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Regulation Sector
Office of the Superintendent of Financial Institutions
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**Subject: Pension Investment Risk Management Consultation Paper**

The Canadian Institute of Actuaries (CIA) applauds the Office of the Superintendent of Financial Institutions (OSFI) for issuing a consultation paper on pension investment risk management.

Actuaries are often involved in helping plan administrators assess and manage risks. While investments involve certain types of risks, it is more important to focus on the combination of asset and liability risks since certain asset risks may be offset (or magnified) by related liability risks. Therefore, we believe it is preferable not to develop guidelines that focus strictly on investment risks; it would be preferable to incorporate investment risks into guidelines that address risk in a holistic manner.

Furthermore, the document states that OSFI is considering developing investment risk guidelines but also states that the Canadian Association of Pension Supervisory Authorities (CAPSA) is expected to develop new guidelines regarding various plan risks – we would strongly encourage OSFI to work with CAPSA, since these issues are relevant for plans in all jurisdictions. In addition, we would like to highlight that some of the items mentioned in the document may already be included in each plan's statement of investment policies and procedures (SIP&P) or other governing documents. We would suggest that any new guidelines consider what is done through the SIP&P and other governing documents and avoid new overlapping requirements. Similarly, with respect to the issue of private investments that are not valued by open markets on a regular basis, we note that auditors have professional standards to follow in the review of asset statements, so pension regulators should recognize that plan administrators can rely on auditors and consider any caveat that might be included in their reports.

We believe that it is critical for pension plans and their sponsors and administrators to understand, manage, and report on the risks they face in a robust and transparent manner. The approaches outlined in OSFI's consultation paper are largely consistent with the approaches employed by the largest public-sector pension plans in Canada. Many of these plans are governed and operated as stand-alone entities managed separately (at arm's length) from the participating employer(s). These plans tend to have an independent risk oversight function that is separate and generally independent of the investment decision makers.

It is not clear to us that following the same approach is practical or appropriate for mid-size and smaller pension plans, or for single-employer plans where the sponsoring employer also has responsibility for administering and overseeing the pension plan. Adopting the proposed structure could be deemed as excessive, duplicative, and add to the significant administrative burden and cost of running a defined benefit (DB) pension plan. A regulatory requirement to establish and maintain such a structure could serve as a disincentive to maintaining a DB plan.

We believe that it is possible for these types of plans to manage and report on risks effectively without having to adopt the independent risk reporting structure outlined in the consultation paper. We have provided further comments on this in our responses to the questions below.

We would appreciate more context on OSFI's findings regarding current risk management practices. Does OSFI believe that risk management practices at pension plans are deficient on a widespread basis in the four selected areas covered by the paper? If the issue is concentrated among a small subset of plans, it may be more effective to raise these issues with the plans rather than issue detailed guidance. A one-size-fits-all approach could be disruptive and burdensome to plans which already employ good risk management practices.

We have chosen to respond to selected questions from the consultation.

1. *How have independent risk oversight functions been successfully implemented by pension plans?*

   Risk oversight is most commonly implemented through the segregation of duties. The largest investment risk, being the asset/liability mismatch risk, is managed through the investment policy, which is typically developed through conducting regular asset-liability studies. Many large plans have a pension committee at the board level that oversees all aspects of the pension plan, including the adoption of the investment policy; hence, this group effectively serves as the oversight body.

   Having a plan's investment activities reviewed by an internal audit function would likely be ineffective in assessing investment management risk processes, except for the largest pension plans operating as stand-alone entities or organizations managing financial risks as part of their core business (i.e., banks), as few auditors would have the knowledge and skills necessary for complex investment strategies.

   Internal audit functions are effective to ensure there is a segregation of duties. External auditors are already tasked with assessing certain risk reporting and mitigations.

2. *How do pension plans anticipate implementing an independent risk oversight function as outlined in this consultation paper?*

   The fiduciary responsibilities of the plan administrator encompass prudent management of risks. While plans may establish risk frameworks, and adopt approaches to assess, monitor and report risks, for most plans it is not realistic to have a separate risk oversight reporting stream and risk professionals that sit outside of the investment process. In practice, it

would make more sense for the risk professionals to be integrated with the investment process such that they can support investment decisions with a risk perspective.

The more the investment process is concentrated, the more an independent risk oversight function becomes necessary. For example, plans that invest funds internally should consider independent risk controls, whereas plans that use external fund managers already achieve significant independence between operations and oversight.

3. *OSFI believes that an independent assessment of pension plan investment risk is a sound principle. However, not all plans have the level of risk that would merit an internal independent pension risk expert. How should pension plans with less complex investment strategies achieve the benefits of this principle in an effective way?*

   Less complex investment strategies are not necessarily indicative of a reduced level of risk. A plan may have a simple investment strategy but may still be exposed to substantial investment risk, often due to asset/liability mismatch. The survey shows that asset/liability modelling is one area that has widespread adoption. Such modelling is usually conducted by third parties with the necessary expertise. In our view, this approach permits a better assessment of risk.

4. *What do you consider to be the key risk limits for pension plans?*

   At the most basic level, risk is the possibility of failing to meet the objectives for the pension plan. Consequently, it is important for plan sponsors and administrators to establish and articulate clear objectives to measure and manage the risk of not meeting those objectives. The appropriate risk metrics and limits will vary based on the unique circumstances of the pension plan and the objectives that are established by the sponsor and administrator, considering applicable regulatory requirements.

   Most pension plan sponsors can articulate risk metrics and limits that measure their objectives with respect to pension costs (e.g., contribution requirements or pension expense exceeding a certain threshold). However, it is also important that risk metrics and limits be established that measure the primary objective of the pension plan which is to deliver on the pension promise. These risk metrics and limits could be related to maintaining the funded or solvency ratio of the pension plan at a certain level, maintaining sufficient liquidity to be able to make the pension payments under a stress scenario, etc.

   Examples of key risk limits are as follows:

   - Limits on the likelihood of solvency ratios falling below certain threshold levels.
   - Limits on the likelihood of costs (contribution rates or pension expense) exceeding certain levels.
   - Asset class limits (i.e., asset mix) – the most significant determinant of investment performance (and risk) is the asset mix policy of the pension fund. The long-term asset mix target, as described in the plan's investment policy, should be determined with

reference to the plan’s objectives (and, therefore, its various liabilities and funding requirements), and is typically based on an asset/liability study. Upper and lower ranges for each asset class help to constrain deviations from the target mix, keeping in mind implementation considerations for certain types of alternative asset classes (e.g., it may take some time to get fully allocated into private market assets, depending on the investment structure used). Deviations from the long-term asset mix (outside of the defined ranges) could detrimentally impact the risk profile of the plan and should be reported regularly.

- Concentration limits – diversification is another key tool for mitigating risk of investment return volatility. The investment policy should specify the single asset concentration permitted – it may refer simply to the legislative requirements or could go further to limit any single asset exposure to no more than x% of the fund’s market value. Limits on concentration by geography, sector, counterparty exposure, foreign-currency exposure, or within-asset-class sectors are additional examples to be considered.
- Credit quality – the acceptable investment grade for corporate fixed-income investments should be defined in the investment policy, and expected credit loss limits could be imposed if they are expected to be material.
- Leverage limits – in certain circumstances, using leverage can be appropriate in a pension fund. Depending on how it is used, leverage could either increase or decrease overall risk. For example, employing leverage to invest in liability-matching bonds could reduce risk. Consequently, it is important to not place blanket limits on leverage without consideration of how it is utilized. If leverage is utilized in a manner which increases overall risk, leverage ratio limits should be defined and monitored.
- Liquidity coverage ratios (short and long term) should also be measured and monitored as relevant depending on the maturity profile of the plan and the cash requirements of the investment strategies (e.g., for currency hedging and other derivatives).

5. *How do pension plans anticipate implementing risk limits?*

Most of the risk in pension plans results from the intentional mismatch between assets and liabilities. This mismatch could result in significant volatility in the funded status and costs of the plan. Consequently, a natural way for plan sponsors to develop risk limits is as part of their asset-liability study process, the primary purpose of which is to establish a strategic asset mix. The process should involve developing risk metrics that measure the likelihood of the plan objectives being met, based on each asset mix being considered.

Plan sponsors and administrators should have the flexibility to define whether to employ hard risk limits that cannot be breached or softer risk tolerance measures that identify when the plan’s risk profile is outside its desired risk appetite. We have seen both models work effectively in practice.

Asset-liability studies are typically conducted every three to five years, so these risk metrics, risk limits, and/or risk tolerances would typically be reviewed and reassessed based on that

frequency. We believe that this is appropriate as a minimum standard, recognizing that pension plans are long-term in nature. However, reporting on some or all these metrics on an interim basis between asset-liability studies (e.g., annually) should be strongly encouraged.

Once the risk limits are established, reporting against the risk limits or tolerances would be the responsibility of the asset manager (in the case where a single organization is responsible for the management of the pension fund), or of an external advisor with sufficient access to the underlying information to produce such reporting (e.g., an outsourced chief investment officer or investment consultant). The body responsible for overseeing the risk limit/tolerance reporting should review the reporting regularly (as defined in their specific governance framework), and ensure that, if risk limits are breached, remedial action is planned and implemented.

6. *How will the implementation of risk limits impact the investment management activities of pension plans, if applicable?*

   As noted above, establishment and measurement of risk metrics, limits, and tolerances should be an integral part of conducting an asset-liability study. The asset-liability study will help the administrator determine the appropriate target asset mix, acceptable ranges around the target mix, and potential constraints regarding maintaining a minimum level of liquidity. Consequently, the establishment of these risk limits or tolerances will constrain the investment management activities to maintaining the asset-liability mismatch within certain bounds and maintaining sufficient liquidity to pay pensions even under a high stress scenario.

   In all cases, the risk limits or tolerances must be communicated to the investment managers for the plan, and reporting parameters need to be defined. The ease or difficulty of implementation of pension fund risk limits/tolerances will depend on the asset management structure in place. Where asset management is decentralized and implemented through multiple managers, risk limit reporting will need to be aggregated to ensure correct reporting. For example, multiple managers may be investing in a particular company's equity. Each manager may be invested below the concentration limit for their portion of the portfolio; however, if other managers are also investing in that same company's equity, the portfolio exposure could exceed the concentration limit. In this case, the allocation of the risk limit to individual investment managers should account for the number of managers for that asset class.

7. *What are key tasks that a plan administrator should carry out to identify which risk limits should be in place and how often they should be monitored?*

   As noted above, the risk metrics, limits, and tolerances should be tied to the objectives for the plan. The administrator should ensure that the metrics, limits, and tolerances appropriately measure the risks facing the plan. The risk limits or tolerances should be

reviewed and revised whenever the plan objectives and/or investment strategy are established or revised. Risk metrics, limits, and tolerances should also be reviewed and assessed whenever an asset/liability study is performed.

The appropriate frequency of monitoring risk metrics, limits, and tolerances will depend on the complexity of the pension plan's investment strategies and risk profile, and the sophistication of the plan sponsor and administrator. A minimum standard should be to monitor the risk limits/tolerances based on the same frequency as asset-liability studies. However, many larger plans monitor risk metrics, limits, and tolerances more frequently – as often as annually and, in some cases, quarterly.

10. *How do plan administrators evaluate third-party valuation processes and procedures?*

The valuation policies and processes for private assets are evaluated versus standards established by professional bodies and industry organizations, varying by asset class. Assessing the appropriateness of the valuation methods and frequency should form part of the due-diligence process prior to engaging third parties, such as external investment managers. The investment monitoring process should identify and review any changes in valuation processes and procedures. We expect, at minimum, an annual independent valuation from well-established firms, with a second review by auditors. However, during periods of stress, private valuations are slow to adjust and more frequent valuations should be considered during these times.

11. *During periods of market stress, how do plan administrators ensure that third-party valuations (e.g., investment funds) reflect fair market value?*

Plan administrators would engage with external investment managers and other third parties to assess the impact of valuations lagging market stresses. This process can involve looking through the funds to the underlying assets and considering how such assets are affected by the market stressors or assessing the impact at an asset class level (e.g., retail real estate). Though lagged valuations may result in a delayed recognition of market stressors, the implications thereof may be modest given the long-term nature of pension plans. Ultimately, if the plan remains ongoing, the effect becomes a timing impact, particularly as contribution requirements are often determined annually. Of course, the implications of lagged valuations could have a significant impact if the plan were to be terminated while the plan sponsor became insolvent.

12. *Please describe examples of successful implementation by smaller plans that pursue less complex investment strategies of one or more of the risk management principles described in this consultation paper. What challenges were encountered, if any, and how did plan administrators adapt their approach?*

The approaches for smaller plans should be similar as for a larger plan, and we note that the size of the plan should not determine the approach. Smaller plans tend to have less

exposure to private assets and tend to employ little or no leverage or use of derivative strategies. Plans which employ less complex strategies will generally need to be less concerned about liquidity risk than plans which do employ these strategies.

The approach for plans which use simpler strategies should be primarily based on the size of the asset/liability mismatch and the sponsors ability to fund that risk, not on the level of complexity of investment strategies.

For example, a plan invested 100% in pooled equity funds may be exposed to material asset/liability mismatch risk that a sponsor may not be able to fund.

Sponsors of smaller plans generally size their approach based on time, effort, and ability to fund a mismatch risk, but the approach is similar in that they articulate risk metrics to be adhered to, establish an investment policy, engage with outside professionals, and have independent oversight (e.g., a board of directors).

Costs for implementing any approach can be a challenge that is weighed against the sponsor's ability to tolerate and fund the asset/liability risk resulting from the investment policy.

For a smaller plan, a sponsor often engages external consultants to articulate a strategy based on risk metrics that the sponsor sets. The analysis performed will generally be commensurate with the sponsor's ability to fund.

13. *How should smaller plans that pursue less complex investment strategies implement the risk management principles described in this consultation paper?*

    Sponsors of smaller plans generally size their approach based on time, effort, and ability to fund a mismatch risk. The principles, however, are often consistent in that they establish a risk framework consistent with their ability to fund and the costs associated with a specific approach.

14. *What controls or practices can be put in place to ensure that plan administrators of smaller and less complex pension plans are kept informed when their pension plan is approaching levels that are outside of their risk tolerance?*

    Several controls and practices are in place today. Sponsors are generally required to issue audited financial statements in which the pension plans are reported, the plans perform funding valuations filed with regulators, contribution plans submitted to the trustee are developed, pension fund financial statements are prepared, and performance reporting (of either plan assets or funded status) is prepared. These all serve to keep sponsors and administrators informed of the effects of market conditions on their pension plan and the associated funding risks that evolve.

15. *What are examples of risk management strategies implemented for defined contribution plans that address the principles described in this consultation paper?*

    Risk management strategies for defined contribution (DC) plans are different in nature as the plan member bears the investment risks by design of the arrangement. This means the members may make decisions based on their own risk appetite and ability to withstand volatility, and where they themselves can control how and when funds will be accessed. Sponsors may limit the type of investment options based on the record keeper's abilities to administer and report on the investment options and/or their member's ability and willingness to make investment decisions. As investment risk resides with members, some of whom are not educated to deal with certain risks, sponsors may also provide investment vehicles that provide a pre-determined path to limit the members exposure to adverse events as they approach retirement ages (e.g., target date funds). DC arrangements also have different liquidity needs at member retirement, when the assets must be available to purchase retirement income or be transferred to an individual vehicle, which is fundamentally different than a DB plan that pays benefits over the lifetime of the retiree and spouse.

The CIA appreciates the opportunity to provide feedback on these issues, and we would welcome further discussion with you throughout this process.

If you have any questions, please contact Chris Fievoli, FCIA, Actuary, Communications and Public Affairs, at 613-236-8196, ext. 119, or chris.fievoli@cia-ica.ca.

Sincerely,

[original signature on file]

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