Client Advisory

CAPSA releases Guideline No. 10 – Guideline for Risk Management for Plan Administrators, effective September 9, 2024

October 7, 2024

Summary

CAPSA released a new Guideline addressing pension risk management. It articulates the key elements of a risk management framework and the views of pension regulators on the importance of pension risk management. The Guideline provides a systematic approach for identifying, evaluating, managing and monitoring material risks facing pension plan administrators, as well as risk considerations for specific topics, including cyber security, third-party risk, investment governance, ESG factors, and use of leverage. Pension plan administrators should consider the recommendations in this Guideline as a way to meet the standard of care expected of fiduciaries.

Introduction

The Canadian Association of Pension Supervisory Authorities (CAPSA) has released Guideline No. 10 – Guideline for Risk Management for Plan Administrators. CAPSA suggests that pension plans should consider how to implement the new Guideline effective September 9, 2024, taking into account the legal requirements, size and sophistication of the plan, and that any necessary IT system or process changes resulting from it should be implemented by January 1, 2026. The new Guideline No. 10 complements other CAPSA Guidelines that address governance (No. 4) and funding policy (No. 7).

This new Guideline is designed to assist pension plan administrators in identifying, evaluating, managing and monitoring plan material risks. It is intended to be relevant to administrators of all pension plan types (defined benefit, defined contribution, pooled registered, target benefit and hybrid) regardless of the size of plan membership and assets or the operational risks and complexity of their administration and investment strategies. The Guideline acknowledges, however, that proportionality is an important consideration and that implementation of the principles in the Guideline may differ depending on a plan's specific circumstances and risks.

Regulators may periodically review a pension plan's risk management framework to assess whether the administrator is fulfilling its fiduciary duty and meeting the standard of care.

Overall approach to risk management

CAPSA recommends that administrators set out, in writing, an overall risk appetite, risk tolerance and risk limits. These should be integrated into the plan's governance and risk management frameworks. CAPSA also recommends that the sponsor identify specific objectives for the plan, such as benefit security, predictability, and affordability. With defined and documented objectives, the plan administrator can then implement risk management practices to increase the likelihood that the objectives are met.

The Guideline explains that risk management involves establishing sound governance and oversight commensurate with the plan's complexity and size; establishing processes and methodologies for identifying, evaluating, managing and monitoring risk; and establishing effective controls to understand, manage, and mitigate those risks.

Although Guideline No. 10 is primarily intended for plan administrators, CAPSA states that risk management is also an important consideration for plan sponsors, and that both parties should work together to identify and manage risk and address the potentially conflicting responsibilities when acting in a dual role.

Risk management four-step process

Guideline No. 10 sets out a four-step risk management process.

Step One – Identify Risks, is to identify, record and regularly review all risks, immediate or prolonged, to which the plan may be exposed, as well as the controls that are or could be in place to reduce the severity and/or likelihood of those risks. The Guideline lists potential sources of information to aid in identifying risk, and provides a sample of possible risks as well as an example of a risk register.

Step Two – Evaluate Risks, provides that administrators should develop a process, based on the nature, size and complexity of the plan, for evaluating and then prioritizing risks to reflect their likelihood and severity. Furthermore, Guideline No. 10 suggests that material risks should be quantified. It provides a sample heat map as one approach, and lists possible financial risk assessment tools. Regardless of the method of evaluation the plan administrator chooses, it should help ensure that resources are directed to priority areas of material risks.

Step Three – Manage Risks, involves establishing cost efficient controls to mitigate and manage risks. The controls should be suitable for the nature of the risk and proportionate to the risk's likelihood and impact. The Guideline lists possible forms of controls including financial policies, reviews, disaster recovery plans, contingency plans, training, insurance, audits, etc. Administrators are also expected to measure the accountability and effectiveness of their controls, to identify residual risk, and to decide whether they should: accept the residual risk; avoid the risk; respond to the risk by implementing further mitigation measures; or transfer some or all of the risk to a third-party. Administrators should also engage in contingency planning to respond quickly and effectively to any risks that materialize.

Step Four – Monitor Risks, involves ongoing monitoring of risks and controls to ensure that they are appropriate and effective. The risk management process should be repeated periodically to identify emerging risk and opportunities. The Guideline notes that risk management is an ongoing rather than a one-time process.

Guidance for specific risks

In addition to general guidance, Guideline No. 10 addresses specific risks in the following areas. CAPSA notes that some concepts may not be applicable to all pension plans.

Third-party advisors or service providers

CAPSA notes the possible risk to the plan's operational and financial resilience or reputation due to a third-party's failure to provide goods and services, protect data or systems, or otherwise carry out their mandated activities. The Guideline mentions lawyers, accountants, third-party administrators, actuaries and investment consultants as examples of typical third parties. While services and responsibilities may be delegated to third-party service providers, the plan administrator retains its fiduciary duties and remains responsible for the oversight, management, and administration of the plan. Administrators, as such, should define and document third-party responsibilities, implement effective oversight, and regularly monitor and where necessary modify their approach to managing third-party risk.

Cyber security

This type of risk includes malware, phishing emails, hacking and inadvertent disclosure of information. Plan administrators should recognize and be aware of their fiduciary duty to manage cyber risks. Appropriate controls vary depending on the nature, potential impact and likelihood of the risk at issue. Steps should be taken to protect plan beneficiaries and assets against the risk of cyber-attacks, including managing third-party cyber risk, planning for incidents and a response, and potentially developing resiliency plans and playbooks. Incident reporting is also discussed. Plan administrators are expected to track this emerging area.

Investment risk governance

The Guideline notes the wide range of investment risk management practices available to plan administrators. Their utility will depend on the complexity of the plan administrator's investment strategy and risk appetite. It discusses various practices available for investment risk management, in a fiduciary context, such as portfolio limits, risk-based sensitivity limits, Value-at-risk (VaR), stress testing and asset liability modeling. It also discusses considerations for alternative assets held directly by the pension fund, particularly noting liquidity risks and the difficulty of obtaining accurate valuations during periods of market volatility.

Environmental, social and governance (ESG) issues

The Guideline notes that using ESG information to provide financial insight is consistent with an administrator's fiduciary duty, suggesting that ignoring or failing to consider ESG information that might materially affect the fund's financial risk-return profile could be a breach of fiduciary duty. Plan administrators should identify and address whether/how ESG information may be material to the financial risk-return profile of their fund, and adjust the governance structure to incorporate necessary fiduciary duty actions to reflect that conclusion. The Guideline includes a discussion of certain ESG risks, including climate change, and how ESG considerations might be incorporated into investment decisions.

Use of leverage

Issues addressed include purposes for which pension plans use leverage (hedging, increasing return, and investment efficiency), the prudent use and increased importance of managing leverage risk, the common types of leverage, key risks associated with leverage (market, liquidity, and counterparty risks) and how to identify and manage these key risks by implementing prudent use and oversight of leverage. Where a plan uses leverage, it must be properly documented in the statement of investment policies and procedures.

Additional guidance and materials

Guideline No.10 also contains a glossary of terms and the following Appendices:

- Appendix A – Risk Table: Sets out common risks faced by plan administrators in the operation of a pension plan including: funding, liability/pension/actuarial, investment, governance, operational, plan sponsor, and emerging risks
- Appendix B – Sample Heat Map: Explains how to prioritize risk using a sample "heat map"
- Appendix C – Risk Assessment Tools: Sets out risk assessment tools for developing a sound approach to risk management, with an emphasis on proportionality, including sensitivity analysis, scenario testing, scenario projections, stress testing, reverse stress testing, and stochastic modelling

Recommended actions

Although CAPSA Guidelines do not have the force of law, they articulate the expectations of the regulators, and should be considered when assessing whether and to what extent plan administrators are meeting their fiduciary duties and standard of care.

Administrators should assess their current risk management policies and practices in light of the above factors and consider how best to implement the positions set out in Guideline No. 10, taking into account the legal requirements, size and sophistication of the plan, effective September 9, 2024.

Administrators should also identify and undertake any related IT system or process changes by CAPSA's suggested implementation date of January 1, 2026.

For more information

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