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Pension Risk Management: The Importance of Oversight

By Susan Mangiero

PENSION OVERSIGHT HAS ALWAYS BEEN IMPORTANT, but perhaps never more so than today. More than a few public and private retirement programs are in financial trouble, the regulatory environment is rapidly changing, "breach of duty" lawsuits are on the rise and market volatility is a constant.[1]

The consequences of incomplete or poor oversight are far from trivial. According to the U.S. Department of Labor, there are "approximately 730,000 private sector pension and 401(k) plans, covering 102 million individuals" subject to the fiduciary provisions of the Employee Retirement Income Security Act ("ERISA").[2] In addition, there are millions of government employees and other participants who are in plans not covered by ERISA, but who are nevertheless dependent on proper governance of their retirement monies.

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Surprisingly, while there is a lot written about general investment fiduciary duties as they relate to retirement plans, there is relatively little information about pension risk control. While that is slowly changing, it is important to understand attitudes about risk management in the pension community.

RISK MANAGEMENT ATTITUDES

The term "risk management" means different things to different people. A traditional interpretation, often used, refers to the use of insurance products to protect fiduciaries against litigation-related liability. Others define risk management as the use of derivative instruments to transform cash flows or minimize market risk. A more comprehensive use of the term refers to the management of multiple risk types—such as financial, operational and legal risks—and assumes some use of derivatives. (This broader definition underlies the discussion that follows.)

Complexity—perceived or otherwise—is another factor. A fiduciary person who is uncomfortable with investment concepts is unlikely to ask tough questions about derivatives, performance metrics or risk control strategies. As a result, consultants and other advisors may feel it is not necessary to spend time discussing the topic with pension clients.[3] Moreover, there is a widely held belief that the delegation of duties to external money managers completely takes care of any further responsibilities on the part of fiduciary persons. In fact, pension plan sponsors still maintain risk monitoring responsibilities in cases where delegation is permitted. [4,5]

Finally, there is the issue of motivation. Unless and until fiduciaries recognize the need to fully incorporate risk management as part of the investment process, it will be difficult—perhaps impossible—to get those in charge to spend the requisite time and money to identify, measure and manage risk. Plan trustees need to assess their comfort level with the status quo by asking questions such as: What risk factors currently affect portfolio value and returns? How is risk mitigated, if at all? And is the risk management strategy uniform across investment strategies and outside money managers?

Whether litigation worries, regulation or interest in implementing best practices will take fiduciaries to the next step is unclear. What is certain is that fiduciaries play a vital role in the financial health, good or bad, of a pension plan. How they carry out their duties is a question of increasing interest to beneficiaries, regulators, shareholders and taxpayers. Having a clear, logical and well-documented risk management process in place can make a big difference. This is especially true if the risk policy comports with prevailing law, reflects relevant economic characteristics of a plan, promotes discipline in the form of adequate checks and balances and offers an opportunity to improve the risk-adjusted financial performance of plan assets on behalf of beneficiaries.

GETTING STARTED

A cornerstone of the pension risk management process is a commitment on the part of senior decision-makers to make resources available. This is easier said than done. Changes to municipal plans, and the related operating budgets, frequently require approval by busy legislators who are under increasing pressure to keep taxes low. Terms and conditions of multi-employer plans are often the result of long, and sometimes difficult, labor negotiations. These plans are rarely, if ever, open to quick change.

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Nevertheless, a top-level commitment to prioritize risk management and make it an integral part of the investment process is essential to success. Why? In addition to authorizing money to buy or upgrade systems, people have to be hired to make and to carry out appropriate policies and procedures. Beyond that, a commitment to risk management affects how and why people are compensated.

Paying people to take excessive risks, in anticipation of higher returns, can be fatal for a pension plan that is obligated by law to make good on its promises. The flip side is to have a structure in place that rewards people for prudent decision-making. That doesn't necessarily translate into avoiding riskier investments. It just means that promotions, bonuses and raises should be tied to allocating assets, selecting securities (if not outsourced) and making risk control decisions that satisfy the goals set forth in the pension plan's investment policy statement.[6]

Of course, establishing a risk management process doesn't happen all at once. Making a commitment to managing risk, and implementing an appropriate reward system, is just the beginning. As shown in Exhibit 1 (right), training, systems, internal controls and effective communication are other essential elements of the risk management process.

It is also worthwhile to note the fact that the activities required to set up and to implement a risk management process are rarely executed in sequence—and can be done concurrently. So it's important to ensure that you have the necessary education, personnel, strategy and systems in place before making any important decisions. For example, buying or improving a computer system makes no sense in the absence of adequate training; authorizing limits will do little good without an adequate system in place to track violations; and failure to communicate results will make it hard to support a budget to pay qualified personnel.

COMPREHENSION AND COMPUTERS

The human resources dimension is another vital part of the risk management process. That includes hiring and training qualified people, not just in trading and analysis but also in operations. The costs of making support staff more fully aware of proper procedure for processing and settling trades is tiny compared to the benefits of minimizing loss. This is especially true when reputation is taken into account, since the monetary damage associated with a single transgression seldom incorporates the lingering effect of bad publicity. A plan sponsor may lose business or incur additional costs in the form of a special audit or regulatory investigation in response to news about back-room problems, model mistakes or poor oversight. Moreover, pension trustees could be found personally liable and incur separate costs to defend themselves.

Providing tiered training to reflect differences in education and experience is also a fine idea. But regardless of seniority and function, employers need to keep one thing in mind when hiring risk management profession-

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*Exhibit 1:

The "Five C" Approach to Risk Management℠

VARIABLE	OBJECTIVE
Commitment	■ Ensure that adequate resources are made available to support risk management activities. ■ Promote an organization-wide risk management culture that results in appropriate compensation and operational policies and procedures.
Comprehension	■ Ensure that all relevant staff members sufficiently understand risk management basics, including the interdependence among departments, to avoid unnecessary losses. ■ Promote risk management best practices.
Controls	■ Mitigate the adverse effects of rogue trading. ■ Stem losses before they get too large.
Computers	■ Review risk-adjusted performance and possibly revise strategies. ■ Identify trading limit violations. ■ Improve fund governance.
Communication	■ Ensure budgetary approval for risk management resources. ■ Instill confidence in beneficiaries and regulators that the plan is well managed.

** This is not an exhaustive list of process components.*

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als: though quantitative skills are paramount, a facility with numbers is not enough. There is no substitute for understanding what makes markets tick and using common sense to know when something seems wrong. Additionally, the ability to anticipate adverse consequences—and investigate further, when necessary—is a hallmark of a savvy risk manager.[7]

In addition, the importance of having a good technology system in place cannot be emphasized enough. Even when a pension fund uses outside firms, trustees are unable to do their job effectively without being able to properly collect data, corroborate external numbers and monitor performance vis-à-vis already established investment goals.

Budgetary constraints, type of assets under management, number of delegate firms and existing infrastructure are just a few of the factors that will determine whether to lease, buy or internally develop a user-friendly system. Similar considerations determine the requisite functions and, by extension, the cost of a system. The ultimate shopping list will vary by the type and the size of a pension plan, as well as by how much an organization can spend and by the ability of staff to understand how to use the system.

Whatever your decision, it is wise to allow for time and money to test the system. Find out what resources are available to train staff. Ask about what money managers use the system and inquire about the underlying algorithms used to measure risk. It would be a shame to spend a lot of money on a system that is hard to use, difficult to modify and incompatible with the performance reports sent by various money management firms.

CONTROLS AND COMMUNICATION

Buying a sophisticated computer system and spending money to train staff is a waste of money unless good controls are in place. Time and time again, losses can be traced back to weak (or nonexistent) checks and balances. Internal and external controls should work together to provide an early warning that something is awry.

If a problem is not picked up at the outset, ideally there should be a mechanism in place to ensure that someone, at some point, is alerted and can take corrective action. Trustees should document internal controls and make them widely available throughout the organization. In addition, pension professionals need to ask auditors and outside money managers about how often their controls are updated and about the process they go through when a violation occurs. As stated earlier, times are changing. Pension fiduciaries are being asked to explain mishaps and neither ignorance nor benign neglect offers a legitimate excuse.

Fiduciaries have two choices. They can adopt a comprehensive risk management policy because they have to or they can choose to do so voluntarily, recognizing the benefits of being proactive and prudent. Either outcome involves communication. In the first case, foul play, once made public, generates ill will and can invite litigation or regulatory inspection. In the second case, pension leaders can let others know that their money is in good hands. Some pension sponsors provide performance numbers. Others add information about investment strategies and/or risk management initiatives. The key is to shed light on the process, not just the results, and to do so in an understandable manner.[8]

THE ROAD AHEAD

As Confucius once said, “A journey of a thousand miles begins with a single step.” If a plan has no risk management process in place, now is the time to move forward.

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For those organizations with an established process, a review and possible revision are in order. Regardless of where fund trustees currently stand with respect to risk control, detailed documentation and justification are crucial.

What was the reasoning behind a particular part of the risk management process? How was the decision made to use derivatives or to forgo their use in lieu of an alternative approach?[9] What is the current compensation arrangement by job function and objectives and does it reward speculation? Who has the authority to change trading limits? How are money managers hired and fired as a function of their reported risk-adjusted returns? What risk metrics are deemed appropriate and why? Process means little without comprehensive documentation that spells out answers to these and many other pertinent questions.

No one is exempt from doing the right thing on behalf of existing and soon-to-be retirees. This is true regardless of plan type.[10] Even honest and well-intended players stand to lose, since fiduciary breach elsewhere has the potential to accelerate an already fast-moving trend toward increased regulation. If that occurs, plan sponsors will lose the flexibility to make important decisions on their own and will incur higher compliance costs, making it that much harder to generate cash flow and to satisfy plan obligations.

Waiting is no longer a viable option!

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END NOTES

1 According to the Administrative Office of the US Courts, new ERISA cases filed rose from 9,167 cases in 2000 to 11,499 cases in 2004.

2 See the February 17, 2004, press release entitled *"Labor Department Issues Guidance on Fiduciary Duties in Response to Mutual Fund Abuses."*

3 In June 2004, the US Department of Labor launched an education program called, *"Getting It Right — Know Your Fiduciary Responsibilities,"* to assist plan sponsors and other fiduciaries in discharging their duties.

4 Plan sponsors need to seek the advice of a legal professional about relevant delegation rules, including the way assignment should take place, who can be a delegated fiduciary and when delegation can occur.

5 Thomas Z. Reicher. *"Pension Alert: Selecting Asset Managers,"* Journal of Financial Planning, April 1993.

6 It makes no sense to invest without first establishing a clear, comprehensive and appropriate policy statement. It provides the roadmap to guide trustees for every aspect of the investment and related risk management processes.

7 For more information, see Susan M. Mangiero's *"Life in Financial Risk Management: Shrinking Violets Need Not Apply,"* AFP Exchange, July/August 2003. Contact the author for a copy of the article.

8 Obtaining information about pension plan performance and investment/risk strategies is far from uniform. Plan type, and related regulation, determines reporting frequency and scope. Moreover, in some cases, it is downright difficult to get timely and detailed data. For a detailed discussion about pension fund reporting, see chapter four of *Risk Management for Pensions, Endowments, and Foundations,* by Susan M. Mangiero.

9 For further information about the role of derivatives in discharging fiduciary duties, see George Crawford's "A Fiduciary Duty to Use Derivatives" *(Stanford Journal of Law, Business & Finance,1995)* and Randall H. Borkus's *"A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivatives Techniques" (Real Property, Probate and Trust Journal, 2001).*

10 Plan type determines the exact obligations of fiduciary persons.