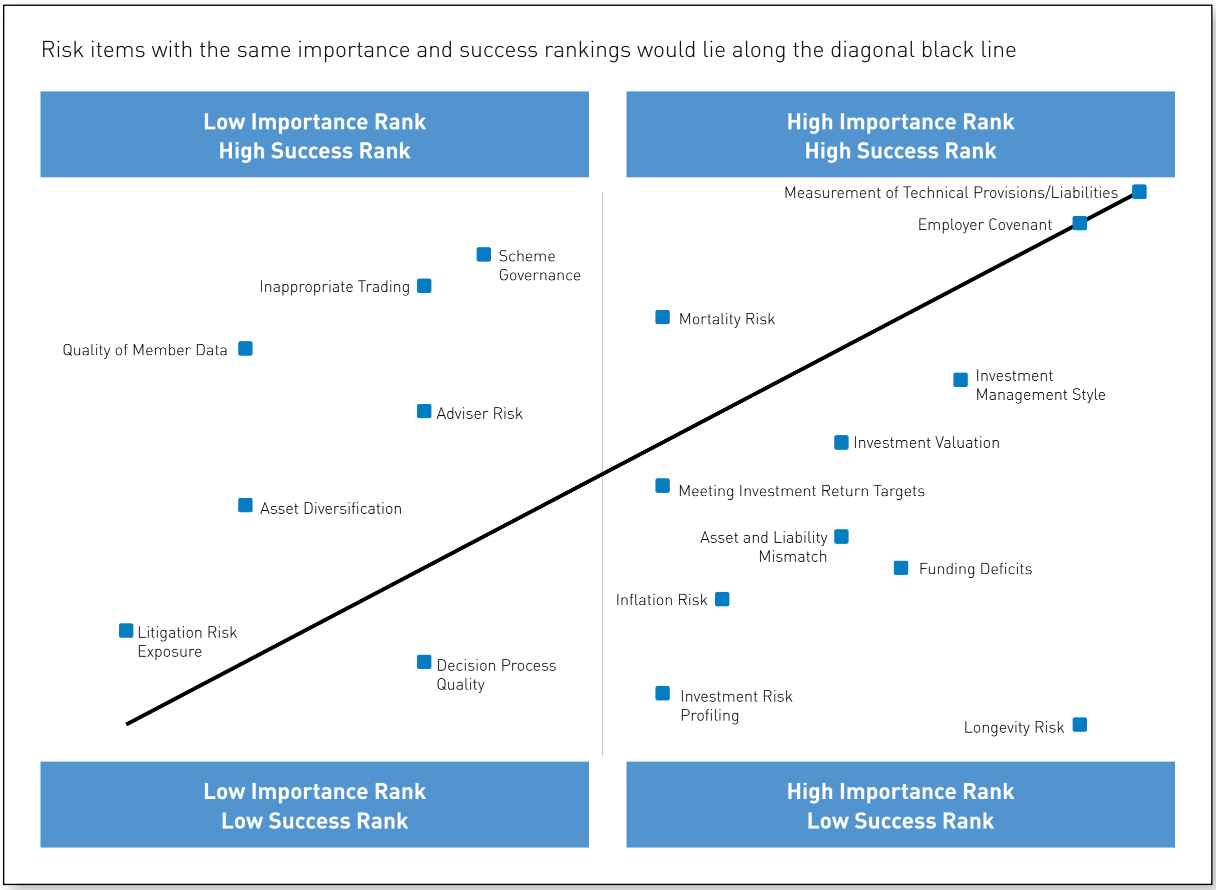
Chart 1: Consistency of "Importance" and "Success" Rankings (US)



UK Consistency Chart

There is very close alignment between importance and success in only two risk factors, Measurement of Technical Provision and Employer Covenant, but two thirds of the risk items lie in quadrants representing a reasonable level of reported success relative to importance, consistent with the overall indications of the study that respondents believe that they are successfully managing their important risks. However, there are some notable exceptions. Longevity Risk, in particular, has a very low reported success level despite its high place in the importance ranking. Along with the other risks in the High Importance / Low Success quadrant, scheme sponsors and trustees may be well advised to focus greater attention on these risks and the tools available to manage them.

Chart 2: Overall Consistency of "Importance" and "Success" Rankings (UK)



CONCLUSION

Without question, the pension landscape in both the UK and US has been changing. Over the past decade, scheme design has swung firmly against DB pension schemes in favour of defined contribution schemes where employer costs can be controlled to a greater extent.

Despite this shift, which is by definition prospective in nature, scores of companies will need to manage their scheme's DB pension liabilities to make good on the promises made in the past, of a secure retirement for the lifetimes of their pensioners. In fact, existing DB scheme liabilities, even for schemes closed to new entrants, will extend a long way into the future.

In both countries, the current market environment, increased regulation and demographics have significantly raised awareness of the risks associated with managing DB liabilities. These forces are also impacting how pension risk is managed. As a result, those responsible for managing pension risk recognise that the investment, liability and business risks that impact their schemes and how they are interconnected have taken on increasing importance.

The good news, and one important commonality, is that scheme sponsors and trustees in the UK and plan sponsors in the US are developing a broad view of pension risk management. Furthermore, survey respondents in both countries also believe they are successfully managing risk overall. Sponsors on both sides of the Atlantic do a comparable job in how successfully they manage the risk factors that they deem most important, albeit as a result of different drivers.

Finally, a truly holistic view of risk management requires those responsible for the scheme fully to assess and prioritise all risks collectively, even those for which they are not primarily responsible. To achieve this it is imperative that scheme sponsors and trustees communicate openly and regularly with each other and their advisers about the full range of issues that affect their scheme.

The governance structure to support this could be varied, but options worth considering are a sub-committee established specifically for this purpose or, where the need is sufficient, consideration of a Pensions Chief Risk Officer. This would go a long way in ensuring that the broad view of risks gets implemented in a co-ordinated and effective way with the end goals of protecting member benefits, while reducing volatility, and cost, for the scheme sponsor.

MetLife

MetLife Assurance Limited
15 Bedford Street, London WC2E 9HE
www.metlife.co.uk/metlifeassurance

Virtual Group UKUS1011