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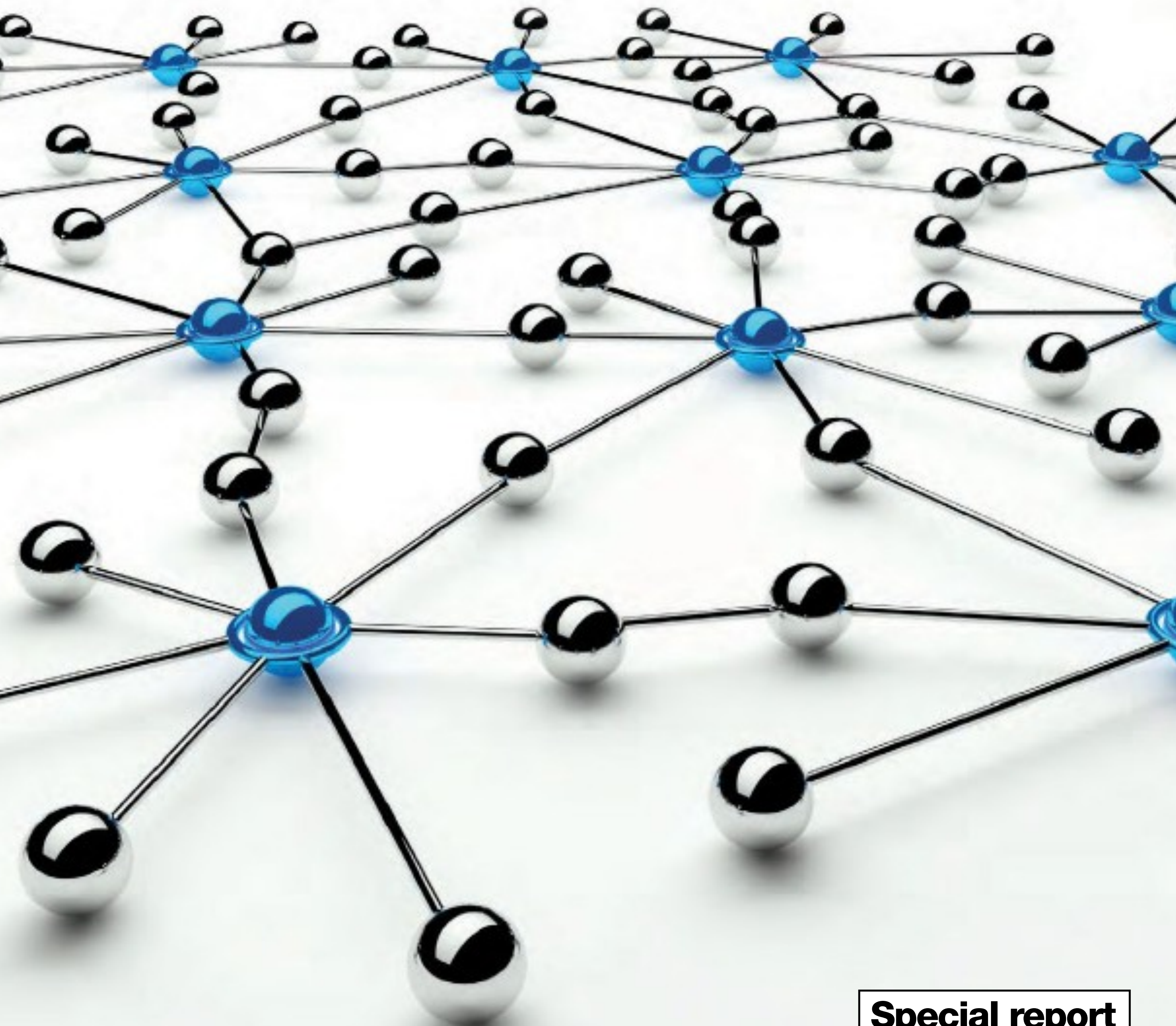


Special report

Connecting the dots

The importance of risk management cannot be underestimated. The emerging roles of today's risk manager demand a much wider set of competencies, as well as a board presence to enable frictionless communication and decisive action. From regulatory and legislative changes to cashflow and liquidity, risk in all its forms ignites the motivation for growth.

A FERMA commitment to the future

Jorge Luzzi
President, FERMA

As the new president of the Federation of European Risk Management Associations (FERMA), I am pleased to collaborate with *FDE* and support a unique report that explores the role risk management plays in corporate strategy. This topic is particularly relevant to our federation as we have recently submitted answers to the green paper by EU Commission staff on a corporate governance framework, and later this year we will provide further guidance on the risk management provisions of the eighth EU Company Law Directive in collaboration with the European Confederation of Institutes of Internal Auditing (ECIIA).

What is of most relevance to the readers of *Finance Director Europe* concerning these measures is that there is clear responsibility given to boards of directors and their audit committees. Senior management is expected to be involved in risk management and risk-taking. Directors have to give direction depending on the risk appetite of shareholders.

Key 'black swan' events and disasters – the financial meltdown in 2008, the BP Oil disaster in 2010 and more recently the earthquake and tsunami in Japan – have reinforced the importance of an effective risk mitigation strategy to the board.

The role of the modern risk manager was one of the items on the agenda during the recent FERMA biannual forum in Stockholm, which attracted over 1,500 delegates and featured Joseph Ackermann, CEO of Deutsche Bank, as keynote speaker. Highlights of the forum are featured in the first part of this report.

This is followed by a series of exclusive interviews with prominent risk and insurance managers (who are either board members or close affiliates of FERMA) interviewed alongside their finance directors. These interviews are complemented with insight from two leading D&O liability insurance underwriters, who look at the importance of robust global D&O liability insurance in a climate of bribery legislation and greater personal risks posed by increasingly litigious stakeholders.

The second part of this report revolves around the topic of defined benefit pension risk management. An aging population coupled with considerable market volatility is fuelling ever greater pension deficits, and CFOs, as pension plan sponsors and often as trustees, need to be aware of the various options for de-risking.

On page 60, Philip Broadley, group finance director of Old Mutual Group and chairman of the 100 Group's pension committee, provides an interesting perspective on the various challenges presented by the proposed risk-based supervision of IORPS to regulate pan-European pension funds. Broadley touches on the challenges of Solvency II, which is also a concern for FERMA and its members.

As well as being the president of FERMA, I manage risk at the global tyre company Pirelli, collaborating closely with the Pirelli board as well as the group finance director, Michele Lerici – I therefore hope that, as a finance director or CFO, you find this report of value.

Look out for an interview with Michele and me in a forthcoming edition of *Finance Director Europe*.

FERMA

Since 1974, the Federation of European Risk Management Associations (FERMA) has been the leading organisation for risk management in Europe, providing the means of coordinating risk management and optimising the impact of national risk management associations outside of their national boundaries. FERMA promotes communication among its members and also within IFRIMA (International Federation of Risk and Insurance Management Associations), of which FERMA is a member.

FERMA is frequently invited to participate in meetings and discussion groups with other trade and business organisations. Through these professional networks FERMA presents the risk management methodology and its benefits to business and the community. Every two years, it holds its Risk Management Forum, featuring specific seminars and surveys.

FERMA works with educational bodies in Europe and welcomes collaboration from academics and professionals involved in risk management. As part of its continuing influence, it is in ongoing discussion with risk management organisations in other countries to expand the membership.

Source: www.ferma.eu

The role of the modern risk manager

The role of today's risk manager was a central talking point at the annual forum of the Federation of European Risk Management Association (FERMA) that took place in Stockholm in October. During a plenary panel discussion, Paul Taylor, chairman of the UK risk management association Airmic and director of risk assurance at Morgan Crucible, asserted that the role of the risk manager has evolved into a key support function for a board.

"The role of insurable risk management hasn't changed, what has changed is the broader scope of risks that many risk managers are involved with," he said. "The role of a broader strategic enterprise risk management has evolved over the last ten years because boards of companies, senior executives, have realised that they need to manage the downside risk of their business in a better way and they need to have clear contingencies in place when things go do wrong, as sometimes things will go wrong."

According to Taylor, a diverse set of skills and competencies are now required by today's risk manager to operate effectively in today's challenging global economic landscape. This view was echoed by Julia Graham, chief risk officer of DLA Piper, who also spoke at the forum, stressing the importance of risk managers talking the language of the board.

"To skill-up, risk managers need to improve their own financial awareness and ability to perform because if they are talking at a board level, [then] these are the kinds of issues that boards understand and deal with," she said.

One FERMA board member was keen to distinguish between risk management and strategy setting, stating that a risk manager should not be a board member or an architect of corporate strategy but instead be there to help support strategy development.

"Risk management is not responsible for setting strategy. That is for the boards," he said. "Instead, what risk management does is connect the dots, so that strategy impacts the risk environment, and the most significant risks require the strategy team to deal with that. So you link the two in discussions. I am not a strategist and I am not responsible for that." ■

Top ten risks for 2011

1. Economic slowdown
2. Regulatory/legislative changes
3. Increasing competition
4. Damage to reputation/brand
5. Business interruption
6. Failure to innovate/meet customer needs
7. Failure to attract top talent
8. Commodity price risk
9. Technology failure or system failure
10. Cashflow/liquidity risk

Source: Aon's 2011 global risk management survey

Aligning governance, risk and compliance

The recent 'Roads to Ruin' report by UK association Airmic suggested poor risk management and corporate governance were behind companies' failure to respond effectively to crisis. **Paul Taylor**, **Kevin Dangerfield** and **Terry Miles** of Morgan Crucible explain to Jim Banks why bringing together corporate governance and risk management, including insurance, under one umbrella can bring significant rewards.

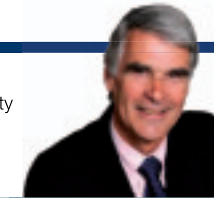
Risk has been foremost in everyone's mind since the global economy took a turn for the worse in 2008, and many companies have taken a long, hard look at how they identify, quantify and manage risk. In the boardroom, questions will often be raised about how risk affects corporate strategy, how it drives a business forward and what dangers it poses to profitability and long-term success.

The UK is leading the way in enterprise risk management and corporate governance, with many organisations looking at a broad spectrum of risk and controls, often implementing a risk framework that permeates the organisation from top to bottom. One such company is Morgan Crucible, which has a senior executive focused on risk – not only to develop a clearer picture of the company's risk exposure and manage it more effectively – but also to ensure that its attitude to risk is not too conservative. After all, risk goes hand in hand with opportunity.

"Why do this? Well, there are specific benefits, like improved decision-making throughout the organisation, and there are fewer unwanted surprises, which has happened recently in UBS and BP," says Paul Taylor, director of risk assurance at the Morgan Crucible Company and current chairman of Airmic, the UK risk managers' association. "It also improves compliance, which is important for a quoted company. The changes we have made to hearts, minds and culture are already bearing fruit."

Kevin Dangerfield
Kevin Dangerfield is chief financial officer of Morgan Crucible. He joined the firm in 2000 as deputy group controller and was promoted to group financial controller. He then joined the board and was appointed CFO in 2006. Previously, he worked for London International Group and Virgin Retail Europe.

Paul Taylor
Paul Taylor is director of risk assurance at Morgan Crucible with responsibility for creating and implementing risk management strategy, upgrading corporate governance, and managing and developing the internal audit function. He is chairman of Airmic, the UK risk managers' association.



Terry Miles
Terry Miles is head of insurance procurement for Morgan Crucible. He is responsible for the placing of global insurance policies and liaison with brokers. Prior to joining the firm in 2006, he worked for Aon, specialising in global insurance programmes for major multinational corporations.

A FTSE 250 company, Morgan Crucible is one of the UK's largest manufacturers of carbon and ceramic products for industrial use. Taylor has been at the company for three years, and along with the treasury team and the head of insurance procurement, Terry Miles, he reports to the company's CFO Kevin Dangerfield, who also chairs its risk committee.

"I came in to evolve what was in place, moving towards a new direction, a new strategy," says Taylor. "There were discussions about what had been done well and what could be improved and we put together a three-year strategy on governance, risk and compliance, including internal audits and control of policies. Now, we are in the third year of the roll-out."

"In the past, the company had not looked at risk in a comprehensive and disciplined manner, and the same is true of many corporations," says Dangerfield. "Paul has come in to give us a level of risk analysis that goes from the operational side right up to the boardroom. It gives us clarity of risk for the group, enabling management to think more clearly about risk in a disciplined way as part of a comprehensive governance, risk and compliance plan."

So far, the new approach to risk management has proven effective, not only in identifying risk within the organisation, but also external issues.

"We can't control all of the external risks, like the trends in the global economy or disasters such as the earthquakes in Japan," continues Dangerfield. "But we have weathered the economic storm well through 2009

“We want to quantify risk as a number. That focuses the attention when deciding whether a risk is acceptable. Our holistic approach gives us better, quicker decisions across risk, corporate governance and insurance.”

and this year with resilient earnings and cashflow. That shows the change that has been made in the company, how management looked at risk and the value of its sensitivity analysis. We saw some issues from the crisis in Japan, but we also saw the opportunities to supply to our customers when our competitors could not. So, our approach to risk means we are better at responding to outside events.”

A holistic approach

Within this framework, corporate governance is an important strand. A recent report prepared by CASS Business School on behalf of Airmic showed that the main reasons companies fail to respond well to crises are tied to both risk management and corporate governance policies.

The ‘Roads to Ruin’ report suggested that risks arise from inadequate boardroom skills and the inability of non-executive directors to exercise control; blindness to inherent risks that might threaten a company’s business model or reputation; inadequate leadership on corporate culture; defective internal communication; organisational complexity; inappropriate incentives; and the ‘glass ceiling’ that prevents risk managers from addressing issues in a company’s top echelons.

Improving the structures, processes, and even the language used for managing risk can encompass all of these issues.

“Corporate governance and risk are dealt with as one thing across the group,” says Dangerfield. “It is important to set the tone from the top. For instance, robust controls are important in light of the UK Bribery Act, so we have run global training sessions as part of a rolling programme of corporate governance measures on a worldwide basis.”

A similarly broad approach is taken to insurance as a powerful tool in managing risk.

“It is mandatory for all countries in our group to be part of a global insurance programme, though auto and employee liability insurance are handled locally,” says Miles, head of insurance procurement. “We have a strong team ethos here, so there is no resistance to having a global programme.”

Inevitably, there are challenges to implementing an insurance strategy across more than 50 countries, as Morgan Crucible does, not least of which is the complexity of the regulations in different jurisdictions.

“We run local programmes under a global umbrella and no one has the answer to compliance on a global basis,” continues Miles. “A lot depends on interpretation of the law, but you have to take a sensible approach. We no longer have a captive insurance company, which many companies would think was a natural thing to have, because there has been a shift in the insurance market and deductibles are low, so there are not sufficient business drivers for a captive.”

The structure for procuring insurance, establishing risk controls and instilling corporate governance priorities should focus on giving everyone in an organisation a better understanding of how risk affects a business.

“It’s all about clarity of thought and the ability to see what the top risks are in the organisation in a qualitative and quantitative way,” says Dangerfield.

“What gets quantified gets managed, and we want to quantify risk as a number,” adds Taylor. “That focuses the attention when deciding whether a risk is acceptable. Our holistic approach gives us better, quicker decisions across risk, corporate governance and insurance.” ■

Held to account

In the wake of the global financial crisis, legal action is on the rise and is increasingly being targeted not just at companies, but also at individual executives. Géraud Verhille of **Chartis** discusses the legislative changes that have facilitated this, the implications they have for executives and boards of directors, and what they can do to protect themselves.

The global financial crisis of 2008 set off a wave of litigation activity that is gathering pace with each passing year. Grievances related to the ethical conduct of directors, alleged anti-competitive behaviour (anti-trust or corruption) and bankruptcy proceedings are being pursued to the fullest degree. Such cases are not only a cause of concern for corporations; they increasingly target individual executives.

The number of claims brought against company directors in Europe is running at 20% above 2009 and 2010 levels, which were already considered 'peak years', and this pattern looks set to continue. The introduction of legislation such as the Dodd-Frank Act in the US and the Anti-Bribery Act in the UK is likely to underpin this pattern in the future, as it further empowers regulatory bodies and criminal courts to place past and future actions of corporate board members under intense scrutiny.

"There is a greater push for transparency in what corporations do, especially in the financial markets, and a drive for a more ethical business conduct across the globe," says Géraud Verhille, vice-president, Financial Lines Europe at the insurer Chartis. "This is aided by legislation such as the Dodd-Frank or Bribery Acts but also by the allocation of government resources, the existence of bodies such as the Enterprise Chamber in the Netherlands, or quite simply by historically active regulators like the Corte dei Conti in Italy or the AMF in France. In a way this has been an existing trend for a number of years but the crisis has provided a renewed political drive that has accelerated the process."

> "The number of claims brought against company directors in Europe is running at 20% above 2009 and 2010 levels."

Shareholder power

This increased power to hold individuals to account manifests itself in a number of ways. Many direct or derivative shareholder actions are being launched out of anger and disillusionment with recent events. In certain instances this is for financial recovery, but in many others it is about governance. For example, new 'say on pay' rules have given shareholders greater powers of governance and a higher volume of motions are being tabled at company general meetings. "This is at times even supported by social media, which gives people the ability to drum up support and frame an issue in a certain way," Verhille says.

There has been a rise in the number of cases related to corporate bankruptcy proceedings, impropriety in the context of mergers and acquisitions, including instances of aiding and abetting or simple breach of fiduciary duty. This is observed in many countries, including Spain where the burst of the real estate bubble – a sector rife with acquisitions – has had far-reaching consequences including bankruptcy proceedings and shareholder litigation.

"On the litigious side, where there have been financial losses, shareholders are quite simply trying to bring directors to account," Verhille says. "Allegations based around the way organisations make representations to the market are also very common at the moment. CFOs have personal liability for this, which is why regulators and shareholders are going after the individual, not just the company."

Another noteworthy change is the increase in collective action suits in European courts. The US has long been seen as the most favourable forum for such disputes, leading many foreign investors to join US actions even if their case did not directly relate to that jurisdiction. The US Supreme Court decision in the Morrison case has strengthened the hand of judges to push such cases back into more geographically relevant arenas.

"They may not be full-blown class action suits like we see in the US yet, but multiple party actions involving groups that have suffered common losses or share common problems are emerging in Europe," Verhille explains. "What also contributes to this is US courts telling holders of foreign shares 'there is an alternative forum for your class – you did not purchase your shares on the US stock exchange' and redirecting the case to an indigenous forum. As a consequence we see the foreign component of existing US actions being pushed back into Europe and litigated here."

A class act

This must also be seen in the context of the increased strength of regulatory and legal authorities in a number of different countries. In the UK, for example, the recently introduced Bribery Act has given the Serious Fraud Office potential access to a much greater number of companies and individuals. The terms of the legislation mean that the onus of guilt has shifted, placing greater pressure on the executive boards of companies to prove that no wrongdoing has taken place. Recent years have also seen a noted increase in

cross-border cooperation between regulators, an acknowledgement of the global impact of how modern business is conducted.

"Before the Bribery Act the criminal prosecution had to prove that there was a 'directing mind' within a company that led to an act of bribery," Verhille explains. "Now, once an act of bribery has been discovered, a company can be liable unless it can demonstrate that all possible measures had been put in place to prevent it. It makes it so much more difficult for company directors and so much easier for the authorities to enforce and fine."

"The increase in the budget allocation to ensure enforcement in the US and a review of plans to consolidate regulatory bodies in the UK for fear of losing effective enforcement are strong political signs," Verhille explains. "The changes in the legal landscape regarding whistle-blowing and self-reporting are also helping to allocate enforcement resources more efficiently. As a result, we are now seeing that when regulators and subsequently investors decide to litigate, the action tends to go further. It's an issue that sticks."

In addition, some of the key deterrents to civil action are eroding in Europe. The 'loser pays' rule made many possible claimants think twice about launching action, wary of the need for a watertight case if steep costs were to be avoided. The rise in the amount of litigation funding available in certain European countries mitigates this and the local implantation of law firms used to US-style class actions, as well as the relaxing of contingency fee limitation (e.g. in the Netherlands) has provided extra impetus to pursue claims.

Ensuring transparency

There are things that finance officers can do to mitigate two of the largest risks they might face; one with respect to representations to markets and the other to bankruptcies. If companies are to ensure the correct representation of information to the markets, systems must be put in place that allow for real-time, cross-company visibility of both operational performance and liquidity levels. This includes subsidiaries and sub-groups, which are being targeted more and more.

"Most CFOs are clearly aware of these risks and their consequences, which is the first major step," says Verhille. "In terms of mitigation, many have been moving in the right direction for years, changing the way organisations are run to make more accurate representations to the market. There is also a lot of risk associated with providing guidance, as altering it tends to affect your share price. Should we provide it? How should we do it? These questions need to be assessed rigorously.

"When it comes to liquidity and solvency, CFOs must monitor all parts of the group. Bankruptcies of subsidiaries or affiliated companies can lead to tough litigation against individuals – allegations of late notification or asset-stripping are typical. You have to try to stay abreast of these situations to build up as strong a defence as possible should anything happen," he adds.

Know your ABC

There are three kinds of directors and officers (D&O) liability insurance, which offer varying degrees of coverage:

- **Side A** directly covers directors and officers for losses resulting from claims made against them for wrongful acts committed in their capacity as an executive for which no indemnification by their company is possible.
- **Side B** coverage reimburses a company for the cost of indemnifying its directors or officers as a result of claims made against them.
- **Side C** provides coverage for a company's losses for claims in relation to the violation of securities laws, typically brought by shareholders.

Private vs public

In this environment, steps need to be taken not just by large public firms, but by private companies as well. In Verhille's view there has been a misconception that directors of private companies have a much higher immunity to claims. The reality is that cases lodged against executives of private companies now outnumber those brought against their public counterparts.

"Of course, most private companies don't have to worry about cases related to misrepresentation to financial markets," he explains. "But they are at the mercy of a whole range of claims, not least brought about by state attorneys. For example, with respect to health and safety, anti-trust issues, or cases related to the environment, executives of private companies are just as accountable. On the civil side they face cases brought by their stake-holders related to breach of fiduciary duty which may have led to financial losses. All of these are on the rise."

Defence industry

For all the doom and gloom, strong defence of directors and officers against litigation often proves successful. Even if initial decisions prove unfavourable, recent history suggests that many appeals lead to the dismissal of a case or the reduction of an award or fine. Comprehensive, road-tested directors and officers (D&O) insurance combined with strong claims-handling experience and a global footprint can go a long way to mitigating risk. Court action is always costly and stressful, but strong defences can make it much less so.

"There just needs to be that risk awareness," Verhille says. "When it comes to criminal or regulatory investigations and prosecution, a powerful defence is expensive but paramount. Whether you are big or small, strong defence is critical because the ultimate consequences to a practice, or as a director or officer, be it fines, imprisonment or disqualification, could be considerable." ■

Further information
Chartis
www.chartisinsurance.com

A triumph of risk management

Insuring the right risks at the right price while mitigating all other hazards and exposures for which cover is not available is often a complex and dynamic process. **Javier van Engelen** and **Sabrina Hartusch** of international lingerie and shapewear manufacturer Triumph International Spiesshofer & Braun KG explain why it helps to integrate insurance and risk management within the finance and administration function.

Based in Switzerland but founded in Germany 125 years ago this year, family-owned Triumph was for a long time a decentralised organisation that grew to become a company with a turnover of CHF2.2 billion and 36,500 employees. Today, it manufactures in ten out of the 46 countries in which it has an established presence, and operates in a total of 120 different markets.

Triumph specialises in high-quality, mid-segment-priced underwear, where fit and comfort are of crucial importance. Renowned brand names such as Triumph, Sloggi, Valisère and HOM belong to the group. As CFO Javier van Engelen explains, Triumph has recently made two major strategic changes. The company began to centralise its functions, not least risk management and insurance in its global headquarters in Bad Zurzach. It also decided to establish its own retail stores alongside its wholesale trade.

Risk mapping

"Two years ago we started with global risk mapping," says van Engelen. "We asked everyone within the company to do a risk map, a heat map of the biggest risks that we have from their individual functions." Up until this point, there had been a disjointed view of the totality of risk. Creating the map produced a picture of the compounded risks and opened executives' eyes to the reality that while individual risks could be managed, there was considerable complexity when they were taken together.

It was also clear to the Triumph global management board, which oversees risk management, that all risks should be reviewed at least annually, along with the strategies to mitigate them.

Insurable hazards such as trade credits, any type of liability and trade or value chain disruption were clear and defined. However, as Sabrina Hartusch, Triumph's global head of insurance, points out, it is still important to promote competition among insurers and to diligently select your provider. The company insists that policies are tailored to Triumph's specific requirements rather than simply supplying off-the-shelf products.

Hartusch has conducted a stringent analysis of Triumph's insurance world. As a result, the company does not pay for risks it no longer considers important. Moreover, competition has reduced premium cost and delivered a better service. What is also clear is that global insurance is ultimately responsible for all company policies, from legal entity to personnel insurances.

Van Engelen and Hartusch have done much to promote effective communication within the Finance and Administration function and emphasise the importance of cross-departmental alignment among all stakeholders, not to mention the great strides that have been made in terms of Triumph's organisational structure.

Uninsurable risks

Among the uninsurable risks that were thrown up by the risk map, van Engelen singles out three key areas. Being first to market with quality, innovative and consumer-focused products is a constant challenge he says can only be met by the firm's commitment to workmanship and its 125 years of experience.

A second risk concerns Triumph's global scale. Its main competitor, Victoria's Secret, may be bigger but it is US-focused. Triumph is the only truly international player; it therefore must leverage that reach to stay ahead of competitors who, says van Engelen, will challenge it with lower cost and lower-quality products in an industry where margins are shrinking because of commodity price rises.

The third challenge is to remain best in class, not just in commercial terms by bringing new products to market, but also in the way Triumph manages itself internally.

Javier van Engelen
Javier van Engelen is the global CFO and a member of the global management board of Triumph International. Previously, he worked in multiple countries for Procter & Gamble and AstraZeneca Pharmaceuticals. He holds a masters degree in Economics/Econometrics from the Antwerp Business School.

Sabrina Hartusch
Sabrina Hartusch is global head of insurance at Triumph, responsible for the group's global and the local subsidiaries' insurances. She holds an MSc in insurance and risk management from Cass Business School, London, and is on the board of the Swiss Association of Insurance and Risk Managers.

"This comes back to insurance, finance and risk," van Engelen explains. "What we're doing here in terms of our finance structure and the overall risk management has to be a top-quality approach."

The mitigating advantage that Triumph enjoys is its family ownership. Short lines of communication mean that problems can be spotted and fixed quickly, and van Engelen notes that five generations of owners have pursued the same fundamental mandate: to reinvest in the business.

He also says that it's not possible to have a global mandate for credit risk. Instead he drives home to local subsidiaries the need to assess credit risk and insure where appropriate. These local subsidiaries are held accountable for bad debts, but despite Triumph having many thousands of customers, the recession has not produced any significant increase.

However, he admits: "Life is not always rosy. We have been hit by one bad debt. A major German retailer with a triple-A credit rating and they still went into insolvency and we didn't have any insurance against that. We thought there was absolutely no risk. We got it wrong. However, in the total scheme of things, it was a very small pimple on a smooth surface."

The solvency of Triumph's insurers and their three renowned banks is always on the risk radar. There is, however, one risk area van Engelen doesn't have to worry about: foreign exchange risk.

Triumph has been creating lingerie and shapewear for 125 years.

"For me, the biggest differentiator is not necessarily being private or public," he says. "It is about how you manage your cash. There is one big difference between private and public companies, which has implications, and that's the quarterly reporting. The advantage that we have is that we do not have to worry about fluctuating results, quarter by quarter. So we have a bit more flexibility. We do not have to cover for all potential risks and to hedge them over time so that we avoid significant disruption. We save money."

"The translation has nothing to do with the operational health of the company," van Engelen continues. "It doesn't impact my profit margin. It is purely translating operating results from all my subsidiaries into a Swiss franc consolidation report."

The current strength of the Swiss franc has only impacted the 2% of sales the company makes in Switzerland.

There is one 'risk' that van Engelen cheerfully admits he would never have suspected when he came to Triumph three years ago. Apparently, when a new colour is introduced to an underwear range, it can affect the all-important fit of a garment. It seems there are some scenarios even an experienced CFO cannot plan for. ■

Company profile: Triumph International

Triumph International, one of the world's leading manufacturers of lingerie and underwear, is a family-owned company with 36,500 employees worldwide and an annual turnover of CHF2.2 billion in 2010. It develops, produces and markets underwear, sleepwear and swimwear both wholesale and through its own stores for its Triumph, Sloggi, Valisère, and HOM brands.

Triumph began life as a corset manufacturing business in southern Germany in 1886. Founders Michael Braun and Johann Gottfried Spiesshofer laid the foundations for an innovative product policy, coupled with the highest standards of material and workmanship. Triumph rapidly became a pioneer in the transformation of the shaping corset into luxury lingerie.

Having extended its name to Triumph International in 1953, the company subsequently opened subsidiaries on all continents. Today, it has a presence in over 120 countries.

Calculated risk

Risk management is a complex task for any multinational and DLA Piper, the world's largest law firm, knows only too well the many challenges posed by different regulations and insurance requirements. Chief risk officer **Julia Graham** and CFO **Paul Edwards** explain to Jim Banks why the company's decision to appoint a CRO to coordinate an enterprise-wide risk management strategy has been its trump card.

In early 2011, DLA Piper became the world's biggest law firm with more than 4,000 lawyers in 76 offices in 30 countries. For such a globally distributed organisation risk management and insurance provision pose many challenges, not only in terms of divergent regulations in different jurisdictions, but also from a cost perspective.

To ensure that the right insurance and risk mitigation strategies are in place, and that they are cost-effective, the organisation places great emphasis on the relationship between chief risk officer (CRO) Julia Graham and the firm's top management, including CFO Paul Edwards.

Graham, immediate past president of Airmic and currently VP of FERMA, is in charge of the firm's handling of legal and regulatory risk, operational risk – including HSE and business continuity – and client intake issues such as conflicts of interest and money-laundering countermeasures. Her brief also covers compliance, the purchase of insurance and claims management for all classes of cover. Her previous experience in the financial services industry gives her a unique insight into how different things are in a professional services firm.

"Our business model drives many things, including the relationship between CRO and CFO," says Graham. "It is not like financial services, where often the CRO is the CFO and the role focuses on the market, credit and liquidity risk. In a law firm the agenda is different. Both Paul and I are on the risk committee, which includes the chairman, managing directors and some senior partners, but my focus is on insurance.

Julia Graham
Julia Graham is chief risk officer for global law firm DLA Piper. Her responsibilities include the design and procurement of international programmes for all classes of insurance. Graham is a past chair of Airmic and a board member and vice-president of FERMA.

Paul Edwards
Paul Edwards was appointed chief financial officer of DLA Piper International LLP in 2004. Prior to that he was finance director for eight years at Simmons & Simmons. Edwards has also worked as a chartered accountant with Arthur Andersen in both London and Brisbane, Australia.

> "The CFO and CRO may have a natural conflict, the former driving growth and the latter controlling risk, but that tension can be very important in creating solutions."

"Paul looks at financial management and control, so he wants to see that I spend our money wisely. My role is to agree the insurance programme with the partners who run the business, while part of the CFO's brief is to address challenges like tax and transfer pricing as part of the global insurance programme. He needs to know that it is compliant and appropriate for the territories in which we work."

Edwards, who is responsible for all financial matters outside the US, is part of the firm's international board and its management executive. An ACA, he qualified with Arthur Andersen and has since worked in the finance teams of leading law firms.

"The key thing is the very existence of a CRO, as we need a specialist to advise us when we make commercial decisions," he remarks. "We absolutely need insurance, but it adds red tape and can constrain the business.

"Julia runs the risk committee and it is her job to show all the risks and exposures the firm faces. Usually, the CFO and CRO may have a natural conflict, the former driving growth and the latter controlling risk, but that tension can be very important in creating solutions," he adds.

Graham agrees but says that she is not always pushing in the opposite direction to Edwards.

"Risk management is not just about prevention; it is about converting opportunity," she explains. "It is partly about comforting non-executive directors

“Compliance can be a challenge, especially in emerging markets. You have to navigate a very complex landscape in which markets are at very different levels of maturity, and regimes are changing all the time.”

so that they are less risk-averse. Risk has negative connotations, so the challenge is to play the upside.”

“The management team doesn’t see the CRO role as a negative thing,” stresses Edwards. “We must have a more enlightened view. Professional indemnity, which is a very specific area of expertise for Julia, is very important. Sure, the CFO might get frustrated by the many regulations around the world, but Julia must guide us through that to help the board understand them.”

Global policy, local cover

DLA Piper operates a global insurance programme to ensure consistency and economies of scale, but the most important driver is central control. The core team of centralised expertise under Graham makes managing compliance simpler.

“Compliance can be a challenge, especially in emerging markets, where local tax and regulatory regimes differ,” comments Graham. “You have to navigate a very complex landscape in which markets are at very different levels of maturity, and regimes are changing all the time. There is no blueprint for an insurance programme. You can’t just get an off-the-shelf solution from a broker.”

The core team handles many kinds of insurance, but the most significant is cover for malpractice; broadly speaking, this is the equivalent of D&O insurance.

“Malpractice insurance is the biggest professional risk for us,” confirms Graham. “D&O insurance covers management liability for the actions of external directors and the management of the firm, but professional indemnity, or malpractice, is our largest kind of cover by far and takes priority over D&O.”

Important work by the likes of FERMA and Airmic is bringing the industry together to improve the options from brokers and make choices less disparate, but there is still much to do.

“The complexity of a global insurance programme means that as CRO I have to be very inquisitive and constantly vigilant,” says Graham. “My team must stay informed and educated, which helps relationships with brokers. We develop a partnership with them and work closely together

“ The problems at News Corporation emphasise issues like reputational risk, and raise questions about the workability of D&O cover when management schisms pit directors – and their insurers – against each other. ”

to design programmes. For instance, we may need local cover to get a business running in a particular market, as well as the umbrella of the global programme. It is a complex structure, which is why we need a dedicated professional to manage it.”

Topical risks

To control this complexity, DLA Piper has a risk register which is constantly updated to track topical risks. These comprise: the economic environment; the rising tide of tougher regulation; security of information; the fight for top talent; perennial risks; and the risk of catastrophes, whether they be natural disasters or the social unrest seen in markets like Egypt.

“We have to look at very specific types of risk and mitigate any risk that might affect the way we deliver on our strategy,” says Graham. “We are specific about risks so that people can embed them in how they manage the business. Governance and risk compliance are managed very closely together.”

“I want a CRO who brings up and addresses issues by working with the CFO and senior management,” says Edwards. “We want to know if we have suitable plans for disaster recovery to react to things like outbreaks of swine flu or the earthquakes that Japan had this year. We need Julia to put a good system in place that is cost-effective.”

Events constantly inform the firm’s risk profile. The ongoing problems at News Corporation emphasise issues like reputational risk, and also raise questions about the workability of D&O cover when management schisms pit directors – and their insurers – against each other.

In short, a big professional services firm needs not only a risk specialist like Graham, but a coherent, global, enterprise-wide strategy for risk management to ensure compliance and cost-effective cover. ■

Company profile: DLA Piper

- DLA Piper was created in 2005 by the merger of DLA, Piper Rudnick and Gray Cary.
- The company employs 4,200 lawyers in nearly 76 offices in Asia-Pacific, Europe, the Middle East and the US.
- With a direct presence in 30 countries, DLA Piper’s clients include more than half of the Fortune 250 and nearly half of the FTSE 350 or their subsidiaries.
- The company offers services in multiple business sectors including banking; healthcare, insurance and reinsurance, and technology.
- DLA Piper adopts an enterprise approach to risk delivered by an integrated, international risk management and compliance team.
- In 2011 DLA Piper became the world’s largest law firm.

Reduce complexity with global D&O cover

More than ever, company directors working in unfamiliar countries and jurisdictions need robust D&O coverage. Michael Rieger-Goroncy of **Beazley** explains why working with his firm – a Lloyd's of London insurer licensed to operate in 79 countries – can save businesses valuable time and money.

In 2009, the title for the FERMA conference was 'Global village: the future of risk management'. Two years later, life in the village is far from harmonious. Political unrest in the Middle East and North Africa, and extreme economic volatility in the eurozone and North America have contributed to the world becoming a much more unstable place, with the risk of nationalist and protectionist reactions from governments increasing daily. As a result, company directors working in unfamiliar countries and jurisdictions require reliable, far-reaching directors and officers liability insurance (D&O) coverage.

In the past, directors have taken comfort in the fact that their global D&O policy purported to afford them cover all around the world. However, many governments are now requiring directors and companies to use policies that comply with local legislation. The penalties for failing to do so are significant; either a sanction against companies and their insurers or – more ominously from the director's perspective – a prohibition on the payment of D&O claims under a global policy.

> "Many governments are now requiring directors and companies to use policies that comply with local legislation. The penalties for failing to do so are significant."

The problem is particularly serious for directors when they are operating in overseas jurisdictions that forbid companies indemnifying directors, meaning they cannot be protected by so-called Side B D&O cover. In these cases, the director will be personally liable for costs arising for local legal representation to conduct their defence. In the absence of dedicated Side A cover that complies with local requirements to cover such costs, they will be completely on their own.

A flexible policy

So how can insurers help to resolve this? Some are now offering local policies provided by their regional subsidiary or a local partner fronting the policy. However, this can prove both costly and complicated – especially if the local insurer is not an expert in writing D&O insurance. Experience shows that getting local policies fulfilled is, at best, a difficult and time-consuming task. Problems often arise when dealing with local laws and regulations, negotiating different terms and conditions for each jurisdiction, and, finally, consolidating all of this coverage in the global policy.

Of course, everybody dreams of buying a genuinely global policy that offers compliant coverage in each jurisdiction without having to resort to local policies. While there is no panacea, the problem can be significantly eased by working with an insurer licensed to write direct business in a wide range of countries.

Beazley, like other Lloyd's of London insurers, is licensed in 79 countries and can offer immediate coverage in many territories. This prevents the need for complicated, time consuming and costly local polices in these countries.

Furthermore, Beazley is able to offer this solution even when it is not the primary insurer on a programme, but on an excess layer only. The risk manager can elect to buy an additional Beazley Side A excess endorsement with an 'international drop down' provision. While this may not always prevent the company from having to buy local policies (for example, in Brazil, where Lloyd's is not currently licensed), it will often help to make the placement of an international programme much easier, faster and less expensive than if the primary insurer needed to issue local policies for all territories. ■

Further information
Beazley Group
www.beazley.com

Clean without soap

When Siemens agreed to pay a record $1.34 billion fine for bribery and corruption in 2008, a wide-scale compliance transformation programme was already in full swing within the company. *Finance Director Europe* looks back at how Siemens cleaned up its act and why robust compliance and internal controls are so important for modern companies in a climate of increased bribery legislation.

The UK Bribery Act came into force in July this year. *FDE* readers based outside of the UK will be interested to know that they are not necessarily immune, as non-UK subsidiaries of UK companies – as well as other non-UK incorporated companies – can be liable if they carry on a business or 'part of a business' in the UK. Individuals, no matter what their nationality, are also liable if an offence was committed in the UK; so too are British nationals working abroad and directors and officers, even if they are only passively (see table, opposite) involved in an offence.

The UK Bribery Act takes a leaf out of the 34-year-old FCPA (Foreign Corrupt Practices Act) in the US and when comparing the two, the UK Act appears tougher. The FCPA has clocked up over 50 successful prosecutions against companies including German conglomerate Siemens, which agreed to pay a massive $1.34 billion fine in December 2008 for operating a S$2.3 billion slush fund in Singapore to help win international contracts. Speaking on a *Forbes* podcast in July 2011, group CFO of Siemens, Joe Kaeser, acknowledged that the crisis gave Siemens a much-needed reality check. "The compliance crisis gave us that fundamental push and change in culture to make this company a much more focused one."

Pillars of strength

The compliance transformation at Siemens gained momentum when Andreas Pohlmann was appointed in September 2007 as chief compliance officer. In an interview given to the United Nations Global Compact,

> "The crisis gave us that fundamental push and change in culture to make this company a much more focused one."

Pohlmann outlined Siemens' three-pillar "prevent, detect, respond" compliance system, whereby 'prevent' focuses on information quality, integrity and reliability, as well as anti-corruption training; 'detect' focuses on early-stage detection of misconduct, such as a help desk function to encourage employees to communicate problems and thus help build a stronger culture of integrity; and 'respond' focuses on the strict enforcement of policies and regulations coupled with consistent and appropriate sanctioning across all levels of the business in the event of employee misconduct. Peter Solmssen, Siemens' current general council, took over the role of chief compliance officer in 2010. In spite of the inevitable media storm that surrounded the scandal, Siemens' reputation seems to have remained intact with revenues of €76 billion and a net income of €4.1 billion in 2010.

With ambiguities around the application of the UK Bribery Act in specific scenarios such as corporate hospitality and the sensitivity of specific vertical markets to bribery (such as the pharmaceutical sector), ensuring clear guidance and policies for employees, such as those adopted by Siemens, could well be a good idea for all companies today. ■

US Foreign Corrupt Practices Act (FCPA) v UK Bribery Act

Who is being bribed?
FCPA: Limited to the bribing of 'foreign officials'.

Bribery Act: Prohibits bribes paid to any person to induce them to act 'improperly'.

Nature of advantage obtained
FCPA: Payment must be 'to obtain or retain business'.

Bribery Act: Not limited to business advantage – extends to any improper action.

[1]Active offence vs passive offence
FCPA: Only the act of payment, rather than the acceptance of payment, is prohibited.

Bribery Act: Both bribing another ('active offence') and being bribed ('passive offence') are prohibited.

Potential penalties
FCPA: Individuals face up to five years in prison and fines of up to $250,000; Entities face fines of up to $2 million.

Bribery Act: Individuals face up to ten years' imprisonment and potentially unlimited fines; for entities, potentially unlimited fines.

Seize the day

In today's volatile pensions market, more and more companies are looking to transfer the risk to insurance providers. With a vast array of available options, including annuity buy-ins and buyouts, **Prudential**'s Greg Wenzerul (far right) and Andrew Reed explain why many companies cannot afford to wait to transact.

These are tricky times for defined benefit pension schemes. Faced with the double whammy of increased longevity risk and extreme market volatility, many of them have been plunged into deficit. With ever more schemes closing to new members, the central concern for sponsors and trustees is finding ways to safeguard existing members' interests.

Managing down the risk is therefore seen as essential. "The current climate has really focused trustees' minds on de-risking," says Greg Wenzerul, corporate deal principal at Prudential. "For many trustees, the goal of de-risking their schemes has become a lot more pressing."

The picture, however, is complex, with no two schemes operating in quite the same way, and no one solution suitable for all. While transferring risk to an insurance company may seem like an attractive prospect, it is important that sponsors and trustees remain alert to what this may mean in practice.

> "If you can find a counterparty that you believe is strong and reliable, and they can meet that price, then transact. Don't wait."

Buy-in vs buyout

Two widely discussed options are annuity buy-in and buy-out solutions. Buyouts transfer the pension liabilities from the sponsor company to the insurer, whereas buy-ins entail purchasing an insurance policy that fully matches those liabilities.

"At Prudential, we have been in the annuity buyout market since the mid-90s, with the annuity buy-in market taking off around 2006," explains Wenzerul. "The key difference is that a buy-in is an asset of the scheme. It's similar in many ways to a corporate bond, but instead of coupon payments it pays the actual benefits of the underlying members."

While buy-ins represent the ultimate de-risking solution for many companies, they require the support of the scheme's sponsors and affordability remains a consideration.

"It's difficult to say, 'now's a good time to enter into a buy-in or a buy-out'," says Andrew Reed, Prudential's director of defined benefit solutions, "because although it is very much a good time if a company has the right assets, for some companies it is not possible. They may be quite heavy in equities, and equities have dropped down in value quite significantly."

Prudential therefore offers a nuanced range of approaches suitable for companies' specific needs. With schemes increasingly using a combination of solutions as part of their long-term risk management strategy, Prudential works on ways of incorporating these into an individually tailored route map.

An important point of focus has been adding flexibility to buy-in contracts. One such area of flexibility is to cover future retirees within a transaction at an affordable price – a pilot project known as Defined Benefit Vestings. "Defined Benefit Vestings allows you take out annuities as people retire," says Reed. "That's particularly attractive when you've secured your pensioners, and you just want to carry on building up the annuitisation."

Another promising solution is the Future Premium Product (FPP). It is suited to most schemes and avoids the drawbacks of the much touted longevity swaps, which for some schemes may not represent especially good value for money.

The main thing, as Reed and Wenzerul see it, is to ensure that you pick an insurance company that will work with you to provide the optimal solution for your particular scheme. "With more turbulence expected ahead," says Wenzerul, "we recommend schemes transact with a counterparty that is financially secure, stable and will be around in the market for the life of its members."

It is an area of the market in which Prudential holds great sway. With an instantly familiar brand and a long history in life insurance, the company benefits from a potent combination of solid administration and financial strength. Since 1997, it has secured pension scheme liabilities in excess of £5.4 billion, and has successfully completed over 430 buy-out/buy-in transactions. Such transactions look set to continue for many years.

"My view would be, understand what your criteria are for transacting," says Reed. "If you can find a counterparty that you believe is strong and reliable, and they can meet that price, then transact. Don't wait. You often miss the boat." ■

Further information

Prudential
DBSolutions@prudential.co.uk

The risk renaissance

The effects of volatile investment markets on pension funds could be compounded by the proposed EU risk mitigation regulations. **Philip Broadley**, group finance director of Old Mutual and chairman of the pension committee of the UK's highly influential Hundred Group of Finance Directors, talks to Nigel Ash.

Earlier this year, Philip Broadley, CFO of Old Mutual and past chairman of the Hundred Group of finance directors visited an exhibition in Florence on the activity of the city's Renaissance bankers.

"Florentine banks suffered from many of the same concerns we have today," observes Broadley, "about whether the bankers were facilitating trade or merely extracting an economic rent from doing so. There were many questions relating to risk-taking in Florence during the 15th-century. That demonstrates that none of the arguments is new; they just come round every once in a while."

The whole issue of risk is currently dominating regulatory thinking, particularly in Europe, and in the view of many it is skewing thinking on efficient markets. The very complexity of some proposed regulations, such as IORP 2 (Institutions for Occupational Retirement Provision) and Solvency II might even be contributing to the element of risk that they are supposed to be preventing.

"I suppose my anxiety is that we are living in an environment at the moment where, for understandable reasons, there is a desire to take risk out of everything," explains Broadley. "I think it is true to say that there can be no reward without some risk in any enterprise, and this is also true of banking. If we want risk-free banks, then we will either have to accept that our mortgages are repayable at call or that our deposit accounts have a 30-year notice period."

A key exception that Broadley and his colleagues take to the thrust of proposed EU legislation is that it conflates pensions funds with insurers. "This ignores the nature of a pension scheme and in the end the importance and value that attaches to the sponsor's covenant."

Philip Broadley
Philip Broadley is group finance director at Old Mutual. He held the same position at Prudential and was a partner in Arthur Andersen. Broadley is chairman of the Hundred Group of Finance Directors' pension committee and a founding member of the CFO Forum of European Insurance Company Finance Directors.

While UK pension provision had taken a while to develop, Broadley believes that the current system, with the powers of the trustees and the ultimate backing of the Pension Protection Fund, works effectively.

> "There were many questions relating to risk-taking in Florence during the 15th century. None of the arguments is new; they just come round every once in a while."

Euro vision

In July 2011, the Hundred Group, in its submission to the European Commission's call for advice on the proposals from the European Insurance and Occupational Pensions Authority, argued that current pension provision across the EU was diverse. Therefore, any significant reform of funding requirements would not necessarily assist those countries with the lowest levels of provision. It would, however, impact disproportionately member states such as the UK that had widespread systems of funded defined benefit provision.

Broadley accepts that pan-European schemes might of themselves be relevant in the longer term. However, he is concerned they would be of less use to multinational companies that also had operations outside the EU and would in any case add considerable complexity.

He argues that, in the UK, members of defined benefit schemes generally understand their schemes and their benefits. They can "put their arms around" their pension provisions, which would not be the case in a remote, pan-European fund.

He has a further warning. "I would think that, increasingly, employers regard pension provision simply as part of the overall remuneration that they offer to their employees. I would put forward the argument that certainly very few large employers are now particularly thinking in terms of pension provision from the point of view of any welfare obligation.

"So with that in mind, there are still quite significant differences in remuneration practice in different markets," he continues. "Some of those are a function of the markets themselves and people's expectations. Some of them are also a consequence of other regulation."

Objective of IAS 19

The objective of IAS 19 is to prescribe the accounting and disclosure for employee benefits, or all forms of consideration given by an entity in exchange for service rendered by employees. The principle underlying all of the detailed requirements of the standard is that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable.

Source: Deloitte Global Services Limited

Broadley cites the efforts to regulate banking pay. Just as the provision of saving products across Europe is still very different, so pension provision varies as a result of custom and practice.

But he warns that over-regulation will be counterproductive. "It will lead to a further continuation of benefit reduction, the closure of defined benefit (DB) schemes, the switch to defined contribution often with lower contribution rates, buyouts and more conservative investment strategies for those DB schemes that do survive."

Though apparently arcane, he believes that this last element would be particularly relevant for the UK, more so probably than anywhere else in the EU.

"DB schemes will want even less to invest in equities than they do currently," he explains. "Thus it increases the long-term trend, which one can observe in the UK market, which is that pension funds will not wish to be long-term holders of equity. If the pension funds are not holders of UK equity, who is?"

Cutting the clutter

Broadley sees the revision of IAS19 as being of particular value to general portfolio managers who need to have a view across various sectors.

"There will be a reduction in profits shown in the financing line from the expected return on assets being changed to the discount rate," he observes, "and that will affect everyone and there will be a removal of spreading from the small number of schemes currently using it."

The impact will vary between firms, and he anticipates there is likely to be a large number of additional disclosures.

"It is interesting that there are quite a number of initiatives underway in various quarters to 'cut the clutter' – the phrase that is used around financial reporting," he notes. "Yet here we have something that is going against that. The removal of spreading will increase volatility for some but the benefit ultimately for analysts is that there will be greater consistency between companies' disclosures." ■

Overview of changes introduced by IAS 19 Employee Benefits, as amended in 2011

The standard requires recognition of changes in the net defined benefit liability (asset) including immediate recognition of defined benefit cost, disaggregation of defined benefit cost into components, recognition of remeasurements in other comprehensive income, plan amendments, curtailments and settlements:

- Introduce enhanced disclosures about defined benefit plans.
- Modify accounting for termination benefits, including distinguishing benefits provided in exchange for service and benefits provided in exchange for the termination of employment and affect the recognition and measurement of termination benefits.
- Clarification of miscellaneous issues, including the classification of employee benefits, current estimates of mortality rates, tax and administration costs and risk-sharing and conditional indexation features.
- Incorporate other matters submitted to the IFRS Interpretations Committee.
- Applicable on a modified retrospective basis to annual periods beginning on or after 1 January 2013, with early adoption permitted.

Source: Deloitte Global Services Limited

Risky business

As finance directors look for ways of managing down the risk of their pension schemes, they must select from a complex array of solutions, both within their company and externally. John Smitherman-Cairns of **Lucida** explains the benefits of transacting with an insurance company and the importance of an individually tailored approach.

Over the last few years, the pensions market has followed a clear-cut trend. With companies seeking to protect against volatility, de-risking solutions are in greater demand than ever, and the market is evolving to meet this demand.

While much of the risk can be managed internally, the external market is growing fast. Increasingly, finance directors are calling upon insurance companies to take on the liability from their pension funds, thus transferring the risk and administrative burden elsewhere and freeing up resource to focus on their core business.

"We are in a period where more and more UK corporates are looking to take risk off the table," says John Smitherman-Cairns, corporate development director at Lucida. "For many it's not a case of, are they going to de-risk? It's a case of, when are they going to de-risk and what approach are they going to take?"

These are pertinent questions for finance directors, who are generally the ones tasked with writing the cheque. Of late, they have been making some very significant contributions to pension schemes. For example, in 2010, around £10 billion was paid in as deficit funding by FTSE 100 companies alone.

> "Writing insurance protection for defined benefit pension schemes is a capital intensive proposition and demand has the prospect of outstripping capacity."

"They don't want that payment to just go into what they might see as the black hole of the defined benefit pension scheme," says Smitherman-Cairns. "That's what's driving a lot of the de-risking activity we're seeing in the market."

For those that transact with external providers, the product offering is extensive. In recent times, there has been much discussion of buy-outs, where the liabilities are transferred directly to the insurance company, and buy-ins, where the insurance policy fully matches the scheme liabilities. The particularly striking thing, however, is the number of ways these products can be adapted.

"Some companies want full risk transfer solutions, whereas others want, or can only afford, solutions that just address a slice of the risk," says Smitherman-Cairns. "Within defined benefit pension schemes there are obviously risks around longevity, and we're seeing a lot of reports in the market around how people are living longer and the burden they're placing on corporates. With a longevity swap, the scheme chooses to retain all the other risks of the pension scheme, but passes on the longevity risk to an external party."

Flexible, strategic solutions

As an insurance company specialising in annuity and longevity risk business, Lucida offers a full and nuanced range of solutions. Progressive buy-outs, for example, allow clients to purchase a series of insurance policies over time, each covering a different portion of the scheme and leading ultimately to a full pension de-risking solution. This fits better with some organisations' funding plans and helps them to selectively de-risk.

Day one risk transfer, meanwhile, removes risk instantaneously while also giving the insurance company responsibility for closing the pension scheme.

The difficult thing from a client's perspective is working out what will work best for them specifically. "There has been a rapid expansion in the range of products offered, and that creates opportunities for pension funds, but also some confusion," says Smitherman-Cairns. "So this is a process where clients often turn to expert support. We are very happy to sit down with trustee boards and companies, and talk them through what they are trying to achieve and how we can customise the product to deliver that."

Lucida prides itself on delivering the optimum blend of strategies to meet each company's requirements. The aim is to engage clients in open discussion at the earliest possible stage.

Its individual focus extends right through to the payment schedule. In this regard, Lucida is immensely flexible, as Smitherman-Cairns explains: "We offer deferred premiums, where a corporate can secure an insurance policy immediately with part of the premium deferred and paid to the insurer at a later date, say five years. This enables the pension scheme to retain a degree of investment freedom or fund the premium through future agreed contributions.

"Rather than crystallise recent losses, deferred premiums provide the pension scheme with the opportunity to benefit from future increases in the value of the retained assets before paying them to the insurer," he continues. "This opens up possibilities to clients that have seen deficits emerge or widen and concluded that they cannot, at present, afford to transact. Therefore, there are answers if your asset values have fallen. Solutions just need to be a bit more sophisticated to deal with the current market volatility."

Ultimately, the advisability of transacting will depend upon a corporate's investment profile and objectives. Although the last few years have not been kind to many funds, this does not apply across the board. If a company's scheme, for example, holds a portfolio of gilts, transacting may not be as expensive as the true cost of holding on to the risk.

Informed decisions

The cost of de-risking will also depend on whether the client is coming from an accounting or a funding perspective. Most trustee boards are focused on their funding liability, but companies will also be focused on the P&L and balance sheet impact. Clear communication between the parties will be imperative.

Corporates that do not wish to transact tend to focus on modifying benefits and restructuring their schemes to dampen down some of the liability. Solutions include early retirement programmes, enhanced transfer value exercises and pension increase exchanges. However, many businesses are running what is in essence a quasi-insurance company on the side with limited control over the way the risks are managed.

"We monitor what's happening in the markets almost on an hour-by-hour basis," says Smitherman-Cairns. "We make sure that we're selectively trading our assets to take advantage of market opportunities, and that is quite an intensive approach to managing our exposure. A pension scheme has quite a different governance structure, and is not always in a position to be able to react the same way."

The crucial thing is to stay savvy in the face of a rapidly changing picture. As pension costs continue to rise, and the market remains unpredictable, defined benefit pension schemes are starting to seem untenable.

Corporates are jumping onto the de-risking bandwagon in their droves. In the UK, around £30 billion of insurance-based deals have been performed since 2006, with roughly £7 billion of those deals originating with FTSE 100 companies.

Nor do present market trends show any sign of abating. "I think we're in a time where the product offering has become increasingly sophisticated to appeal to a wide range of client needs," says Smitherman-Cairns. "But if we look forward and take account of the growing demand for de-risking solutions, I believe capacity could become a key issue.

"Writing insurance protection for defined benefit pension schemes is a capital intensive proposition and demand has the prospect of outstripping capacity, unless significant new capital comes into the market."

"As pension costs continue to rise, and the market remains unpredictable, defined benefit pension schemes are starting to seem untenable."

For now, the onus is on trustees and sponsors to manage risk intelligently – a tricky process made simpler through harnessing all available expertise. "This is where trustees and corporate sponsors could benefit from a detailed conversation, either with their advisors or with insurance companies, just to talk through their options," says Smitherman-Cairns. "And there always will be options with so many innovations on the product front." ■

Further information
Lucida
www.lucidaplc.com

A grown-up approach to pensions

With more and more defined benefit pension schemes looking to de-risk, the market for risk management solutions is starting to mature. **Aviva**'s Nick Johnson explains why this is less about offering new products, and increasingly about adopting a more collaborative approach.

Of late, the risk management landscape for defined benefit pension schemes has become vastly more sophisticated. With many new solutions on the table, ranging from bulk buyouts and buy-ins to longevity swaps – and even the method of auction used to choose a provider – scheme trustees are being asked to choose from an ever-evolving set of options.

Bulk annuities, for instance, have changed almost beyond recognition. Whereas five years ago, a bulk annuity was little more than a bundle of individual annuities, it has since developed into a complex and customisable product.

"The amount of bespoking, along with the scheme-specific elements that shape what the bulk annuity looks like, has grown exponentially," explains Nick Johnson, head of defined benefit pension risk at Aviva. "This is not merely an off-the-shelf product, which you can choose to buy or not, it's something for which we ask, 'What could we do extra to help you purchase this?'"

For an insurance provider like Aviva, the task is to assist schemes manage down their risk. If there is something specific that has previously prevented that scheme from transacting, Aviva will sit down with the trustees and discuss their perceived obstacles to success.

> "The critical thing is to pick the right provider. You need to have full confidence in whoever you choose, selecting a partner you believe will be around for the life of the scheme."

Key to the company's mission is an understanding that no two pension schemes look alike. A scheme may have grown up over a number of decades, taking in numerous changes to trustees and administrators in that time and as many changes in legislation.

"The history behind each scheme is different," says Johnson. "When you throw its funding levels and investment strategies into the mix, you see that every pension scheme is in a unique position. All these issues determine whether you can do a deal and what risks you're willing to accept as part of that."

Generally, schemes benefit from having a range of tools in their armoury. Because liabilities manifest themselves in various forms – interest rates, inflation and longevity risks among them – it can be worthwhile implementing several different solutions.

For example, Johnson believes that longevity swaps can represent a useful step on a de-risking journey, but that they should be viewed in a similar way to synthetic investments within your scheme rather than a comprehensive answer. "Longer term, you need to ask what is the real worth to you, how marketable is it, and are you going to get realisable value for that asset?" he says.

Working relationships

Concurrent with the diversified product offering is a change in the relationship between sponsor, trustees and insurance provider. "There has been a shift of opinion," says Johnson. "It used to be the case that companies would do the difficult bit themselves, and treat the insurance company simply as the provider of a product. History has shown that this process isn't particularly efficient – many schemes would get to the final transaction before companies realised they couldn't actually afford it. They didn't have perfect information from the outset."

These days, rather than looking at insurance providers as an opponent to win against, trustees and sponsors are embracing a new spirit of collaboration. With the shared goal of a transaction, the focus is on working together and openly sharing information to ensure that this contract will take place.

The critical thing is to pick the right provider. You need to have full confidence in whoever you choose, selecting a partner you believe will be around for the life of the scheme.

Aviva is a major player in this market. The sixth-largest insurance company in the world and the biggest in the UK, it benefits from a long track record, and continues to develop in accordance with new demands.

"Over the last five years, insurance companies have been on a steep learning curve," points out Johnson. "Initially, the market was almost embryonic – it was a question of 'can we do a deal, who will give us the cheapest price?'. Now it's got to the stage of, 'how do we work together to transfer pension risk to the insurer?'. That requires a grown-up, joined-up approach." ■

Further information
Aviva
www.aviva.com

It pays to get the right advice

Defined benefit pension schemes are notoriously complex, with a host of legal issues to consider when managing down the risks. Catherine McKenna, partner at **Squire Sanders Hammonds**, explains how schemes can benefit from the advice of a specialist law firm, especially in light of the upcoming regulations around auto-enrolment.

What are the key legal issues in the bulk annuity buy-in and buy-out process?

Catherine McKenna: There are three main issues that you're going to face legally. Number one, both buy-in and buy-out involve an element of cross-subsidy. The second point is collateral – if the insurer you've transacted with goes bust, will you be able to strike a deal that puts you in a more advantageous position than their normal unsecured creditors? The third one would be the different protections that apply before and after a buy-out, which differ a lot in terms of their impact.

These are complex legal contracts, and your rights and obligations will be governed by them. So they're not the kind of thing you'll want to enter into without legal or actuarial advice. That's where a specialist law firm comes in.

What other strategies are open to finance directors looking to manage down the risks associated with defined benefit pension plans?

Aside from buy-ins and buy-outs and other forms of investment hedging, I'd say there are three main options.

One of these is an enhanced transfer value exercise, where the corporate approaches its ex-employees and offers them an enhancement if they transfer their benefits elsewhere. This will almost certainly cost less than providing those benefits over the fullness of time.

Another option is to offer a similar deal to the people who are currently in receipt of the pension, reshaping it in such a way that they can have more cash today, but give up future increases on parts of it.

And then the third main strategy is to try to find something other than cash to fund the scheme, such as real estate, brands, receivables or trade debts. This gives the fund assets if the company's no longer there.

How should finance directors prepare for the extra costs involved in the auto-enrolment regime?

When auto-enrolment is ultimately rolled out across the UK, the average cost for a business with 5,000 heads will be around £2 million a year. We have a hit list of things that we think finance directors should be doing in order to minimise the impact.

Firstly, you can delay putting people into the pension plan and paying contributions for them for three months. Secondly, you can implement a salary sacrifice, which typically saves both employer and employee NI and can wipe out 15-20% of your extra costs. Thirdly, you can implement a pay freeze, adjusting other employee benefits instead. Finally, you can employ more part-timers, because unless an employee earns more than £7,500 a year, they will not have to be auto-enrolled.

To what extent are pension deficit issues dictating outcomes in mergers and acquisitions?

M&A activity is slower than it has been, but where you get a pension deficit it's still a major issue. The two main risks that you face are firstly that you crystallise the shortfall in the pension plan and have to pay it, and secondly that, because of the way the deal is struck, the pension regulator expects you to re-open your deal.

The overall message is that if pension deficit issues are recognised and managed they won't get in the way of an M&A deal, but otherwise they can trip them up.

What were the main drivers behind your recognition as the European Pensions Law Team of the Year and Global Pensions Law Team of the Year at the European Pensions Awards 2011?

One driver is the critical mass of the UK team. We have about 60 specialist lawyers within our pensions practice, which is about the biggest in the industry. We also now have a global platform as a result of our recent merger with US firm Squire Sanders, which is represented in 17 countries.

And then the third one is a recognition that we're not just reactive lawyers – we're proactive. We have a role in many of the industry bodies, which gives us advance warning of developments and a chance to lobby for change. ■

Further information
Squires Sanders Hammonds
www.ssd.com

Definite benefits to de-risking

Donald Fleming (near right), Simon Willes (centre) and Paul Thornton of **Gazelle Corporate Finance**, which advises the trustees of some of the largest UK defined benefit pension schemes, offer their views on important questions facing FDs in this specific industry sector.

Defined benefit pension schemes were once a major part of a corporate remuneration package, but now they are being seen more as a financial risk liability. For a smaller business, the endgame would be to buy out. For larger schemes, where a buyout might not be feasible, the need to de-risk has come to the fore. Paul Thornton, Donald Fleming and Simon Willes of independent pension advisory group Gazelle Corporate Finance share their views on the subject.

How should FDs see de-risking? Are they too focused on short-term financial performance?

Paul Thornton, chairman, pensions advisory: FDs often look at de-risking in terms of opportunity cost – 'If we hadn't spent money on de-risking, we could have bought a new factory'. They need to think 'This is adding value to our business because we've removed this very dangerous area of risk'. We are trying to help it along with our own thinking.

> "Increasingly, pension schemes will be seen as 'legacy' liabilities, and for FDs they will be a significant source of financial risk."

Donald Fleming, managing director, pensions advisory: Today's finance director is focused heavily on what the investor base and equity analysts are saying about pension risk. But the analysts are often still using market measures of pension risk and relying on fairly basic accounting measures. This focus is not always helpful in that it may work against the real problem, which is containing and managing overall pension scheme risk rather than just reducing pension contributions – which may make for a much bigger problem later on. We need to move to a more holistic measurement and management of pension risk.

What form of de-risking should FDs be looking at?

PT: Increasingly, pension schemes will be seen as 'legacy' liabilities, and for FDs they will be a significant source of financial risk. The issue can hang over a company's share price and credit rating, limiting strategic options. Against this background FDs should have a long-term game plan for de-risking.

Pension trustees can be expected to welcome de-risking measures, if not actively initiate them with the company as part of funding negotiations.

DF: For most smaller and medium schemes, the ultimate solution will be an insured buyout. This fully removes the financial risk by transferring both liabilities and assets to the insurance provider at a cost that reflects the strength of the scheme. For schemes that may be too large for the insurance market to absorb, 'self-sufficiency' is a more realistic aim, where liability risks are fully hedged without recourse to the insurance market. The cost of moving to such a position should be viewed against the shareholder value created as well as the value for money in actuarial terms.

PT: It makes sense to introduce as many risk reduction measures as possible. The foremost risks to hedge are usually interest rate and inflation risk, and these are commonly done through swaps. Equity risk may be diversified by the use of 'alternative assets'. Once these risks have been addressed, longevity risk may need consideration. Trustees and FDs need to proceed with caution, as at this stage of the market there may be residual counterparty risk and hidden costs arising from a lack of transparency.

Simon Willes, executive chairman: De-risking comes at a price, but FDs need to embrace this by considering the value added to the business by removing unnecessary risk.

Are FDs too reliant on equity performance to get them out of deficit repair problems?

PT: Ever since the 1960s there has been an implicit faith that equities will give a higher return in the long run, if you see them through the ups and downs. Particularly in the 90's that paid off handsomely. It's taken quite a few years of financial crisis to shake that implicit faith.

At the same time, many employers have realised that, once a scheme got into deficit, if they should get out of equities and into gilts they would just be sealing their fate. As long as they continued to hold some equities, which might bounce back, they could get out of trouble. So there has been much less de-risking than has been needed.

DF: Unfortunately, the last several years have shown that there is high risk in maintaining an equity strategy. It's fine for companies whose pension liabilities are relatively small, but smaller companies have been drawn into this and they can't really afford the downside. Good governance now is about hedging risk as much as possible. Not everybody is where they should be on that. But as long as FDs take account of the equity risks they are carrying, it's much less of an issue.

Are FDs right to substitute contingent assets for cash contributions or security?

SW: We are professionally sceptical about contingent assets. These come into play where a company needs to repair its deficit but hasn't got the available cash to do so without hurting the business. The trustees are unlikely to push the argument too hard because it's a long-term relationship and they are hoping the scheme will be attached to the company in the future. That's where the trustees would benefit from contingent assets to help plug the cash gap.

> "We try to take a more holistic view where the covenant assessment, investment strategy and actuarial funding advice are linked up much better than they have been."

PT: These arrangements are advice intensive and careful due diligence is needed. The special purpose vehicles that are created are structurally complex, difficult to value and often lack liquidity. They are challenging for trustees to assess and the more complex ones are subject to the law of unintended consequences.

What value can an independent trustee board bring?

PT: There is an integral long-term dependency between scheme and employer both in terms of funding and membership. However, the interests of key stakeholders – shareholders, bankers and scheme – are not naturally destined to coincide. The trustees may not have the depth of expertise when difficult choices have to be made. The pensions governance and regulatory framework needs to provide the necessary checks and balances. But this is about a balance of stakeholder interests and these checks and balances need to be proportionate.

DF: They effectively have to deal with another board, which is independent of the company. This is an interesting and quite challenging relationship. Since the Pensions Act of 2004 it's very difficult for a finance director to be on the board of a pension scheme. In some situations, such as during one of the three-yearly actuarial valuations, when a funding recovery plan is being negotiated, the FD is in a very difficult position regarding their knowledge of the financing needs of the company and affordability of the scheme.

So what was treated very much as a board linked with the company has developed a great deal of independence. This means that sometimes the trustee board can lack independent or internal in-depth financial knowledge of the company. Advisors such as ourselves bring trustee boards up to speed.

To what extent should FDs value independent covenant assessments?

PT: Covenant assessment is a developing area and generally the value is increasing. Assessments themselves are becoming better, more forward looking and more integrated with corporate information sharing protocols, risk management information and forecasting. Equally, trustee boards are learning to use assessments more effectively in the overall assessment of scheme funding risk, affecting levels of prudence adopted for valuation, investment strategy and the appetite for de-risking.

DF: This isn't a threat for the sponsoring employer. In many ways the more professional the trustees, and the more experienced they are in finance, the easier it is for the FD to deal with the trustee board. Advisors like us are using the same financial language as the FD and have no axes to grind or emotional involvement.

SW: Having said that, some of the covenant assessments that have taken place have been rather routine assessments of key financial ratios from current statements. They haven't really looked deep enough under the bonnet at underlying factors and how the business is evolving. We try to take a more holistic view where the covenant assessment, investment strategy and actuarial funding advice are linked up much better than they have been. ■

Further information
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