Pension Investment Association of Canada
Association canadienne des gestionnaires de caisses de retraite

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Peter Routledge
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Dear Mr. Routledge,

Re: OSFI Pension Investment Risk Management Consultation

The Pension Investment Association of Canada (PIAC) is writing this letter to provide our response to the OSFI consultation on pension investment risk management that was issued on March 17, 2022.

PIAC has been the voice for Canadian pension funds since 1977 in matters related to pension investment and governance. PIAC's members manage over $2.4 trillion of assets on behalf of millions of Canadians. Our mission is to promote sound investment practices and good governance for the benefit of plan sponsors and beneficiaries.

General Observations & Feedback

We appreciate the opportunity to provide a response to your consultation. This is a complex topic that has significant breadth of issues and significant disparity in successful approaches. The approach to investment risk management varies across our membership and the approaches vary generally based on the size of the plan, funding levels, maturity, asset- liability mismatch, cash flow and investment portfolio complexity.

The most important feedback we can provide is that given the varying degrees of inherent risk in pension plans that the ultimate guidance from OSFI and other regulators needs to be principles based and flexible enough to cost effectively implemented by smaller plans (<$500 million) and yet still relevant to the very large plans (>$40B) and all those in between.

The principles that PIAC supports are as follows:

1. Pension plans should be required to articulate their risk appetite in writing and that it is approved by the governing fiduciaries. There should be flexibility in terms of the methodology and metrics that can be utilized.

2. Established risk limits must be in place, however there should not be any requirement on the type of metric or measurement methodology. It is also important that the risk limits are not hard limits that cannot be breached. The purpose of risk limits should be to raise awareness, prompt consideration and enable understanding of the risks being taken and why. As the circumstances for breaches of limits can vary in magnitude and the underlying reasons can vary in severity, and ability to action a risk reduction, there should not be any requirement that the limits are firm or that metrics be brought down to below the limit in any specific amount of time.

3. There should be regular risk reporting at various levels of the pension organization with content and frequency or reporting flexible depending on the needs of the pension plan's managing and governing fiduciaries. The needs are largely driven by pension plan size and investment portfolio complexity.

4. Risk reporting should be prepared and presented while ensuring reasonable independence from investment decision making. There should not be specific requirements on who prepares reporting, or how their independence is obtained and maintained. Reporting could be generated internally or externally and independence achieved in many different ways. The emphasis should be for the pension plan to be able to explain, demonstrate and evidence that that reasonable independence exists without mandating specific rules and requirements.

Specific Questions & PIAC Responses

<u>2. Independent Risk Oversight Function</u>

Question 1: How have independent risk oversight functions been successfully implemented by pension plans?

This is highly dependent on the size of the plan and complexity of the plan's investments. Smaller plans with non-complex investment approaches (all public assets using external managers) would likely have risk reporting provided by an external consultant on a quarterly basis. The appropriate metrics may be as simple as total equity exposure, largest positions, credit level breakdowns on corporate bonds, etc.

Mid-sized plans ($500M - $40B) and some smaller plans with complex investment portfolios, may have internal staff focused on risk management and may have more sophisticated risk models for surplus risk, active risk, liquidity risk and others. Reporting may still be quarterly to governing fiduciaries and more often to the CIO and investment teams. Risk management is often integrated with investment management since risk analysis is a critical input for good investment decision making processes. As such, the risk professional(s) have a dual role of providing support for investment decision making processes and providing oversight reporting. Independence may be achieved in various ways including external reviews of models, controls audits, and in-camera meetings with governing fiduciaries.

For larger plans ($40B+): There will typically be a Chief Risk Officer (CRO) or equivalent and a team of risk management professionals. The risk team still typically has a dual mandate of supporting investment decision making with risk analytics and also a risk oversight function. The CRO typically reports to the CEO and independence achieved in similar methods as the mid-sized plans.

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

This depends on the size and complexity of the pension plan both of which will play a key role in the risk organizational design and oversight function. The ability for plans to maintain having risk professionals and risk analytics that support a dual mandate of investment decision making support and independent oversight is critical. Independence can be obtained through combinations of incentives, reporting hierarchy, direct access to governing fiduciaries, and external audits or models, controls and reporting.

Question 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?

Smaller plans that do not have the scale or complexity will need to engage external consultants to provide these services. The frequency, metrics, and sophistication must all be flexible to allow for tailoring to the needs of plans of varying sizes and investment complexity. PIAC has some concern with the additional costs this could result and cautions that the cost/benefit for smaller plans be an important consideration in the final regulatory guidance.

3. Articulated Risk Appetite Statement and Risk Limits

Question 4: What do you consider to be the key risk limits for pension plans?

There should be a direct linkage between the risk appetite, risk limits and the objectives of the overall pension plan. For example, keeping overall pension plan surplus volatility below 10% or keeping the overall pension plan interest rate hedge ratio above 40% or ensuring funded status does not drop by more than x% over some time period, are all linked to the overall funding risk of the pension plan. The type of limit and methodology of calculating should be left flexible given the diversity of plan situations.

It is important to think of Risk Limits are soft and this can be achieved with ranges (i.e. a yellow or warning zone) that begin to “warn” all stakeholders of problem areas that may lead to risk appetite breaches or straying off course. Risk limits on their own are of limited value unless a strong communication protocol is in place to raise awareness and educate on the underlying reasons for the changes to risk metrics.

Question 5: How do pension plans anticipate implementing risk limits?

This is largely a function of size, complexity and resources. Consultant driven approaches for smaller plans and internally for large plans with ample budget and sophistication.

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

Having risk limits in place with ongoing research, analytics support and regular monitoring may lead to improved investment decision making by raising awareness of evolving risks that arise from actual portfolio changes and/or from changing market dynamics. Support for the decisions on what, if any action to take, and on the implications of taking actions should lead to improved decision making.

Question 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?

There needs to be meaningful research and assessment of options and understanding of the linkages to the risk appetites, the objectives of the plan, the plan maturity and funded status. Utilizing asset liability studies and modelling is an obvious first step.

4. Comprehensive Portfolio and Risk Reporting

Question 8: What controls do plan administrators have in place to ensure that portfolio and risk reporting is comprehensive?

Again this depends on the size of the pension plan and complexity of the investment program. As a minimum the following should be in place, for Board and internal stakeholder reporting:

- An evergreen list of top-level risks that are monitored, measured and reported on. If a new risk is added to the list, the rationale for the addition must be communicated to all stakeholders and the same if any risk is removed
- Regular measurement of key risks and reporting on the risks relative to risk limits

- An escalation protocol so that all stakeholders are made aware and key actions can occur should they be required.

Question 9: How do plan administrators manage data limitations relating to investment funds?

Various methods including the use of proxies to measure the risks of illiquid and/or limited transparency investments or the use of third party software that provides risk exposures relating to underlying constituents. This is an area of ongoing research in the industry and there is significant debate on the best methodologies and changing views on the best practice approaches (i.e. de-smoothing for Real Assets, factor loading using real asset databases, style regression for hedge funds etc.).

5. Enhanced Valuation Policies and Processes

Question 10: How do plan administrators evaluate third-party valuation processes and procedures?

Often consultants are brought in for this effort given their broad exposure to multiple pension plan clients and vast interaction with third-party providers. Annual financial statement audits are also a primary source of evaluating the appropriate of valuations and the processes and procedures for making valuation adjustments. The major accounting firms have valuation experts for multiple asset classes and they are typically engaged by the local audit teams to support pension plan audits.

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

Subscription to various databases (IPD, Burgiss, eVestment, etc.) where one can source similar investments and review their performance during periods of stress. Sometimes, comparisons with public market proxies may prove beneficial from a reasonability standpoint. Note that in periods of market stress more frequent valuations are typically needed and a clear understanding that the valuations of private assets will typically lag public markets.

6. Proportionality Considerations

Question 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?

PIAC represents plans of all sizes and investment complexity, however we do not have line of sight to all our members and their approaches to risk management. As such, we will pass on providing a response to this specific questions.

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

Our responses to previous questions have thoroughly replied to this question.

Question 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?

For pension plans with internal staff there should be monitoring and communication protocols for escalation as risks levels change and limits or tolerance levels are breached. For smaller plans with limited staff resources and reliance on external consultants this is a challenge.

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

Often DC programs are categorized into risk buckets allowing contributors to select investments which best suit their needs which lends itself to the concept of Independent Risk Oversight / Risk Appetite and Risk Limits. Frequent reporting is often part of these DC programs and limited use of private assets and illiquid assets generally keeps many of the risk management considerations and needs more limited in scope.

We would be pleased to provide any further information or discuss this submission further at your convenience.

Yours sincerely,

Sean Hewitt
Chair