Risk-Based Supervision of pension plans

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Agenda

- Introduction
- The Context – OSFI’s Pension Supervision Division
- What is Risk-based supervision?
- Framework for assessing risk in Private Pension Plans
- Conclusion

Introduction

- Who am I
- What experience / expertise do I bring to you?
- What are my goals in this one-hour presentation?
  - Define risk-based supervision and what it takes to get there
  - Show how it is implemented at OSFI in Canada

OSFI's Private Pension Plan Division

- Supervise over 1,200 federally-regulated private pension plans
- Over $200B in assets
- Approx 10% of Canadian pension plans
- Around 300 DB plans, 800 DC plans and 100 Combination plans
- 8 supervisors, so approx. 150 plans per supervisor.
- Supervisors are assigned a portfolio of plans to supervise, largely based on industry
- Split supervision duties from Regulatory Approvals (registrations, asset transfers, terminations)

Risk-Based Pension Supervision

- Focus your attention on plans that pose a risk to member and other beneficiaries benefits
- Must go from compliance to reliance
- Try to look ahead to see where potential risks lie.
- Must have a consistent method of evaluating risk as well as consistent ratings

The Framework

- Sources of Information
- A “System”
- Early Warning Tests
- Risk Assessment Framework – The Matrix and its components
- A “Watchlist”

Sources of Information

- Plan documentation
  - Official plan documents and amendments received from the plan
  - Policies and procedures relating to the administration of the plan

- Plan required returns
  - Annual Information Returns
  - Plan Financial Statements
  - Actuarial / Valuation Reports (if the plan has a defined benefit component)
  - Other required filings, based on your jurisdiction and rules.

Sources of Information (cont'd)

- Special exercises that you may undertake
  - At OSFI, we perform an Estimated Solvency Ratio exercise.
  - OSFI also performed periodic On-site reviews of pension plans

- Supervisor knowledge
  - Knowledge of the industry, plan sponsor.
  - Conversations that the supervisor has with plan administrators, actuaries, auditors, board members, etc.

- Plan custodian
  - Report on late and non-payment of contributions

Codifying the Information – the "System"

- In order to perform an initial assessment of pension plans risk, we must capture key information in a "system".
  - Paper can work, but it is labour intensive
  - A spreadsheet is possible, but it can get complex very quickly
  - A database system is best, capturing vital information about each pension plan and key information from returns and other sources as they come in.
- You will need a (or multiple) resource on a daily or weekly basis, to update your "system" with new information received from pension plans.
- From this "system" one can then run Early Warning Tests that will be always up-to-date.
- This system can also be used as a starting point for the next level of more in-depth analysis.

Early Warning Tests

- Tier 1 Results
  - One of these and the plan gets a more in-depth review.
- Tier 2 Results
  - A number of these (we used 3) and the plan gets a more in-depth review
- Tier 3 Results
  - Items that the supervisor should be aware of if a review is in order, and should investigate, time permitting

Early Warning Tests – Tier 1

- Plan required returns
  - Exposure to equities, real estate or miscellaneous investments for a terminating plan
  - The audited financial statements are qualified by the auditor
  - The valuation report is qualified by the actuary
  - The plan remitted significantly less (say 10%) contributions to the plan than was required by the valuation report
  - Plan has a low solvency ratio (say less than 70%)
  - Plan is taking a contribution holiday that is greater than the surplus available in the plan.
  - Employer / employee contributions receivable are greater than 2 months of required contributions

Early Warning Tests – Tier 1 (cont’d)

- Special exercises
  - Low estimated solvency ratio (we used below 70%)
- Plan custodian
  - There are outstanding contributions to the pension plan
- Supervisor knowledge
  - The plan sponsor is weak, in financial difficulty, or bankrupt

Early Warning Tests – Tier 2

- Plan required returns
  - The plan has gains from changes in either the actuarial asset valuation method or the actuarial cost method in the actuarial report.
  - Plan demographics: average age of active members is over 50, or retirees' share of liabilities is greater than 50% with lots of equity exposure
  - Large increase in employer contributions (say 50%)
  - Plan has a large (say 20%) drop in membership
  - Plan has a history of late filing of their valuation report
  - Plan has current outstanding filings
  - Low solvency ratio (say between 70% and 90%)
  - Contribution holiday is using up most of the surplus (say 90%).

Early Warning Tests – Tier 2 (cont'd)

- Special Exercises
  - Estimated solvency ratio is between 70% and 90%
- Supervisor Knowledge
  - The industry the plan sponsor is in is in trouble
- Plan Documentation
  - Certain types of plans are inherently risky (union plans with negotiated contributions)

Early Warning Tests – Tier 3

- Plan Required Returns
  - High exposures to equity, cash, real estate and miscellaneous investments
  - High level of expenses
  - Deterioration of funded ratio
  - Poor rate of return on assets (less than benchmarks)
  - History of late filings
  - History of outstanding contributions
  - Solvency ration between 90% and 105%

Early Warning Tests – Tier 3 (cont’d)

- Plan Required documents
  - Plan provides consent benefits
- Special Exercises
  - Estimated solvency ratio is between 90% and 105%

Risk Assessment Framework – the matrix

Significant Activities	Inherent Risks					Quality of Risk Management		Net Risk
	Investment	Pension / Valuation	Operational	Legal and Regulatory	Strategic	Controls	Oversight	
Actuarial								
Administration								
Asset Management								
Communication								
				Overall Net Risk				

Solvency			Ongoing Performance			Funding	

CRR:	
Direction:	

Risk Assessment Framework – Significant Activities

- Actuarial
  - Actuarial Valuation of plan assets and liabilities.
  - Advice, analysis, testing and special reports

- Administration
  - Benefit calculations, benefits payments, payment of expenses
  - Regulatory filings , record keeping
  - Collection and remittance of contributions to custodian

Risk Assessment Framework _ Significant Activities (cont’d)

- Asset Management
  - Management of the plan’s fund, asset/liability management
  - Preparation of special financial or risk management reports
  - Preparation and adherence to a statement of investment policies and procedures

- Communication to Members
  - Annual statements, notices
  - Member education
  - Website management

Risk Assessment Framework – the matrix

Significant Activities	Inherent Risks					Quality of Risk Management		Net Risk
	Investment	Pension / Valuation	Operational	Legal and Regulatory	Strategic	Controls	Oversight	
Actuarial		L	M	AA				
Administration			M	AA	H			
Asset Management	L		M	AA	H			
Communication			M	AA	H			
							Overall Net Risk	

Solvency			Ongoing Performance			Funding	

CRR:	
Direction:	

Risk Assessment Framework – Inherent Risks

- Investment
  - Credit risk – risk that a counterparty will not pay and may default
  - Market risk – changes in market prices, currency, interest rates.
  - Liquidity risk – ability to get funds to pay obligations as they come due
- Pension / Valuation
  - Risk that the actuarial methods and assumptions used result in values different from experience.

Risk Assessment Framework – Inherent Risks (cont’d)

- Operational
  - Risk of breakdowns in internal controls and processes, technological failures, human error, fraud, and catastrophes.
- Legal & Regulatory
  - Risk that a plan isn’t administered according to the rules, regulations, best practices, fiduciary standards imposed in any jurisdiction in which the plan operates.
- Strategic
  - Risk that a plan cannot implement policies or strategies required to address problems.

Risk Assessment Framework – the matrix

Significant Activities	Inherent Risks					Quality of Risk Management		Net Risk
	Investment	Pension / Valuation	Operational	Legal and Regulatory	Strategic	Controls	Oversight	
Actuarial						W	W	
Administration						NI	NI	
Asset Management						A	A	
Communication						S	S	
				Overall Net Risk				

Solvency			Ongoing Performance			Funding	

CRR:	
Direction:	

Risk Assessment Framework – Quality of Risk Management

- Mitigation of Inherent Risks is assessed through the risk management function of each plan. Components are:

- Controls:
  - Appropriate processes are in place

- Oversight
  - The plan provides stewardship and independent oversight.
  - Generally performed by the Board of Directors, Board of Trustees or by a Pension Committee.

Risk Assessment Framework – the matrix

Significant Activities	Inherent Risks					Quality of Risk Management		Net Risk
	Investment	Pension / Valuation	Operational	Legal and Regulatory	Strategic	Controls	Oversight	
Actuarial								L
Administration								M
Asset Management								AA
Communication								H
				Overall Net Risk				L

Solvency	NI		Ongoing Performance	W		Funding	A

CRR:	M
Direction:	Increasing

Risk Assessment Framework -- Other Key Ratings

- Overall Net Risk
  - An indication of the aggregate residual risk of each of the significant activities.
- Solvency rating
  - Applies only to DB plans.
  - The risk to member benefits if the plan were to terminate immediately.

Risk Assessment Framework – Other Key Ratings (cont'd)

- Ongoing performance
  - DB plans – an estimate of the ongoing viability of the plan
  - DC plans – investment performance.
- Funding
  - Looks at the plan's access to future or increased funding from the employer(s).
- Composite Risk Rating and Direction of Risk
  - Assessment of the overall safety and soundness of the pension plan and the risk to the rights and benefits of members and other beneficiaries.
  - The direction of risk is forward looking (are things getting worse, improving or staying the same?)

Back to key principles

- Are the ratings consistent across plans?
  - If so, you can act with some confidence based on the results.
  - If not, set standards, and / or perform peer reviews to ensure ratings are assigned the same way.

Interventions / Watchlist

- Based on the CRR and Direction of Risk, and depending very much on the powers vested in your organization by your governing legislation, you will take appropriate interventions
- Low CRR = low intervention
- High CRR = higher level of intervention
- At OSFI, Plans with a higher CRR go on a Watchlist that is reviewed by management on a monthly basis.
- We have gone from a large number of plans per supervisor to a much smaller number of plans that require detailed analysis, interventions and follow-up.
- If you perform these processes well, you will ensure that risks are spotted early and that actions are taken to avoid unnecessary loss of benefits to plan members.

Conclusion

- To move to a risk-based model, you must:
  - Move from compliance to reliance
  - Develop a “system” based on your sources of information
  - Filter out the non-risky plans based on Early Warning Tests
  - Filter again by performing more in-depth analysis
  - Focus your interventions on the resulting high-risk plans
  - Monitor and repeat

Thank you!

QUESTIONS?

Additional Information

- Go to OSFI's website under Private Pension Plans for links to the Risk Assessment Framework