Pension Risk Management: Investment Risks

July 07, 2016

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Risk management relating to pension plans has been a much-discussed topic among plan sponsors and administrators in recent years, particularly after the market crash in 2008. In this second of our Pension Alert series on risk management we examine investment risks.

Investment Risks

(i) General

The largest component of risk to a pension plan is, arguably, investment risk. The universe that comprises investment risk is vast and can go far beyond what one may consider the core risks to an investment portfolio such as equity risk, interest rate risk, inflation risk, credit risk and currency risk. With the increasing breadth of investment products and instruments as well as the financial engineering and tools that are available to portfolio managers, the risks that are enumerated in prospectuses and other disclosure documents often run pages and pages in length.

Consider some of the following risk headings and sub-headings contained in the offering document for an investment fund intended for, among other investors, pension plans: general risks (loss of investment, competition, potential inability to trade or report due to systems failure, financing arrangements, availability of credit, litigation risk, limited regulatory oversight risk, tax audit risk), market related risks (volatility, market disruptions: government intervention, counterparty risk), risks relating to particular strategies (spread trading risks, correlation risk, hedging transaction risk, arbitrage transaction risk, capital structure arbitrage risk, directional investment risk, holding period risk, financial model risk), risks relating to instruments traded (structured credit products risk, subordinated securities risk, liquidity of investments risk, synthetic securities risk, derivatives risk), risks relating to investment techniques, risks relating to product/fund structure, contingent liability risk.

(ii) Political Risk

The recent vote in the United Kingdom on whether to remain part of the European Union has highlighted the need for investment managers to subject the portfolios they manage for their clients to simulated shocks to see how they respond to unanticipated political, economic or financial events.

In large measure financial markets got Brexit wrong and, if nothing else, this has underscored the need for managers to be careful not to rely too heavily on opinion polls. More resources will need to be allocated to voting patterns and themes (for example, the backlash against globalisation). Some commentators have even asserted that in the future politics may become more important than economics to asset pricing.

Managing Investment Risks

(i) General

Although the emphasis in pension plan asset investment varies depending on the type of plan, whether defined benefit (DB), defined contribution (DC) or combinations thereof, the responsibilities of a plan administrator to address investment risks are similar. In the context of a DB plan the ultimate goal is to generate returns that take into account plan liabilities and cash flow to meet the pension promise. For a DC arrangement, where the administrator provides a list of investment choices from which plan beneficiaries select, the goal is to optimize members' benefits, balancing risk tolerances across the spectrum of choices.

(ii) SIP&P

The plan's Statement of Investment Policies and Procedures (SIP&P) is the starting point and essential building block that addresses investment philosophy and investment risks for both DB and DC pension plans. The SIP&P is the responsibility of the plan administrator. The Pension Benefits Standards Regulations, 1985 (Canada) ("PBSR") requires that the administrator establish a written SIP&P that pertain to the plan's portfolio of investments and loans, other than those relating to any member choice account[1], including policies and procedures pertaining to such matters as categories of investments and loans, including derivatives, options and futures, diversification of the investment portfolio, asset mix and rate of return expectations and liquidity of investments, having regard to all factors that may affect funding and solvency of the plan and the ability of the plan to meet its financial obligations[2]. Moreover, these policies and procedures must be reviewed and confirmed (or amended) by the plan administrator at least once each year.[3]

The SIP&P also serves as the key document to communicate the investment and risk philosophy and associated policies and procedures to investment managers, whether the investment function is in-house or delegated to third party asset managers.

Strategies

(i) Analysing the mix of assets to plan obligations

In a DB context, the starting point to achieve an effective risk management strategy to address investment risk is to complete an analysis of the asset-liability mix of the pension plan to understand the nature of the plan's liabilities, the timing of pension payments and the demographics of the pension plan beneficiaries.

Once the plan administrator has a good understanding of the plan's obligations, it will be able to determine the degree of risk and risk tolerance the plan is able to sustain. These risk tolerances should address such matters as exposure to credit risk (a single entity or group of associated entities) and to market risks (interest rate, currency, etc.). The universe of risks that were enumerated at the beginning of this Pension Alert can be assessed within the context of these risk tolerances.

(ii) Prudence

The plan administrator has a fiduciary responsibility to ensure the pension fund's assets are invested in a prudent manner. The so-called prudent person rule is an objective standard of conduct which references the actions of a prudent person. The rule may also be modified by a higher more subjective standard by requiring the use of skill and knowledge the administrator possesses or ought to possess by reason of its profession, business or calling. The demonstration of the application of prudence in the investment of the pension plan's assets is assessed principally by the process through which investment strategies are developed, adopted, implemented and monitored, in relation to the plan portfolio as a whole.[4]

(iii) Due Diligence

One key element of the prudent person rule is that fiduciaries should exercise due diligence. Due diligence emphasizes processes and the importance of having good governance structure, deliberate decision making, appropriate documentation and recordkeeping and the ability to monitor and assess investment management processes.

Prudence also requires effective delegation to parties such as investment managers with the relevant skills, knowledge and expertise, remembering that the administrator remains responsible for these delegated activities.

(iv) Investment Restrictions, Compliance and Reporting

Most provinces have incorporated the federal investment rules, specifically Schedule III to the PBSR, into their local legislation. The restrictions comprise limits on, among other things, diversification, corporate control and related party investments and transactions. These limits are detailed in nature and can be complex to apply particularly in multi-tier investment structures where underlying commingled vehicles are used. These limits have also undergone a modernization with rule changes effective July 1, 2016.

In the Province of Ontario, an administrator is now under an obligation to file a plan's SIP&P together with a Form 14 with FSCO. Form 14 requires, among other things, certification by the administrator as to compliance with Ontario pension legislation including the federal investment rules. Form 14 contains detailed questions in respect of plan investments, including investment practices and the frequency with which the administrator monitors the performance of the plan's investment managers. Filing of the SIP&P highlights now more than ever, the responsibility of plan administrators to document how investment risks are addressed.

Our next issue of Pension Alert – Pension Risk Management will discuss "Administration Risks".

See our previous issue *Pension Risk Management: Financial Risks*.

[1] Under amendments to section 7.1 of the PBSR which came into force on April 1, 2015, the SIP&P established for a federally registered pension plan does not need to address the assets of a "member choice account" as defined in the PBSR. Instead the Federal Government has introduced a series of disclosure requirements concerning investment options offered under member choice accounts. One of the disclosure obligations is to describe each investment option that indicates the type of investments and the degree of risk associated with it.

[2] S. 7.1(1) PBSR

[3] S. 7.2(1) PBSR

[4] CAPSA Guideline No. 6 Pension Plan Prudent Investment Practices Guideline

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