



Deciphering Risk Management Disclosures

When it comes to pensions, beneficiaries, shareholders and policymakers need clear and timely risk management information.

Risk management is one of those topics you either embrace with relish or try to avoid for as long as possible. Several reasons account for this “love it or leave it” attitude, not the least of which is a broad and seemingly arcane vernacular. This makes the subject somewhat of a mystery for the typical investor. Moreover, so little is known about what companies do to manage risk, making it harder for shareholders, lenders and other interested parties to ask concrete questions.

Some may find it surprising to talk about an information-void regarding risk management activity. After all, many organizations are obliged to report information about the use of derivatives pursuant to FAS 133, Accounting for Derivative Instruments and Hedging Activities. Additionally, Section 401 of the Sarbanes-Oxley Act of 2002 directs most companies to report information to the Securities and Exchange Commission about particular types of derivative instruments.

Also, corporate sponsors of defined benefit (DB) plans must now disclose additional information, pursuant to FAS 132, Disclosures About Pensions and Other Postretirement Benefits. Specific requirements address disclosures about assets by category, obligations and cash flows, along with a description of investment strategies, asset allocation numbers and permitted (and prohibited) investments, including derivative instruments.

Pension Plan Transparency and Design

DB plans, the focus of FAS 132, account for a big chunk of private pension plan assets. (A DB plan is a retirement plan that pays benefits to retirees based on a formula that typically takes into account the individual's income over a specified period, length of service and the terms of the pension plan.) A DB plan requires the employer to set aside and invest funds in an amount that hopefully will match existing and future pension-related liabilities. This is in contrast to a defined contribution (DC) plan, where the investment risk is transferred to the employee.

Online Resources

To read more on this topic read “Derivatives Use Unclear When Diagnosing a Pension Fund's Financial Health,” from the January/February 2003 issue of *AFP Exchange* at www.AFPonline.org/exchange.

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There were 56,405 pension plans in place in 1998, accounting for nearly \$2 trillion of assets. Though large, this number reflects a dramatic reduction in plan count since 1983, when 175,143 DB plans were reported. (See “Private Pension Plans, Participation and Assets: Update,” Facts from EBRI, Employee Benefit Research Institute, January 2003.) Higher compliance costs, budget cutting and a need for more flexibility are a few reasons why DB plans have dropped in number over time.

Because risk is transferred to the employee in the case of DC plans such as profit-sharing arrangements or 401(k) programs, the need for transparency is seen by some as less compelling. Others counter that limited investment choices or restrictions such as blackout periods are important to know about with DC plans. However, FAS 132 does not address DC plans.

Why All the Fuss?

The issue boils down to one factor: adequacy. Are established corporate disclosure requirements sufficient to forestall a financial debacle? Does the quantity of information translate into quality that permits readers to identify warning signs before things get out of hand?

These questions apply to financial management in general, not just to the use of derivatives. However, it’s particularly important with respect to the latter because of the leverage associated with their use. More specifically, derivative instruments permit a large exposure to a particular asset class for a small, up-front investment. This can be a boon in good times, but disastrous when things go wrong.

The consequences are far from trivial. Improper leverage that leads to significant losses could be ruinous for plan sponsors or beneficiaries who depend on promised payouts. If a plan were to fail, retirees may have to re-enter the work force to compensate for diminished pension benefits or live on less income. (While basic, private-sector pension benefits are guaranteed, the Pension Benefit Guaranty Corporation doesn’t insure supplemental benefits or benefits over certain levels.) Allegations of fiduciary breach may wind up in court, costing shareholders, taxpayers and plan beneficiaries.

Adequate disclosure about policies, assets, obligations and other characteristics of a DB plan have the potential to pre-empt major losses by focusing attention on what’s being done and why. This assumes information is reported in a straightforward and timely manner.

Report frequency is usually determined by regulatory mandate. Quarterly and annual reporting is the norm for disclosing information to the public. Whether old information is useful depends on many things, not the least of which is market stability. Wide swings in asset values can eviscerate a fund’s surplus or worsen losses in a matter of days or weeks, and few would be wiser until long after this occurs. Unfortunately, this is a fact of life. Given the cost of financial statement preparation, a pension plan sponsor is unlikely to provide detailed information on a frequent basis voluntarily unless users express a real demand.

Selected Questions About the Use of Options

- 1. Why are only options used to hedge equity exposure?** If the goal is to minimize risk, other alternatives may make more sense.
- 2. Are both over-the-counter and exchange-traded options used?** The credit risk, transaction costs and settlement procedures differ by option type. Knowing whether both types of options are used goes a long way in understanding the risk associated with their use.
- 3. How much of the domestic equity portfolio is typically hedged?** In a bear market, an option hedge, if structured properly, can protect a large portion of portfolio value. If only a small fraction of the domestic equity holdings is hedged, pension fund assets are subject to greater losses.
- 4. How often are option hedges re-evaluated and revised, as needed?** An option hedge may start out as effective, but later becomes less so as the relationship between options and stock values diverge. This is why hedges must be monitored and re-sized.
- 5. What type of option structure is used?** Each strategy is unique by virtue of its transaction costs, level of protection against equity movement, risk-return trade-off and sensitivity to changes in asset price, which directly affect the effectiveness of the hedge.

Source: Susan M. Mangiero, BVA, LLC

Good Communication is Everything

Drafting disclosure text that informs rather than confuses isn’t easy, and requires a talented writer who has a good sense of finance and accounting. Moreover, text written for the general audience will likely be unsuitable for someone seeking explicit details.

An example makes the point that providing adequate disclosure is seldom an easy task. Consider the following statement of a hypothetical pension fund. Assume that the declared 10% per annum return goal is compatible with its actuarial estimates regarding amount and timing of benefit payout.

To meet its return goal of 10% per year, DB pension fund XYZ invests 25% in high-quality U.S. corporate bonds, 10% in international stocks, 45% in U.S. large cap stocks and 20% in alternative investments. This asset allocation assignment is reviewed annually and revised as necessary. Options are used to hedge the domestic equity portfolio.

On its face, the announcement provides some valuable insight as to how DB plan assets are invested and the commensurate risk-return tradeoff associated with specified asset classes. However, there’s a lot left unsaid, with regard to the use of options.

In general, an adequate disclosure statement must include detailed information about the exact type of derivative instrument being used. For example, an exchange-listed option often trades in a more liquid market with settlement risk tied directly



Plan Sponsors Say Employer Contributions Have Increased Dramatically

Despite difficult economic conditions, employer contributions to retirement plans increased significantly in 2002. A survey of members of the Committee on Investment of Employee Benefit Assets, (an AFP affiliate known as CIEBA of AFP), revealed that plan sponsors tripled contributions to defined benefit (DB) plans in 2002, totaling \$21 billion in contributions, compared to an average of \$5.9 billion over the previous four years.

CIEBA represents the country's largest pension funds and its members manage almost \$1 trillion. The survey assessed 104 corporate plan sponsors responsible for the management of \$577 billion in pension assets and \$336 billion in defined contribution (DC) plan assets. The plans in the survey cover 9.5 million DB plan participants and 5.5 million DC plan participants.

Survey Findings

In DC plans, employer and employee contributions per active employee totaled \$6,600. This is the eighth consecutive year that per participant contributions increased. The increase in retirement plan contributions took place as year-end assets declined. Both DB and DC plan assets decreased from beginning year levels by 14%. Poor market returns in 2002 contributed significantly to the decline.

Ninety-four percent of CIEBA member companies offer both DB and DC retirement plans. Eighty-six percent of all eligible workers were participants in a DC plan, nearly a 20% increase since 1993. The majority of employees eligible to participate in a DC plan were also covered by a DB plan.

Additional survey findings included:

- DB plans represented the primary retirement plan type provided by CIEBA members. DB plans had 58% more assets, covered 74% more participants and paid out 64% more in benefits compared to DC plans.
- Total contributions to DB and DC plans represented 3.7% and 6.8% of year-end assets, respectively.
- Both DB and DC plan benefit payments represented 9% of year-end assets.

Over half of the assets in both DB and DC plans (56%) were invested in equities. Both DB and DC plan equity allocations decreased from 2001, offset largely by increased fixed income allocations. For DB plans, this change in allocation appears to be largely a result of depressed equity prices and higher bond prices. For DC plans, the percentage of assets in diversified equity portfolios remained relatively stable, while the percentage dedicated to company stock dropped from 36% to 30%.

to the rules of the exchange. In contrast, an over-the-counter option may offer more protection because of flexible terms regarding the size of the hedge.

Deal structure is another important element of disclosure. Consider the following two alternative strategies: 1) Buy a put on domestic equity portfolio and pay an up-front fee; 2) Buy a put and sell a call so the net cash outflow is zero.

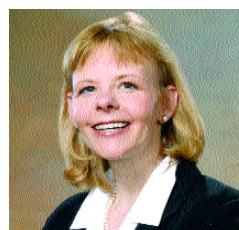
Each strategy provides a way to hedge against a fall in equity values. However, the zero cash strategy — buying a put and selling a call — affords less protection than the outright put. The difference depends on strike price selection and the related factors that determine the option price. (While option pricing models can differ, they share common inputs such as volatility, time to maturity and strike price.) The point is that even when a pension fund discloses its use of similar options, the strategies themselves can differ with respect to economic impact. ■

About CIEBA

CIEBA is the most powerful community of corporate plan sponsors in the United States. To become a member of CIEBA you must:

- Be a senior professional with primary responsibility for the investment of ERISA-governed pension benefit assets
- Work for a corporation with \$1 billion in revenues, or manage \$250 million or more of benefit plan investments
- Participate in an annual profile survey on asset allocation for defined benefit and contribution plans (Individual responses are confidential)
- Contribute annual membership dues

More information on CIEBA membership is available online at www.AFPonline.org/cieba. To participate in CIEBA, contact either Dave Lewis at dlewis@AFPonline.org or Judy Schub at jschub@AFPonline.org, or call 301.907.2862.



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