MANAGING AGENCY RISK IN DEFINED CONTRIBUTION RETIREMENT FUNDS

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ABSTRACT
This paper reviews the regulation and practice of risk management in defined contribution retirement funds in South Africa. A variety of advice and advisers can be observed at present, so that even those boards that try to improve their practice do not always succeed. Basic theory and practice are suggested in order to begin a debate on whether there is a role for actuaries in this field, and if so, whether professional standards are required.

KEYWORDS
Risk management; governance; defined contribution retirement funds; agency risk

1. INTRODUCTION

1.1 Can actuaries add value in those retirement funds where the board has no actuarial or financial risks to manage? Could actuaries, for example, have suggested systems that would have warned boards of the recent collapse of a medium sized administrator? Risk management is one of the more significant responsibilities that boards of South African retirement funds are encouraged to carry out – directly by PF Circular 130 and the draft King III Code of Governance, and indirectly by the Pension Funds Act. When enquiries were made of funds and expert advisers from a number of professions, it became clear that there is a wide variation in advice being given to defined contribution ('DC') retirement funds, and thus a need to develop theory and practice in the management of risk in these funds. This paper is aimed at opening that debate amongst members of the Actuarial Society of South Africa ('Actuarial Society').

1.2 The need for good advice on risk management in DC funds is highlighted by:

1.2.1 The 'trustee' model of retirement funds, including elected trustees, means that many boards are on a steep learning curve for three years, and then vacate office. Myners (2001) stated that "at the heart of the system, we often make wholly unrealistic demands of pension fund trustees. Our legal structures put them firmly centre-stage. They are being asked to take crucial … decisions – yet many lack either the resources or the expertise."

1.2.2 There is therefore a knowledge gap between boards and service providers, so that unscrupulous or incompetent administrators do not get called to account by boards.

1.2.3 The regulator does not always have the resources to intervene with boards and service providers– although that office has recently acquired additional powers to do so.

1.2.4 Some boards experience PF130 as a costly, check-box exercise imposed by the regulator. PF130 does not bring about a change in their understanding or managing of risks.

1.2.5 Where boards have tried to understand risk management, they are often shown a disembodied mantra with pretty arrows and the words 'identify, assess, mitigate, review'. The

board – and perhaps the adviser – do not understand how to incorporate this process into their existing governance processes and internal controls. Others are sold an extensive review of many hundreds of individual risks, but don't understand how to use it, or whether such detail was necessary.

1.2.6 Given that investment management is more profitable than administration, some of our magazines and conferences (and even one representative body!) are strongly supported and / or subsidized by investment managers, thus directing attention away from operational risks.

1.3 Section 2 describes the methodology of the research. Section 3 reports on regulation, and notes that there is little specific guidance given to boards on how to implement risk management. Section 4 reviews a selection of literature on risk management to suggest a theoretical framework linking risk management to internal controls. Section 5 considers the role of the annual audit in risk management. Section 6 proposes that boards prioritise those 'agency risks' that relate to functions under their control, and section 7 suggests pointers to practice in the light of this theoretical framework. Section 8 considers the provision of risk management advice by actuaries and other professionals.

2. METHODOLOGY

2.1 In this section, the methodology of the research is described.

2.2 LITERATURE REVIEW

Given the many publications on the subject of risk management, a purposive selection of literature was reviewed. This selection included guidance to trustees from regulators, curricula of professional bodies, governance surveys and journal articles.

2.3 INTERVIEWS

Informal interviews were carried out with practitioners from various professions who have advised retirement funds on risk management. These included accountants, actuaries, governance consultants and pension lawyers.

2.4 PROCESS

The above qualitative data was analysed against three referents, as follows:

- in what way does risk management add value for stakeholders, and
- is risk management integral to a board's governance of a fund, and
- what is an optimal risk management process?

3. GUIDELINES TO BOARDS

3.1 In this section, three sets of regulatory guidance to boards of South African retirement funds are highlighted and analysed.

3.2 THE PENSION FUNDS ACT

Neither this act nor its regulations explicitly mention risk management. However, Section 7C(2)(a) requires boards to protect the interests of members, which implies managing the risk of the members not suffering a loss; and Section 7(D) (b) requires boards to ensure

that proper control systems are employed. Section 15 requires funds to undergo an annual audit. In the prescribed financial statements, inter alia:

- a board is required to declare that it has employed proper control systems
- schedule HA requires a statement by the board of its risk management policies. (In the pro-forma accounts, risks such as currency, liquidity, interest rate, market and inflation risk are listed – much of which will be irrelevant to a DC fund.)
- schedule I requires the auditors to report their findings on a number of compliance and accuracy checks.

3.3 PF CIRCULAR 130

This circular (Financial Services Board, 2007) is a guidance note to boards of retirement funds from the Registrar of Pension Funds. The circular states that trustees are fiduciaries, and must put good governance in place in order to achieve their primary object, the provision of benefits promised in the rules. This governance is required to be demonstrated , inter alia, in the way the board exercises its discretion and its supervision of delegated responsibilities. Specifically, the management of risk is seen as one of the purposes of good governance, and one of the 12 principles in PF 130 of good governance is devoted to risk management. The exposition of this principle suggests that risks to the achievement of the objective must be identified and controlled, that risks will vary from one fund to another, that there may be financial and non-financial risks, that boards should not micro-manage service providers, and that fidelity cover will be required.

3.4 DRAFT KING 3 CODE OF GOVERNANCE

The draft third edition of a general code of governance for South Africa (King Committee on Governance, 2009) is applicable to all entities. If there are relevant circumstances for not applying the code, an entity must explain these. In a dedicated chapter on Risk Management, the report states that risk management is inseparable from an entity's strategic and business process; and that risk management should be 'intrusive'. An entity's management must carry out risk management, and the directors must ensure that this happens. A risk management plan should be drawn up, typically covering:

- the entity's risk appetite
- how risk management supports the business strategy
- processes for identifying and controlling risks
- review
- communication.

3.5 CONCLUSION

The above guidance was reviewed against the referents set out in Section 2. It appears that risk management in retirement funds is intended to add value for the primary stakeholders, the members, by improving the probability that their benefits will be paid. Further, that the risk management process should be integral to, and permeate every aspect of, the management of the fund. However, little guidance is given on (a) how these aims can be implemented into an effective, integrated and value-adding process, or (b) to what extent the external audit process satisfies this risk management function, or (c) what the commonly encountered risks are.

4. TOWARDS A PRACTICAL UNDERSTANDING OF RISK MANAGEMENT

4.1 In this section, various references are consulted in order to answer question (a) in 3.5 above.

4.2 RISK MANAGEMENT IN LIFE INSURANCE

Deighton et al (2009) review governance and risk management in UK life insurance companies and highlight general confusions around the integration of the various processes. They ask how governance, financial risks, compliance, risk management and internal controls relate to each other. In particular they refer to common confusion between the risk function and that of internal audit. They also expand the concept of risk management into risk management, risk oversight and risk assurance – the so-called three lines of defence model.

4.3 OTHER ARTICLES & INTERVIEWS

Mort (2007) points out that a board's success in governance must be tested against the success it has in achieving the governance objectives of the fund. The primary objective (of the three listed in PF 130) is to provide benefits promised. The other two objectives are optimising benefits whilst minimising investment risks, and having justifiable, transparent and quantifiable costs. Mort suggests that these risks should not be confined to investment risks but should encompass both financial and non financial risk, and proposes further a fourth objective, that the process of delivering the benefits is credible and can be trusted by the stakeholders. Lowther (2006) notes the risk-averse nature of a defined contribution fund, and asks whether governance structures such as sub-committees charged with monitoring delegated duties are not a form of risk management. Representatives of two actuarial consulting firms reported that their advice to funds would be a top-down approach, starting with the fund objective, and – if necessary – including a brief or extensive review of individual risks. Another actuarial consultancy reported more of a bottom-up approach, starting with identifying risks in operational / legal / trustee / investment areas, and then discussing these with board to improve the board's understanding of its business.

4.4 THE UK PENSIONS REGULATOR

Throughout the Regulator's website, the concepts of 'risk management' and 'internal controls' are closely linked. It is stated that risk management underpins good governance as it enables trustees to identify the risks of not achieving their schemes' objectives, quantify and prioritise these risks, and implement adequate controls to manage them. The Regulator has issued a Code of Practice (The Pensions Regulator, 2009) on the subject of internal controls. These controls are defined as arrangements and procedures to be followed in the administration, management and monitoring of a scheme. It is stated that trustees will need to assess which risks the scheme can absorb without the need to take further action, and which risks require further internal controls. The Regulator also gives a useful definition of governance for non-entrepreneurial trust-based entities – i.e. the systems and process concerned with ensuring the overall direction, effectiveness, supervision and accountability of an organisation.

4.5 CONCLUSION

A possible solution to the reported confusion and varied approaches to risk management, internal controls and good governance can be deduced from the above literature. Good governance is seen to cover all the structures and processes set up by a board to achieve its objectives, including for example board sub-committees and the way in which it exercises

its discretion. Risk management is part of this because it refers to a process of identifying risks, checking that identified risks have already been covered by the internal controls, processes and structures; and if not, considering what protective arrangement can be put in place to ensure that risks are avoided or mitigated. Additionally, risk management should deal with the management of an unavoidable or unforeseen risk when it materialises.

5. IS THE ANNUAL AUDIT AN ADEQUATE MANAGEMENT OF RISKS?

5.1 In this section, question (b) in 3.5 above is discussed.

5.2 The authors have not examined the detailed professional requirements that auditors must follow in the audit of South African retirement funds. However, from various examples, a typical audit objective seems to include:

- assurance that the annual financial statements give a fair presentation
- some comfort on internal controls
- identifying fund risks
- assessing compliance with legislation

The last three objectives seem to concern risk management, as opposed to pure audit work. If the auditors are required, by their standards, to identify risks, assess compliance and look at internal controls, is it cost effective for the Board to repeat the process?

5.3 Deighton et al (2009) suggest that 'identifying and managing risk' is a duty of the board, whereas 'integrity and control of processes' is the audit function.

5.4 CONCLUSION

It may be that mandatory audit standards have extended the ambit of the auditor beyond 'integrity and control of processes' and into the board's domain of 'identifying and managing risk'. As a result of the 2008 global financial crisis, further inroads may be expected. This seems to create a potential conflict between the board and the fund auditor where each has a different view as to what constitutes an appropriate management of risk. Should the audit function extend to managing this aspect of the business of the fund – and if so, will the auditors accept liability for unmanaged risks? A possible solution is for boards to understand clearly what risk management function the auditors are obliged to supply, and integrate this into their broader risk management process.

6. AGENCY RISKS

6.1 In this section, an answer to question (c) in 3.5 above is explored. Three published articles by members of different professions are reviewed in order to suggest a classification of risks, highlighting those risks which relate to functions under the control of the board of a defined contribution retirement fund.

6.2 ECONOMISTS

Besley and Prat (2005) look at the role of a retirement fund in the economy. Members are encouraged to save so that they will receive benefits on retirement or other events. Risks to the member that this objective will not be achieved can be categorised, at a high level, as investment market risks, personal judgment, and agency risks. 'Agency' refers to services that

an agent supplies on the member's behalf. In a defined contribution fund, the board, the sponsor, the administrator and the regulator could be seen as such agents. Besley and Prat believe that good fund governance is managing those agency risks which relate to functions that the board controls.

6.3 ACTUARY

Andrew (1994) suggests that the major risks in Defined Contribution funds are those directly affecting the member's asset share – investment returns, expenses, and the level of retirement contributions.

6.4 AUDITOR

Albert (2006) cautions boards that they must be able to demonstrate that they have carried out their fiduciary duty. Failing this, they will be exposed to the risk of claims made against them personally.

6.5 FUND RISKS, MEMBER RISKS AND TRUSTEE RISKS

There is a significant legal debate about whether the board owes its primary obligation to the member or the fund. Besley and Prat (2005) clearly refer to risks that prevent the achievement of the *member's* objective. PF 130 similarly seems to encourage boards to ensure members receiving their benefits rather than merely run an efficient trust operation. The authors have assumed, for the purposes of this article, that all risks to the fund are also risks to the member (not vice versa, of course) – but highlight the issue for further consideration.

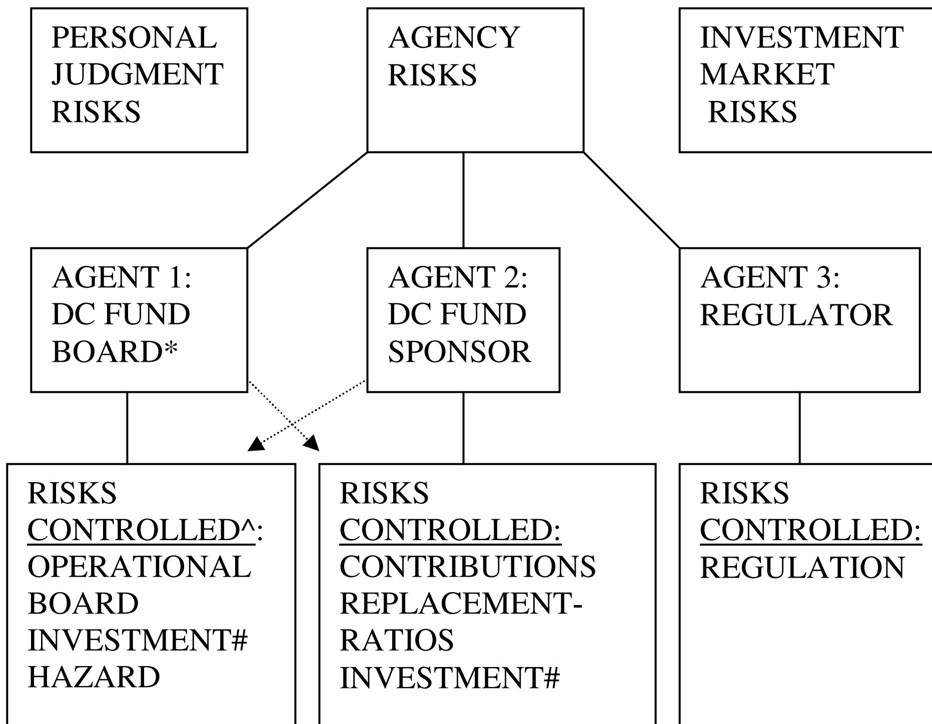
Albert's (2006) trustee risk, whilst important for the trustees, is clearly a risk that the *trustees* will be found wanting in their behaviour. This is not a direct risk to the fund or its members. It might aid understanding if that topic were dealt with under trustee conduct and not risk management.

6.6 A POSSIBLE CLASSIFICATION OF MEMBER RISKS IN DC FUNDS

Of the universe of risks relating to a member of a defined contribution retirement fund, some will be managed by the member, some will be managed by the board, and some will be managed by an entity other than the board, such as the sponsor, a third party service provider or the regulator. Besley and Prat (2005) refer to any of the risks managed by an agent as agency risks. Of Andrew's (1994) list, only the expenses and the practical investment arrangements are likely to be under the direct control of the board, and, in some funds, the suitability of the investments as well. The board may wish to contribute to the management of the other risks, such as the adequacy of retirement funding contributions, to further the fourth governance purpose of credible pensions, but it cannot manage them as they are controlled by another agent or the member herself controls them.

Expressed another way, managing the agency risks for which it is responsible is a necessary fiduciary duty of the board of a DC retirement fund, as it is crucial to the achievement of all four governance purposes: the inadequate management of the agency risk may jeopardise the provision of benefits, the benefits may not be optimised or exposed to unnecessary risk, the costs may not be transparent or justifiable, and all this may contribute to a noncredible, untrusted benefit provision.

Diagram 6.6 below illustrates a possible risk classification for DC funds based on this discussion. The solid lines indicate responsibility for managing risk, whereas the dotted lines indicate areas where the agent may wish to contribute, but cannot manage.



*Part of the management of these risks may be delegated to a service provider
^See section 7 below
#This excludes market risks and operational risks. Control will be allocated by the rules – e.g.investment choice / default option.

Diagram 6.6: A possible classification of member risks in a DC fund

7. MANAGING AGENCY RISKS

7.1 In this section, some practical aspects of managing those agency risks which relate to functions under the control of the board are discussed.

7.2 When risk management is first introduced, a once-off detailed risk identification process may be needed. Thereafter, as suggested in section 4 above, the risk management process would be iterative, requiring the board (a) to understand and document the structures and internal controls set up by the board to achieve its objectives, and (b) thereafter to proceed to identifying unmitigated risks – otherwise the identification process will not be integrated with the rest of the board's management efforts.

7.3 There seem to be a variety of approaches being used to classify agency risks. One consultant suggested that an appropriate 'taxonomy' or grouping of risks should be selected by each fund to suit its needs. Classifications and sub-classifications can aid both practical implementation and the board's understanding of the process. A conscious decision needs to be made as to how far to drill down into individual contingencies. Illustrated below is a division into operational, investment, board and hazard risks. Another framework we have seen is assets, compliance, record keeping and relationship risks.

7.4 OPERATIONAL RISK

Dexter et al (2007) is aimed at life insurance companies, yet its exposition of the management of operational risks suggests a practical method of identifying and controlling risks that may be appropriate to DC funds. Operational risk is defined as the risk of loss from inadequate or failed internal processes, people and systems, and external events. This provides one way of categorising specific groups of risks (see Table 7.4) – but other ways could be by business division, by key process or function, or by stakeholder.

High level risk	Sub-risk	High level risk	Sub-risk
People	Internal fraud / collusion	Systems	Software
	Key person risk		Hardware
	Skills / training		
Process	Client service	External events	Legislative
	Contract and documentation		Physical assets
	Data input		Third party liability
	External data		External fraud
	Financial management		
	Management info		
	Outsourcing		

Table 7.4: Operational Risk based on people, process, systems and external events (after Dexter et al (2007)).

Dexter et al suggest that these 'gross' risks may then be checked against the board's structures and internal controls, including the fidelity and fiduciary insurance, to produce 'net' risks where internal controls are seen as inadequate. One benefit of this procedure is that only the net risks need to be assessed for frequency and severity, and then whether to accept the risk or set up additional controls. However, this short cut could be a weak link in the process, in that 'adequacy of controls' is a subjective judgment. Dexter et al themselves caution that it may not be simple to institute appropriate controls, since one event (such as servicing error) could come from many causes (admin systems, low morale, inadequate training and inefficient processes) or many events could also arise from one cause. Risks are often inter-connected and frequently materialise as a cluster of circumstances. Furthermore, additional risks could be created by instituting a particular control.

7.5 Mort (2007) points out that a large part of the work of the board of a DC fund will be oversight of delegated functions. PF 130 also suggests that boards should not micro-manage their service providers. The board may be able to get a ready-made analysis of delegated risks from the service provider's own internal risk processes. However, it should be noted that a service provider's risk management would be aimed, primarily, at protecting the service provider. And furthermore, that an indemnity from a service provider may not deliver – this could be seen as a 'credit' or 'counterparty' risk to the fund.

A number of interviewees emphasised the difficulty faced by boards in ensuring adequate delivery from administrators. They noted that a detailed service level agreement, edited and understood by the board, is necessary but not sufficient. A vigorous administration sub-committee is also necessary to ensure delivery by

- monitoring on-going deliveries against the service level agreement
- reviewing from time to time the administrator's competence, indemnity, recovery plans and fees

- being available for day-to-day issues, and formulating policies (for board approval) on matters of detail issues as they arise.

An administration sub-committee must drive its own agenda, and not merely react to items placed before it by the administrator. (In the theoretical context of this paper, the administration sub-committee would be an internal control put in place to mitigate the administration risks.)

And this, of course, raises another issue – how much of members' assets should be diverted into funding risk management. One respondent felt that less than 1 000 of the 13 000 registered funds in South Africa could afford risk management.

7.6 INVESTMENT RISKS

The extent to which the board has responsibility and control of members' investment risks will vary from fund to fund, as determined by the rules. At one extreme, commercial retirement annuity funds may offer a range of collective investment schemes with no default option – and at the other, a fund may have a single pool of investments in which all members participate. The board's investment duty might be limited to the appropriateness of the range of portfolio choices to the membership, or could extend to the full range of investment policy, implementation and review. In either case, considerable literature and practice exist for the board to consult. (In fact, a search for 'pension fund risk management' citations will bring up mainly references to investment risk!) It should be noted that there are aspects of the investment process which are more properly classified and monitored as operational risks – for example issues around expenses, unit reconciliations, communication, etc.

7.7 BOARD RISKS

PF 130 highlights the board's management of itself as a separate issue to the board's management of the business of the fund. The management of such risks is well documented elsewhere, especially in the field of business management.

7.8 HAZARD RISKS

Events can occur which are outside the control of the board (and sometimes outside of any agent's control) – yet the board can at least control contingency plans. This would range from fidelity and fiduciary insurance to being aware of developments at the sponsor or the regulator which could change the fund's circumstances.

7.9 REPORTING

Dexter et al (2007) also suggest a reporting framework. In terms of PF 130, this could constitute the required statement or policy of the board of a DC fund on its risk management processes. This statement could take the form of an outline of the key structures and controls set up to achieve the fund's objectives; the timing and nature of the review of risks and internal controls; and a dashboard or scorecard of the current state of the management programme. (In section 8 of their paper, Dexter et al illustrate various reporting formats.) The concept of 'risk appetite' often seen in risk management policies is not relevant to most of these agency risk categories – with the exception perhaps of the case where the board may choose aggressive investment portfolios because of the risk appetites of the members.

7.10 THE FIRE DRILL

One of the actuarial consultants described 'disaster' as the result of unmanaged risks. One way of getting assurance about the risk management process would be a 'fire-drill' of

case studies or scenarios for the board to work through. This technique can also illustrate how common a cluster of minor mishaps may result in a major risk materialising. One of the authors has recent experience of such a 'fire-drill' process and reports that it made the risk management processes real and valued to the board. It highlighted that there are not only risks of unforeseen or unavoidable hazards occurring, but also a significant risk in the mismanagement of that hazard once it has occurred. Thought should therefore be given, to the extent possible, of how the hazard should be managed once it has occurred. The experience referred to highlighted issues such as management of the media and transparency versus the indemnity insurer's discouragement of admission of error.

8. RISK MANAGEMENT ADVICE

8.1 In this section, the provision of risk management advice is considered, bearing in mind that this paper is to be presented to members of the Actuarial Society.

8.2 ACTUARIES – A RISK MANAGEMENT PROFESSION

The vision of the Actuarial Society is to be an actuarial profession of substance and stature, serving, and valued by, its communities as a primary source of authoritative advice and thought leadership in the understanding, modelling and management of financial and other measurable risk. A number of actuarial consultants have indicated that they give advice to defined contribution retirement funds on risk management. The authors did not seek to examine each consultant's approach in detail, but at a high level, it was clear that there were different approaches. This multiplicity of approach is characteristic of a 'wider field' in which standard practice has not yet been codified.

8.3 COMPETITION FROM OTHER PROFESSIONS

Bellis (2000) discusses how professions arise and capture a field of commercial activity in the minds of customers and the public. In the field of risk management, no profession yet appears to have 'captured' the field. (Risk management advice to retirement funds probably does not fall within the scope of the Financial Advisory and Intermediary Services Act.) Hence, not only actuaries, but also lawyers, accountants, management-, risk- and governance-consultants are consulted by clients to give risk management advice. And, as might be expected, the advice received may differ according to the general training of the adviser, and whether any specific risk management expertise has been developed. The authors enquired of pensions lawyers and found some who were reluctant to give this advice on the grounds that it was not their core business and they lacked expertise, and others who did give advice, usually deriving it from an analysis of fiduciary duties, together with any supplementary material they may have studied. Similarly, some audit firms offer risk management advice (beyond the requirements of the fund audit), and some do not; and the emphasis of some auditors may be on the board being able to demonstrate compliance. (One UK accounting firm, however, has a specialist division for fund risk assessments, and has developed a detailed nested template of common risks.) Governance and management consultants will be at a disadvantage until they first become familiar with the unique circumstances of defined contribution retirement funds as opposed to entrepreneurial corporations. Clearly, the possibility exists that boards may get inappropriate advice.

8.4 RISK MANAGEMENT QUALIFICATIONS

The Professional Risk Managers International Association (PRMIA) is one of a number of bodies offering a risk management qualification. A perusal of their website

indicates little material specifically for non-profit trust based entities. Where retirement funds are mentioned, the topics are not related to operational risks and only include investment risk, asset liability management and longevity. Defined contribution funds only get a mention as a solution to these risks! The qualification is predominantly metric. Similarly, the Faculty & Institute of Actuaries have an Enterprise Risk Management subject in their 'specialist technical' range. A perusal of the curriculum indicates that it is also predominantly metric and related to capital adequacy – this can be expected from a 'specialist technical' subject – as yet there is no 'specialist application' subject in this range.

8.5 ACTUARIES – THE PREFERRED PROVIDER?

Until the actuarial profession develops expertise in this particular, non-numerical, niche of risk management it will have difficulty establishing itself as the provider of choice. Practitioners may also be exposing themselves to civil liability by holding out that they are experts in the field, as well as professional disciplinary proceedings for acting in an area for which they do not have adequate expertise. Once developed, these skills could also be used in similar environments such as collective investment schemes and unit-linked life insurers.

9. CONCLUSION

9.1 Risk management in DC retirement funds offers the possibility of improving the chances that members receive their benefits. It is stated that, to be effective, a risk management process should be integral and 'intrusive' to the fund. However, little specific guidance is given to boards by regulators on how an effective risk management process can be implemented and integrated. From the UK Pensions Regulator, and other literature, 'good governance' may be seen to cover all the structures set up by a board to achieve its objectives, including for example board sub-committees. 'Risk management' is seen as referring to a process of checking that identified risks have already been covered by the internal controls and structures; and if not, considering if further internal controls should be created.

9.2 Of the universe of risks to the achievement by a member of her objective in participating in a defined contribution retirement fund, only some will relate to functions under the control of the board. Economists refer to these risks as agency risks. It is suggested that managing the agency risks under their control is a necessary fiduciary duty of the board of a DC retirement fund, as it is crucial to the achievement of its primary objective of paying benefits. Contributing to the management of other risks to the member (such as inadequate retirement funding contributions) will contribute to the achievement of a fourth governance principle (credible pensions), but is not an area that is fully under the board's control.

9.3 Based on this understanding, a possible classification of risks in a DC fund is suggested, together with some pointers on the implementation of a risk management plan.

9.4 A variety of professionals currently give advice to DC funds on risk management. There is clearly a role for the actuarial profession to be the provider of choice. Having reviewed some of the literature and current practice, this article hopes to engender debate within the profession as to whether – and if so what – expertise and standards in this particular, non-numerical, niche of risk management should be developed and codified. Once developed, these skills could also be used in similar environments such as collective investment schemes and unit-linked life insurers.

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