ERISA Fiduciaries Beware

Risk Is More Than a Four-Letter Word

By Susan M. Mangiero

These are tough times for ERISA fiduciaries. The halcyon days of comfortable returns and simple asset allocations are long gone, replaced with a need for more oversight than ever before. Changing demographics, accounting issues, and anemic financial market returns present problems for private and public plans alike. Yet ERISA fiduciaries find themselves in the unhappy position of explaining losses to impatient shareholders, still reeling from a slew of mammoth corporate bankruptcies and foul play. Not surprisingly, ERISA litigation is on the rise with no end in sight.

According to the Administrative Office of the U.S. Courts, new Employee Retirement Income Security Act (ERISA) cases filed rose from 9,167 cases in 2000 to 11,499 cases in 2004. Panelists at a spring 2004 conference sponsored by the Professional Liability Underwriting Society talked about the "startling" increase in ERISA fiduciary liability class actions. In November 2004, the Pension Benefit Guaranty Corporation announced a fiscal year-end deficit of $23.3 billion, more than double the amount a year earlier, due in large part to plan takeovers of companies in distress. If the past is prologue, shareholder litigation will continue to climb as long as pension losses persist, something that looks inevitable for a variety of reasons.

Even in the absence of fraud, pension plans can still get into trouble. Large business failures in the last few years triggered a wave of litigation over financial issues such as the appropriateness of including company stock in employee savings plans. Unfortunately, benign neglect because of bad judgment or ignorance is a poor justification, giving rise to an urgent need to demonstrate—or develop—a solid understanding of investment and risk management concepts and how they are best applied to a particular plan. This is impossible to do if an individual does not even identify himself or herself as a fiduciary person, something the U.S. Department of Labor discovered in its many audits of covered plans. The Department's response was a nationwide training program, launched in May 2004, to help people recognize who has obligations, what they are, and how to carry them out.

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Taking Inventory

Legislated thirty years ago, ERISA defines a fiduciary person as someone who exercises "discretion in administering and managing a plan or controlling the plan's assets." How this is done can vary from plan to plan, though all fiduciaries must use care and prudence in carrying out activities such as diversifying plan assets, adhering to plan documents, and incurring reasonable expenses. Whether they succeed or end up breaching their duties is an assessment best left to legal experts. Besides, it is not always an easy question to answer. More obvious is the economic reality that inflows have to match outflows. Otherwise, the sponsor can face all sorts of adverse consequences, not the least of which is being forced to provide additional funds. Other possible side effects include breaking labor contracts, violating statutory rules, reporting lower earnings, and suffering damage to the company's reputation.

Conducting a fiduciary audit is a good place to start. The purpose is to assess problem areas before they get out of hand. On the investment front, the objective is to evaluate how decisions are currently made, who makes them, and why. That requires documentation that clearly spells out the process used to fulfill fiduciary duties. Oral assurances are far from sufficient. Exhibit 1 showcases some of the many questions that constitute this vital exercise. In reality, a fiduciary audit looks at many areas besides investment management and should be substantially longer and more detailed. Moreover, a periodic review should be done regularly to form the basis for taking corrective steps in a timely fashion. After all, a problem cannot be fixed without knowing it exists in the first place. This is cold comfort for fiduciaries who face personal losses in the event that things go awry.

Conducting a fiduciary audit has a second advantage. It demonstrates a certain level of care and thereby helps outsiders to better understand the reasoning of those in charge. Getting the exact answer may not be as important as having a systematic and disciplined information-gathering and decision-making process in place. This can be especially helpful in

the event of fiduciary turnover or regulatory inspection or in offering a defense in the event of litigation.

Risk Fundamentals

Investing is a complex process. It varies by type of plan, specific actuarial obligations, and regulatory mandates. The use of outside money managers likewise influences the investment process in both strategic and tactical terms. When done for a pension plan, an apt starting point is an assessment of actuarial liabilities as a way to estimate how much money will be needed, when, and for whom. Asset allocation follows, taking into account any plan restrictions on allowable securities or trades, authorized trading lines, need for liquidity, and, perhaps most important, how much risk is too much and therefore unacceptable. (There are lots of different kinds of risk. In an investment context, risk is thought of as any event that diminishes or completely eliminates the expected return on a financial or real asset.)

Determining risk tolerance is only the beginning. Knowing how to properly measure risk is a cornerstone of the investing continuum, along with how to manage it, and then how to evaluate performance based on risk control techniques. (Investment risk itself can be broken into categories such as legal, market, operational, settlement, liquidity, and political risk.) Entire books are written about these various topics—investment performance, risk measurement, and risk management—so fiduciaries with limited knowledge and experience have their work cut out for them. A house built with shoddy materials or missing parts will be unlikely to weather any storm, leaving occupants exposed and hurt and having to rebuild at great expense.

EXHIBIT 1:
Partial List of Investment Questions to Address

1. What does the investment policy statement allow or prohibit in terms of asset class or type of trade?
2. Who decides on optimal asset allocation?
3. Is the policy updated on a regular basis?
4. Who has authorization to change the investment policy statement?
5. What information is used to revise the investment policy?
6. Who is authorized to trade on behalf of the pension plan?
7. How does the plan measure risk?
8. How often does the plan measure risk?
9. Are returns measured with or without reinvestment assumptions?
10. Are returns measured on a risk-adjusted basis?
11. Are correlation coefficients updated to accurately measure diversification benefits?
12. If outside money managers are used, are their reports easy to compare?
13. If derivative instruments are used, what strategies are used and why?
14. What is the process for selecting and changing fiduciary persons?
15. Do fiduciaries have a working knowledge of investment valuation and risk measurement concepts?

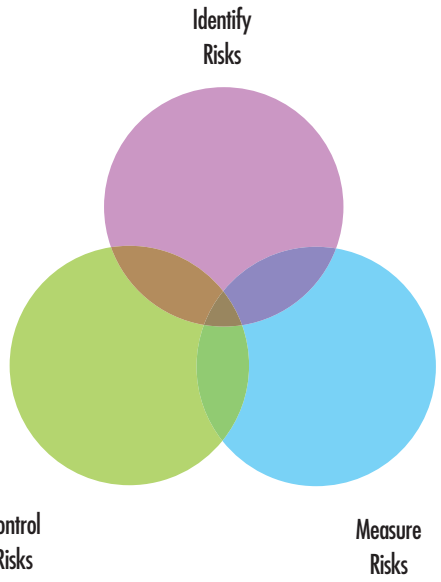
Complicating things is the fact that elements of the risk management process are interdependent. If a fiduciary gets it wrong at one stage, the error is compounded and affects subsequent outcomes. Exhibit 2 illustrates this point. Suppose a pension plan invests in non-U.S. bonds. The fiduciary correctly identifies foreign exchange risk as a source of uncertainty and approves the use of financial futures to hedge that risk. Unless the risk factors that determine hedge size are accurately measured, the hedge will be either too big or too small. In either case, any losses attributable to a poor hedge will affect the performance of the overall portfolio and could encourage additional risk-taking as a way to make up for diminished returns. This notion bears repeating. Bad risk assessment leads to poor decision-making and paves the way for large, sometimes ruinous, losses.

Critics cite risk as a concern for the billions of pension fund dollars being directed to alternative investments such as hedge funds, commodities, venture capital, real estate, or private equity. The promise of higher returns and the chance to diversify the portfolio appeals to many private and public pension plans and accounts for their popularity. This can be a good or bad thing depending on how well those making the decisions understand the risk-return tradeoff associated with these investments. This is especially true when portfolio values can plummet in a short period of time because of inherent leverage or complex structures that make it hard to get out of a position. Making matters worse, not all fund managers provide in-depth information about the risk-return trade-off, and a novice investment fiduciary may not know enough to ask.

Derivatives

An important component of institutional investment management is the use of financial derivatives. Broadly defined, a derivative is an instrument that takes its value in part from the value of a specified underlying asset. For example, the price of a bond futures contract is based on how a specified

EXHIBIT 2:
Investment Process Interdependency



cash bond trades in the secondary markets. There are many types of derivative instruments. Futures, options, and swaps are typical category breakdowns. Although they differ in many ways, futures, options, and swaps share a common attribute. A transaction executed at the start of a specified time period represents today's agreement by the buyer and seller for one or both parties to take action later on. Relevant trade details include price, settlement procedure, timing, and legal venue. This is why many derivative trades are referred to as forward contracts. (Unlike futures, swaps, and hybrid derivatives, option buyers have the right to walk away from a trade once the fee is paid.)

The global derivatives market is huge. The Bank for International Settlements reports an estimated market size of nearly $200 trillion as of the end of 2003 for instruments traded in the over-the-counter markets. Putting this in context, this is almost four times the reported gross domestic product for the entire world. Market size is even larger when exchange-traded derivatives activity is included.

Low transaction costs, flexibility, good secondary markets for common structures, and master contract documentation have each contributed to the continued growth of the derivatives market. Many ERISA pension plans explicitly use derivatives for a variety of reasons, some of which are shown in Exhibit 3. Some investors treat them as a separate asset class. What most fiduciaries do not realize is that, even when derivative instrument use is prohibited, pension plans are nevertheless indirectly exposed if they invest in complex securities such as convertible or callable bonds, mortgage-backed securities, or currency-sharing agreements. Moreover, many large companies are active users of derivative instruments. This means that pensions that invest in straightforward common stocks are logically affected by the way derivative price behavior affects corporate earnings. The same holds true for investments in hedge funds, mutual funds, or any pool of money in which the manager employs derivatives as a strategy tool to hedge, transform cash flows, or enhance returns.

Like anything else, derivatives can be an invaluable addition to ERISA pension plan management, if used properly. In fact, similar to the case of hedge funds and other nontraditional investments, some experts posit that trust fiduciaries who fail to consider the use of derivatives open themselves up to allegations of breach. See Randall H. Borkus, *A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivatives Techniques*, 36 Real Prop. Prob. & Tr. J. 127 (2001).

Documenting discussions and what-if evaluations that should logically precede the use of derivative instruments is a good idea. Derivative use should be spelled out in the investment policy statement as well, either prohibiting their use and explaining why or specifying which derivative products—and related strategies—are allowed. Unfortunately, many plan statements are insufficiently vague and expose fiduciaries to allegations of incomplete analysis.

Fiduciaries cannot ignore the ancillary risks that are unique to derivatives. For example, a pension plan may invest in a long-term bond and then use a derivative instrument to hedge part or all of the risk associated with rising market yields. There is the risk of default on the part of the bond issuer plus the added risk that the derivatives counterparty stops performing before expiration, thereby forcing the pension investor to liquidate at a loss or replace the bad player at a higher cost. Unlike a security, the potential loss associated with a derivative is frequently less than the face value of the trade. Nevertheless, the individuals giving the green light must be confident that the benefit of the combined transaction will likely outweigh the incremental risk associated with the derivative contract.

The enforceability of a derivative instrument contract is another issue. Legal risk merits particular attention, especially in the aftermath of a spate of large bankruptcies involving corporations that defaulted on billions of dollars of derivative contracts. Legal experts and regulators alike are contemplating how best to ameliorate the current uncertainty of how derivative trade counterparties should be treated vis-à-vis creditors.

EXHIBIT 3:
How Derivatives Can Be Used by ERISA Pension Plans

1. Minimize investment risk.
2. Transform cash flows.
3. Synthesize exposure to otherwise unavailable currencies or issuers.
4. Enhance asset returns.
5. Take an anticipatory view of market conditions.
6. Change bond portfolio duration.

Valuation of derivative instruments presents another complication. Some models are intricate, with inputs themselves having to be estimated. This makes it hard for others to validate the model results that are used to measure—and then manage—risks. When the wrong model is used or the right model is applied incorrectly, model risk occurs. As discussed in Susan M. Mangiero, *Asset Valuation: Not a Trivial Pursuit*, 3 FSA Times No. 1 (Institute of Internal Auditors, First Quarter 2004), a model must be tested and reviewed either internally or in tandem with a knowledgeable and independent business consultant. Otherwise, fiduciaries will likely err in how risk is measured, how it is managed, and whether there is enough money to write checks to beneficiaries.

Waiting Can Be Expensive

ERISA fiduciaries have many balls to juggle, not the least of which is recognizing the downside of making poor decisions. If ever there was a time to take preemptive action, this is it. Danger lies ahead, and fiduciaries that choose to ignore the obvious will ultimately be called to task. Too much is at stake for beneficiaries who stand to lose benefits, and for shareholders and taxpayers who will likely be asked to foot the bill.