Canadian Institute of Actuaries | Institut canadien des actuaires

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CAPSA Secretariat
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Subject: CAPSA Guideline – Leverage and the Effective Management of Associated Risks

The Canadian Institute of Actuaries (CIA) is pleased to provide our comments on this consultation.

The draft guideline identifies many important principles for the prudent management and oversight of pension plans, specifically, related to the use of leverage as part of the investment strategy. The use of leverage, as noted, can either reduce or increase the mismatch between pension plan assets and liabilities. As actuaries, we agree, as stated in section 4.1 of the draft guidelines, that plan administrators must consider the impact of leverage holistically from an asset-liability perspective (i.e., on the plan's funded status) rather than an asset-only basis.

Our specific comments on the draft guideline are as follows:

1. Leverage is ultimately an investment decision

The use of leverage is ultimately an investment decision. Although this is alluded to in the draft guideline (e.g., by referencing investment decision-making process and the need to document investment decisions in documents such as the statement of investment policies and procedures), the guideline could be simplified by explicitly acknowledging that leverage can be an investment decision and noting that all existing regulatory guidance that applies to investment decisions also applies to leverage. This would then allow references to topics such as establishment of risk tolerance, decision making, reporting and oversight structures, and documentation of the decision to use leverage to be removed and/or shortened. Because these topics are already covered in existing guidance related to investment decisions, this would also reduce the risk of potential conflicts (now or in the future) between the leverage guideline and other regulatory guidance. It would also allow the draft guideline to focus on the specific issues that apply to use of leverage.

Alternatively, rather than issuing a standalone guidance document on leverage, CAPSA could consider expanding CAPSA's Guideline No. 6 (Pension Plan Prudent Investment Practices Guideline) to include a section related to the use of leverage, and include the specific principles identified for the prudent management and oversight of the use of leverage. This approach has the advantage of providing a self-contained document that addresses all relevant investment practices.

Finally, some of the items mentioned in the draft guideline would typically 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.

2. Definition of leverage should be consistent with market practice

The draft guideline defines leverage as a “means of achieving economic exposure greater or lesser than the capital invested.” This definition is inconsistent with market practice, which defines leverage as achieving economic exposure greater than (not lesser than) capital invested. As such, our recommendation would be to change the definition of leverage in the guideline to be consistent with market practice. This would mean defining leverage as a “means of achieving economic exposure that is greater than the capital invested.”

We believe that the current definition of leverage (i.e., market exposure greater or lesser than the capital invested) may have been used in the draft guideline because reducing market exposure through derivatives can lead to similar non-market risks as using leverage (e.g., counterparty risk, credit risk, liquidity risk, etc.). Although we acknowledge that this is the case, we believe that this would be better addressed in a separate guideline on use of derivatives as has already been done by several Canadian pension regulators.

3. Consistent with other CAPSA guidelines, the guideline should be principles-based and detailed technical appendices should be removed

This is the first guideline document where CAPSA has included detailed technical information, such as specific classifications and measurements for several types of leverage. The draft guideline provides principles-based guidance on the use of leverage, while also detailing several measures of leverage. This is inconsistent with CAPSA’s past approach of issuing principles-based guidance. The principles-based portion of the guidance would be most helpful to all plan fiduciaries, while the detailed technical guidance would likely not be helpful to that audience. The larger, more sophisticated plan operators/investment managers would also likely not find this technical guidance helpful, as they are likely to have already developed appropriate measurements. For the mid-sized and smaller plans using pooled investments, the guideline has already acknowledged that it is likely not practical to adopt any of these measures. Rather than the detailed technical guidance, it may be more helpful to outline a series of questions that plan administrators and fiduciaries should be asking their investment managers and investment teams to gain insight into the ongoing application of leverage and to facilitate appropriate reporting and risk monitoring.

In addition, the measures outlined in the appendices are not specific enough to result in consistent interpretation and comparable results across plans. As such, our suggestion would be to remove Appendix A (and all references to specific measures of leverage) from the draft guideline and focus the guideline on principles-based guidance. Alternatively, if the decision is made to leave measures of leverage in the guideline, then Appendix A should be rewritten to achieve more consistency and comparability across plans.

4. Suggestion to document expected risk and return with and without use of leverage should be removed from the guideline

The draft guideline suggests that plans could document expected risk and return with and without the use of leverage (section 5.2 and appendix A section 2.1). However, the portfolio without use of leverage would, depending on the type of leverage, be different from the unlevered version of the plan's asset mix that simply removes leverage by proportionately reducing allocations. The use of leverage should and typically is considered and evaluated as an integral part of the investment process and is not independent from the setting of the strategic asset mix. Therefore, most plans that employ leverage would have difficulty identifying the asset mix that would exist without the use of leverage. Said differently, a pension plan stating its risk and return expectations with and without use of leverage is similar to stating its risk and return expectations with and without use of public equities (or any other asset class) – in and of itself, this disclosure alone does not add value, and is neither practical nor efficient.

The CIA appreciates the opportunity to provide feedback on these issues, and we would welcome further discussion with you throughout this process. We would like to note that CAPSA has recently released a number of consultations at the same time and with a relatively short review period and similar due dates. In order for our volunteers to provide appropriate feedback, we kindly request that consultations are released with more time and throughout different times of the year as much as possible.

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,

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