

CREATING A FIDUCIARY RISK STRATEGY

By John Por and Tom Iannucci

benefits.canada.com

When Canadian corporations think about risk management, they tend to think more about the investment world than about the structure of their pension plan. But as the pension industry evolves, these modern times bring new challenges – and new concerns. Today there's a new concept that's giving the term "risk" a whole new connotation. "Fiduciary risk" is taking on compelling meaning in the Canadian pension marketplace. It is also requiring that sponsors, particularly defined contribution (DC) pension sponsors, rethink the nature of corporate risk management.

The complexities that arise when companies move from defined benefit (DB) to DC pension plans are frequently discussed. Fiduciary risk, however, usually isn't one of those complexities. In the world of pension governance, many sponsors assume that by moving to DC plans, sponsors eliminate corporate liability for most aspects of plan performance by shifting key areas of responsibility to plan beneficiaries. Not entirely so. In fact, Canadian plan sponsors today still have significant obligations with respect to their DC plans.

Unless the nature of this fiduciary responsibility and potential liability is better understood, there will be bumps along the corporate pension road in the future.

.....

BACK TO BASICS

Let's go back to some of the basics of DB and DC plan design to see where the problem lies. DB pension plans require that the corporate sponsors pay pension benefits to retirees regardless of the investment performance of the plans' fund. Within DC plans, pension benefits are an individual matter, linked directly to the investment choices made by each employee or participant in the plan. While the DB plan sponsor is responsible for all aspects of fund management – such as investment performance, strategic asset allocation and related policy issues – the DC sponsor is not. Similarly, while DB plan participants don't need to concern themselves with asset allocation decisions or performance monitoring, members of DC plans must make that a priority. Since DC plan participants are entirely responsible for their own investment decisions, they are also responsible for any underperformance that may negatively impact the growth of the asset base required to fund their retirement.

So far, the differences between DB and DC plans seem obvious, and the parameters of sponsor/employee responsibility clearly defined. But perhaps they are not. While DC plans may reduce a sponsor's direct exposure to fund performance risk, it does not absolve him of responsibility for what might be termed "contingent liabilities" for many aspects of a plan. Many Canadian plan sponsors, however, haven't acknowledged the implications of this nuance.

Creating a Fiduciary Risk Strategy

By John Por & Tom Iannucci

To begin with, minimum fiduciary standards for DC plans still exist. Sponsors are expected to provide an appropriate overall investment program that will allow plan members to meet their retirement needs. As well, the initial selection of investment managers and fund options remains crucial. Given the broad universe of investment options that employees – as ordinary consumers of financial products – have to choose from (such as indexed, global, derivative funds), failure on the part of the sponsor to provide comprehensive investment choices in-group and other DC plans is a mistake. The days of the plain vanilla GIC or balanced fund option are clearly over – sponsors must put thought into these choices.

An efficient back office operation for plan administration, reporting and monitoring is also key, as is the critical area of investment education and communication.

These are obvious forms of fiduciary responsibility – or liability depending on your point of view. It is in the gray areas where problems can arise.

DB plans provide employees with assurances. In DC plans, they line their pension nest eggs with expectations. One of the thorniest areas of fiduciary risk for the plan sponsor today is potential member dissatisfaction arising from:

- ❖ A lack of investment options offered by the plan;
- ❖ Manager underperformance;
- ❖ Gluttonous fees; or
- ❖ The quantity and quality of the investment and retirement education provided by the sponsor.

.....

MANAGING EXPECTATIONS

In the DB world, employee expectations are easily satisfied by a casual glance at the annual projected retirement income statement. DC plans, on the other hand, may expose the sponsor to new and greater risks, unless member expectations are managed.

The irony is that DC plan members cannot be expected to have the same level of investment knowledge as the traditional pension committee – yet, in effect, DC plans require that employees be their own pension committee and take ownership of the critical investment decisions necessary to fund their retirement.

Now that we have identified the nature of the problem, what is to be done about it? The first step is to define fiduciary risk management. Arguably, it is impossible to eliminate all risks that a corporate sponsor faces with respect to its plan members – and that is really not the point. No one expects a chief financial officer to create perfect hedges for the corporations' interest rate or foreign exchange exposures.

Effective risk management implies exercising acceptable – not necessarily absolute – standards of prudence based on a clear understanding of the risks that now belong to plan members as opposed to the plan itself, as was the case in the old DB plan days. By identifying these risks in a realistic way, sponsors can succeed in demonstrating that they have been prudent with respect to their remaining fiduciary obligations to DC plan participants. Just as in all other areas of a corporation's risk management function, understanding the true nature of risk represents the lion's share of the risk management solution.

Creating a Fiduciary Risk Strategy

By John Por & Tom Iannucci

Further help is at hand. DC plans can benefit from reviewing their governance policies in light of industry best practices. This review should focus on key areas of decision-making:

- ❖ The design of the fiduciary accountability structure;
- ❖ Member communications and education;

.....

AN INDUSTRY CONCERN

Plan Sponsors Should Never Underestimate The Importance of Addressing DC Plan Risks

The accepted structure of effective risk management – congruence between the hierarchy of risks and their management – is often ignored in most defined contribution (DC) arrangements. This may be due to sponsor's ironic, but fundamental, misunderstanding about the nature of DC pension risks. This lack of understanding could cause a backlash should retirees deem that their retirement income is less than it ought to be and seek redress from the sponsor. This risk is legal in nature, not subject to easy control and can be triggered by any plan member.

The organization's risk posture, however, is often set without a thorough understanding and debate by corporate executives. Contrast this with who is involved in controlling DB risks (that is, setting the asset/liability mismatch) – the board of directors, the chief executive officer, the chief financial officer and the investment committee.

Human resources professionals are advised to specifically seek and receive executive approval of the desired risk posture of their DC arrangement.

- ❖ Reporting systems; and
- ❖ Committee operations

Equally important as member education is building and maintaining the knowledge base of those who supervise the plan is also important. As well, all review and decision-making processes should be approved at the appropriate levels (by senior executives and even the board of directors) to ensure a higher level of accountability. It is also beneficial to allocate the highest-ranking items in the risk hierarchy to senior executives to ensure that appropriate decision-making authority is utilized.

In terms of implementing fiduciary risk management processes, prudent sponsors should create written policies for each identified area of risk and should set up monitoring systems for each policy. Where policy implementation is delegated to staff, it is prudent to ensure that it is monitored regularly so that senior management is involved in the process.

The ongoing effectiveness of any DC plan is the result of establishing a clear, predetermined understanding of the risks being managed and the philosophy inherent in the design of the investment program. Without sufficient clarity on these issues, DC pension plans will invariably be ill conceived and sponsors will unknowingly expose themselves to liability.

Creating a Fiduciary Risk Strategy

By John Por & Tom Iannucci

The DC plan sponsor must be willing to wear many hats to ensure that fiduciary responsibility is upheld and fiduciary liability managed. The pension plan risk management hat is just the most recent.

GAME PLAN (SIDE-BAR)

In order to put theory into practice, here are seven steps to creating a DC plan risk management strategy.

1. Determine the risks. Once you decide to implement a DC plan, clearly determine the risks that the company must assume, and those the plan members must assume.
2. Prioritize the risks. Sound governance requires that you establish a clear understanding of the decisions involved in the process of establishing a DC plan. Investment options, member education, member communications, committee structure and procedures, monitoring and oversight requirements and fiduciary education are key areas that require detailed risk analysis.
3. Educate the players. Make sure plan fiduciaries are knowledgeable about their responsibilities. They must be able to make the critical policy and oversight decisions that affect the success of the plan. Staff members, who oversee the corporate pension plan have many other day-to-day responsibilities – proper support and guidance are vital.
4. Take your time. In their efforts to roll out a new plan quickly, sponsors tend to focus most of their attention on selecting investment options and hiring investment managers. Relatively little time is devoted to clarifying the objectives of the plan, identifying the relevant risks and determining the sponsor's stance with respect to each risk area. Underestimating the importance of these issues can have negative consequences for the plan in the long term.
5. Be thorough about your investment policy. Identify key implementation issues prior to rolling out the plan, selecting investment options and choosing managers. This will require a risk management framework and a plan "blueprint" based on senior management's input. The blueprint can also be used by actuaries or other consultants to design the investment program. Then prepare a critical path that will ensure efficient and cost-effective implementation of the newly designed plan. Determine such things as:
 - ❖ The appropriate number and type of investment options, including retirement options;
 - ❖ Use of active versus passive management;
 - ❖ Appropriate use of balanced options;
 - ❖ Investment management styles;
 - ❖ Investment manager selection; and
 - ❖ Termination policies and procedures.

Creating a Fiduciary Risk Strategy

By John Por & Tom Iannucci

6. Follow through. Given that DC risk is different from DB risk, it's important to set up reporting processes that monitor the effectiveness of the risk plan. Some items to be covered are ensuring that:

- ❖ External investment managers have complied with their mandates;
- ❖ The investment program continues to be appropriate;
- ❖ Member education initiatives are effective;
- ❖ Member communications are appropriate;
- ❖ Committee operations are effective; and
- ❖ Legislative and regulatory compliance is maintained.

Accomplishing these objectives requires designing a reporting process and performing data collection and analysis, including, if necessary, member focus groups and survey research.

7. Make education and communications a priority. The most obvious difference between DB and DC plans is that DC members require varying degrees of retirement and investment education and communication. Failure to provide adequate support in these areas may expose sponsors to risk if plan members' decisions result in sub-par investment performance and unsatisfactory pension benefit levels.

John T. Por is president of Toronto-based Cortex Applied Research Inc., a management consulting firm for large pension funds. Prior to founding Cortex, Por was a national partner with William M Mercer. Tom Iannucci is a managing director of Cortex. He has advised many of the largest US pension plans on their fiduciary risk management and governance processes.

.....