

## Pension Risk Management: A New Paradigm

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### Introductory Comments

Life in pension land is about to become even more challenging. Lower interest rates, increased retiree longevity, Congressional scrutiny and skyrocketing ERISA litigation vie for first place in the fiduciary hall of fame. Factor in new pension accounting rules with the potential to roil capital markets and it's off to the races. How shareholders react if they see large chunks of equity disappear in a flash has the smart money betting on a serious wake-up call in C-level suites across the country.

While not all companies will struggle with the benefits conundrum—how to attract and retain talented workers while containing costs—one thing is clear. Pension and healthcare programs are no longer the purview of the Human Resources Department. Treasury is front and center and likely to stay there for the indefinite future. No free lunch, pension benefits, post-employment health care and other forms of deferred compensation impact a company's bottom line, debt rating, borrowing capacity, cost of capital and ability to grow. For some organizations, decentralization will shape the benefits-treasury conversation in contrast with an enterprise-wide approach elsewhere. Performance orientation (cost center versus profit center) adds to the complexity. Notwithstanding these differences, ignoring pension risk management is no longer a viable option.

### We're All Risk Managers Now

Risk management means different things to different people. With respect to employee benefits, a host of factors shape the process, not the least of which is plan design, funding status, regulatory environment, corporate culture and available resources. Risk management for a defined contribution plan is no less important than for a defined benefit plan but takes an altogether different form, especially in the aftermath of the Pension Protection Act of 2006. An employer with a disproportionately

gray workforce is likely to emphasize liquidity risk. Currency risk is a consideration for companies with multi-country plans. Troubled businesses grapple with scarce resources and court decrees. Labor negotiations often impact the direction of financial risk management policies and procedures with respect to contractual obligations.

Contrary to what some believe, the use of outside money managers does not obviate the need for oversight nor does it diminish the intense work involved in creating and implementing a robust process to identify, measure and monitor risk on a regular basis. Figure One, an excerpt of a 1996 regulatory letter about derivative use by external money managers, provides some guidance. Experts add that supervision is an integral element of fiduciary duty and applies to all types of ERISA-covered plans and whether derivatives or not.

### Figure One

#### Oversight of External Money Managers

"If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances."

The take away is profound and bears repeating. Plan fiduciaries must take financial risk into account, going well beyond a cursory review. To do otherwise potentially leaves money on the table, reflects poor practices and could expose an individual to both personal and professional liability as relates to breach. Who wants to end up with

her name splashed across the headlines or having to explain to angry shareholders why the pension plan is such a drag on earnings and cash flow? This is especially the case given the availability of countless risk-control instruments and strategies, making it virtually impossible to plead ignorance. Sometimes formalized as a fiduciary duty to hedge<sup>1</sup>, questions such as those shown in Figure Two, come to mind. While no one size fits all, the absence of a documented deliberation of pension risk matters might be seen as troublesome.

### Figure Two

#### Process is Everything

1. How much homework was done to determine the nature of financial risk and how it changes over time?
2. Who is organizationally the owner of the pension risk management process? What impedes good process?
3. Who has the authority to allocate resources for consultants, training, analytics software, data and legal support?
4. Is there a culture of risk-control or risk-taking?
5. How is risk management rewarded or otherwise recognized within an organization?
6. Does an assessment of corporate liability trouble vulnerabilities address pension risk?

### The D-Word

The proverbial 900 pound gorilla, the global derivatives market is estimated at nearly \$300 trillion. Roughly six times world domestic product, futures, options and swaps offer a bevy of potential advantages at the same time that they introduce new risks such as counterparty default. Anecdotally, many pension plans have shied away from

active use of derivatives, only now testing the waters with liability-driven investing.<sup>2</sup> Explanations include a desire to avoid the leverage oft-perceived as associated with derivatives, a few highly-publicized debacles involving peers, limited staff to monitor positions, organizational pressures to avoid the complex and outsourcing to professional money managers. A forthcoming survey co-sponsored by the Society of Actuaries and Pension Governance, LLC examines pension fund risk management policies and procedures, use of derivatives and inhibiting factors.

Global guidelines and standards exist and may encourage the use of derivatives by pension plans. In its recent policy paper, the Organisation for Economic Co-Operation and Development offers that “legal provisions should address the use of derivatives and other similar commitments, taking into account both their utility and the risks of their inappropriate use”. Of course what is suitable for one organization may prove wholly unsatisfactory to another. Entire books address the topic of derivatives because there is indeed a lot to cover. Valuation, hedging techniques, risk quantification and assessment of competing alternatives are a few of the many topics that demand attention. Suffice it to say, significant and sustained appeal accounts in part for the exponential growth in market size.

## Points to Ponder

Pension risk management is the new paradigm. Employees, retirees and shareholders alike expect plan stewards to undertake a comprehensive, and ongoing, assessment of whatever techniques can possibly help companies keep their word. Effective pension risk management is a sub-set of good corporate governance and a logical extension of treasury’s work. Whether derivatives or some other type of financial engineering is part of the process remains to be seen. What is not in question is the need to act now by recognizing that risk is truly a four-letter word. ▲

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1. See “A TRUST FIDUCIARY’S DUTY TO IMPLEMENT CAPITAL PRESERVATION STRATEGIES USING FINANCIAL DERIVATIVE TECHNIQUES” by Randall H. Borkus, 36 Real Prop. Prob. & Tr. J. 127, Spring, 2001.

2. A common misperception on the part of pension fiduciaries is that their plan has no exposure to derivatives. To the contrary, exposure exists in the form of investments in convertible stock, callable bonds, mortgage-backed securities and pooled funds that actively employ derivatives.