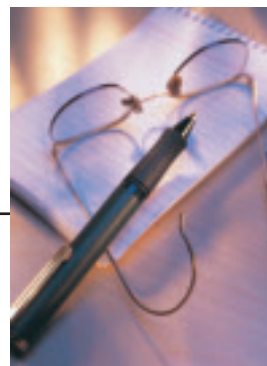


# In Whose Backyard?

Drawing the boundary between corporate and pension plan risk management.



FIELD NOTES

BY ANTHONY TREIER

**A**dvocates for improved efficiency in defined benefit (DB) plan-related risk management would argue that an asset mix policy based on an asset-liability mismatch with a near-static overweighting of equities is no longer a viable long-term risk-reward proposition. This is quite true given prevailing capital markets and other challenges facing the pension industry today. Instead, a more dynamic form of plan asset-liability mismatch risk management seems needed and ought to be implemented on the basis of active risk budgets for allocating among risks, rather than asset types.

Yet, asset-liability studies continue to focus on one-time adjustments in the policy asset mix over some planning horizon, while leaving other potential decision variables either intact or observed for residual impact. Further, asset-liability studies and resulting risk-management initiatives typically try to respond to a composite of various reported (non-economic) plan liability and pension expense measures. This produces unclear policy asset-mix recommendations.

Allegedly, traditional recommendations have featured a near-static passive policy exposure which typically consists of an overweighted and under-diversified equities holding combined with a rump holding of long-duration conventional fixed-income instruments. Also, the recommended policy asset mix in many instances may not reflect any meaningful inclusion of inflation-linked bonds, despite the presence of inflation-indexing embedded in the benefits formulae of some plans.

Some have argued that fuller on-balance sheet disclosure and eventual market-sensitive pension accounting may ensure that investment management occurs more efficiently in a liability-relative sense. However, market-sensitive pension accounting will reflect only a narrow and one-size-fits-all interpretation of economic liability from a plan-related governance standpoint. The consequent period-by-period, marked-to-market-related expense and surplus

volatility may simply result in existing inefficiencies being traded for a host of new ones, related to both broad corporate and within-plan risk-management requirements.

One corporate inefficiency involves potential for distortions in corporate risk reduction behaviour because plan-related assets and liabilities would be marked-to-market while other corporate assets and liabilities would not. Genuine corporate risk management efficiency demands that all risky corporate exposures be consistently marked-to-market to generate the relevant variance-covariance matrix. Indeed, even in terms of potential mark-to-market problems within the plan alone, there remain significant unresolved, fair-value measurement-related issues. As a consequence, a potential inefficiency may involve possibly dangerous overweighting in illiquid asset types, or other asset types with infrequent price discovery.

## Value Estimation

A comprehensive plan-related marking-to-market involves more than discounting an actuarially determined future benefits stream. The fullest economic representation of the pension promise must reflect disclosure of, and ongoing value-estimation for, a host of embedded credit-risky options held by various plan-related stakeholders.

We are not arguing in favour of one form of corporate pension accounting standard (smoothed versus fully volatile, period-by-period marked-to-market pension surplus and expense), but only suggest that the sands are constantly shifting. One corollary of value relevance studies is that such change in pension accounting standards ought not to matter for pertinent, economic-based decision-making, given the evidence of prevailing underlying capital markets' semi-strong efficiency. Pension accounting reform, along with some aspects of pension funding, tax, and other plan-related reforms, represent examples of potential environmental disturbances for DB plan sponsors.

---

Anthony Treier is portfolio manager, Fixed Income, TELUS Corporation Pension Plan.

## Genuine corporate risk management efficiency demands that all risky corporate exposures be consistently marked-to-market to generate the relevant variance-covariance matrix.

### FIELD NOTES

Such disturbances do not themselves represent a source of first-order impact on the prevailing economic risk-reward proposition posed by DB pension plans for their stakeholders' economic welfare. However, they may nonetheless provoke behavioural responses by one plan-related stakeholder, in this case, the corporate sponsor. Inasmuch as the underlying economic risk-reward proposition remains essentially the same before and after pension accounting reform, these behavioural adjustments by corporate plan sponsors might, as a consequence, become damaging for plan members.

In responding to the environmental disturbances noted above, insider trustees could be put under greater strain in terms of arbitrating on potential governance-related conflicts arising as insider trustees attempt, over time, to balance the needs of the corporate sponsor while observing their fiduciary duty to plan members. A corporate sponsor can agitate unilaterally for imposition of a revised corporate-friendly (immunized) policy asset mix within the plan (or even outright plan termination and windup) to suit its own changed risk-management preferences and risk-tolerances in reaction to changed pension accounting standards.

However, a more worthwhile alternative recognizes that good plan-related governance is only assured if unintended welfare-damaging consequences arising from environmental disturbances (i.e., changes in corporate pension accounting standards) are either mitigated or at least appropriately rest with the relevant affected plan-related stakeholder and not inadvertently with plan members.

#### Good Governance

A necessary pre-condition for the conduct of good plan-related governance is access to as many means for implementing high-level risk management initiatives as there are number of distinct plan-related stakeholders that might be impacted by specific plan-related environmental disturbances. This allows a clear separation of risk management initiatives between those that are appropriate at the plan level and those that specifically respond to plan sponsor requirements at the corporate

level, hence targeting the specific needs and preferences of the affected plan-related stakeholder.

Fortunately, with increasingly cost-effective, commoditized access to derivatives markets, such separation is now viable, and risk management solutions can be specifically tailored to the unique needs and tolerances of most plan sponsors. Investment management ought to be encouraged to pursue prudent longer-term, value-adding initiatives within the plan itself while any short-term-oriented corporate risk management requirements are addressed with a swap-based overlay at the corporate level. This can address potential corporate concerns regarding excess short-term volatility of corporate pension expense and plan surplus on its financial statements, while respecting the fundamental longer-term economic going-concern risk-reward proposition that the plan represents for plan members.

While changes in corporate pension accounting standards and other potential disturbances in the environment may provoke distraction, governing fiduciaries need more than ever to remain focused on high-level risk management requirements uniquely appropriate for their plan situation. A vital initial step toward achieving efficiency in liability-relative risk management involves a more basic plan-related governance consideration, namely, defining in whose backyard a particular high-level risk management initiative ought to be taken (plan sponsor or plan members) in response to any environmental disturbances, and, once such determination has been made, implementing the relevant risk management initiative at either the corporate level or at the plan level, as the case may be.

It is only by properly determining in whose backyard an initiative is to be taken that neutrality-of-impact can be assured for all stakeholders from a plan-related governance standpoint, thereby ensuring that there are, and will be, no unintended negative welfare consequences for any plan-related stakeholder as a result of misplaced initiatives. ■

#### Endnote

Bader, Lawrence N., and Jeremy Gold, "Reinventing Pension Actuarial Science" in *The Pension Forum*, vol. 15(1) (Schaumburg, Illinois: Pension Section of the Society of Actuaries, 2003)