A LESSON FROM TEACHERS'

Risk strategies from one of Canada's pension fund leaders.

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In the mid-1990s, we believed that the loss of assets through active management posed substantial risk to the funding position of the plan. Today, we still think active management risk is important, but view the risk of a drop in the funding ratio as our primary concern.

This shift in focus means that we now begin the risk management process by reviewing the plan's funding policy, the impact of pension rules, and the asset mix policy before we consider our active management program.

Define Risk and Tolerance

The first step in the risk management process is to define what risk means to your plan or organization and determine your risk tolerance. At Teachers' we quantify risk in many ways, but the most important is its impact on the contribution rate. To do this, consider what situations are uncomfortable for your plan. These could be cash contributions over a certain amount, or large swings in the overall pension expense, for example.

Review Plan's Funding Policy

Once risk is defined, you can effectively review the plan's funding policy, or perhaps develop one if one doesn't exist. First, what is a funding policy? A funding policy outlines who makes decisions around setting the benefits and contributions of the plan, and how those decisions are made. It recognizes that a pension plan is a balance of benefits on one side, countered with contributions and investment returns on the other. A funding policy includes policies such as maintaining a minimum surplus cushion after benefits are improved or contributions reduced. Your plan's actuary can help you in this process.

Teachers' has realized the importance of gaining a thorough understanding of the impact of pension rules. The process raises a number of questions:

- When would regulation require you to make additional contributions?
- When would pension rules not allow you to make contributions?
- What flexibility exists in the rules? For example, when is smoothing of the assets allowed?

A useful exercise is taking an open group (i.e., one that includes new entrants) and determining what rate of return is needed over the next 10 years to sustain current benefit and contribution levels. Is your investment policy consistent? You also need to address what information or ongoing education should be provided to the decision makers so that they can understand the implications of their decisions. It is very important to document the funding policy so that it is clear and understandable for the current and future decision makers.

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Determine Asset-Mix Policy

Once you have the plan's definition of risk, an idea of the plan's risk tolerance, a funding policy, and which pension rules are of concern, then you can begin the process of setting the asset-mix policy. Various asset-mix strategies can be compared to the plan's risk tolerance and targeted policy return. The final step is to decide on the targeted value added and then begin the risk budgeting process across managers to achieve this target. ■

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