Board of Directors Series

Risk Appetite Policy – Framework and Retirement Plan Application Example

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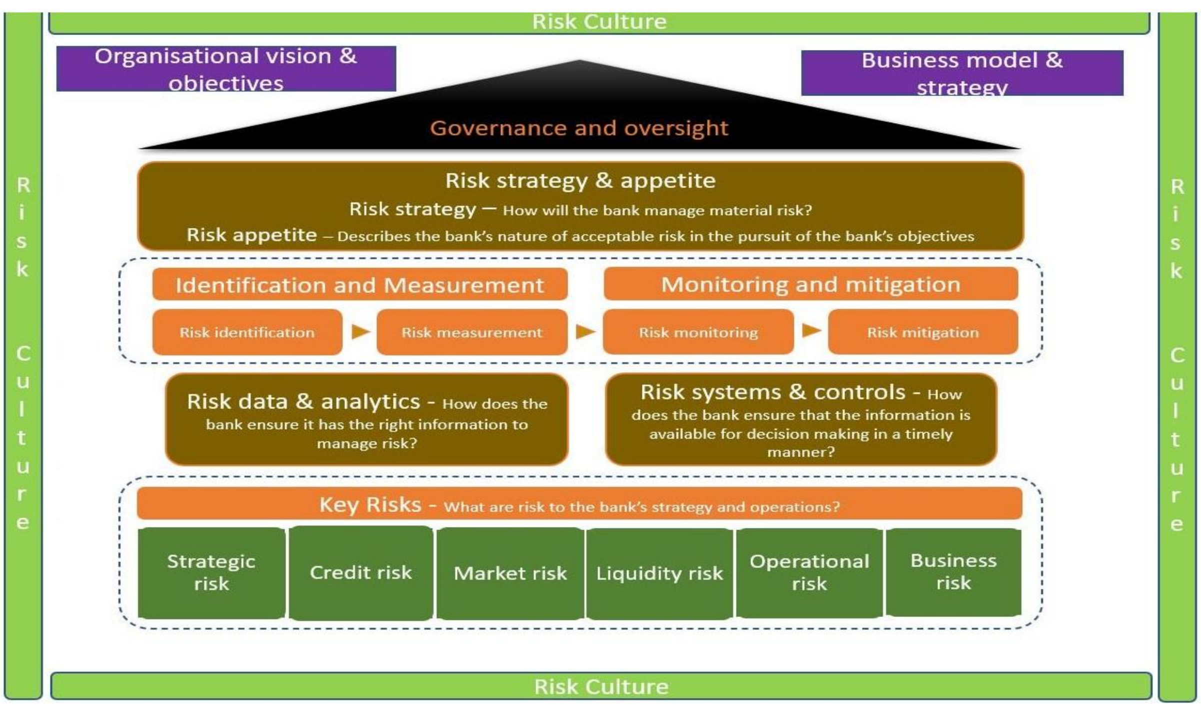
Introduction

While organizations acknowledge the importance of assessing, mitigating, and managing risks, not all have developed Risk Appetite (RA) Policies, and even fewer have developed RA Policies covering long-term obligations such as defined benefit (DB) retirement plans. RA Policies are a critical part of an organization's ability to identify, quantify, prepare for and manage the risks which may impact long-term sustainability of both the organization and its contracted benefits. RA Policies define risk categories and scope, metrics, acceptable limits, management and mitigation methods, and governance components. And for an organization's Board of Directors, the development of RA Policies and overall risk oversight is a fundamental fiduciary duty and one that has become increasingly critical as the nature of risk has evolved over recent decades to encompass financial, geopolitical, human resource, and technological factors. This article focuses on RA Policies for organizations that sponsor DB retirement plans, informed by my experience working with finance, human resource, and risk management colleagues of multiemployer entities.

Risk Management Framework and Risk Appetite Policy

Risk Management Framework:

Organizations' business models begin with mission and purpose, under which are established a governance structure, strategies, business plan methods of operation, systems and controls, data and analytics. A key part of governance is the identification of key risks and resources, which are quantified, measured, monitored, and enhanced (resources) or mitigated (risks). As Erin Essenmacher outlines, "risk monitoring starts with understanding and identifying what creates material risk to the business"[1] and then determining ways to manage and mitigate those risks within a risk management framework (RMF, see chart below[2]).



Risk Appetite Policy:

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[1] Erin Essenmacher, Why Every Director is a Member of the Risk Management Committee, Directors& Boards Sept. 12, 2024.

[2] https://www.katalysys.com/insights/overview-risk-management-framework-appetite

Organizations should set RA policies for all material risks, specifying the collective types and levels of risk they are willing to assume (risk capacity) to achieve strategic objectives within their business plans. For each risk, a risk tolerance range should be established, with maximum/minimum quantitative limits which identify acceptable (business-as-usual, often colored green), early warning (colored amber), and trigger (maximum risk before breaching concern metrics, colored red) levels. The levels should be linked to key mission/business plan metrics, such as capital/equity or liquidity requirements. RA Policies provide and organization's Management with the ability to manage operations within permitted levels, optimize risk positioning based on economic or market conditions, monitor risk trends, and report metrics to the Board in a manner consistent with the Board's established RA framework. If/when triggers occur, governance guidelines are established in the RA Policy, providing a framework for Management and the Board to address issues and/or trends.

To demonstrate risk management framework and RA policy development, the following section provides an applied example of an organization which sponsors DB plans. The DB plan-related RA Policy's background, asset-liability financial statement impact and influences, metrics and integration with the sponsor organization and plan governance.

Risk Appetite Policy Components: Sponsors of Retirement Plans

Background:

Sponsors of defined benefit (DB) retirement plans have contractual obligations to participants based on specific plan documents, and the obligations are influenced by hiring and salary practices, cost-of-living adjustments (if any), underlying inflation, mortality patterns, and external factors such as interest rates, public health trends (e.g., obesity, other trends, and pandemics), and global macroeconomic and geopolitical conditions. Consequently, sponsors must balance the financing of defined liabilities (and the variability of these liabilities) with their own operations and sustainability.

Asset-Liability Financial Statement Impact:

Any sponsor complying with International Financial Reporting Standards (IFRS) or U.S. Financial Accounting Standards Board (FASB) Generally Accepted Accounting Principles (GAAP) must report the assets and liabilities of DB plans in their financial statements (FS) as of the mid-2000s. Annually, sponsors report the accounting measures of DB plans' assets and liabilities (actuarial measures for both components differ) in their FS. The surplus (deficit) of assets over liabilities is shown as net positive (negative) values on the sponsor's balance sheet equity, with annual shifts in surplus (deficit) reflected in the sponsor's cash flow statements. For those issuing public debt, their ratings from nationally recognized statistical ratings organizations (NRSROs)—federally recognized bodies that assess creditworthiness—are influenced by various factors, including capitalization, asset quality, earnings, and liquidity. Following the U.S. passage of the Pension Protection Act (PPA) of 2006, and in adherence to GAAP and FASB rules, changes in the accounting assets and liabilities of defined benefit (DB) plans impact the sponsor's net equity. Consequently, due to NRSRO rating criteria, these changes also affect the sponsor's borrowing interest rates and ability to carry out operations.

Key Influences on DB Accounting Assets and Liabilities:

Key influences on *DB accounting assets*, which are largely marked to market values (with some lag for private assets), include global macroeconomic conditions. These conditions encompass global and national economic growth (GDP), global and national inflation rates, and global and national interest rates. Additionally, the assets utilized by the DB plans and their respective proportions (strategic asset allocation, SAA), the performance of these asset classes, the plans' outperformance or underperformance relative to asset class indices, and net cash inflows and outflows (resulting from contributions, benefit payments, and expenses) also play significant roles.

Key influences on *DB accounting liabilities* include inflation, interest rates and demographic factors. Inflation impacts accounting liabilities similarly to fixed income assets, with values rising (falling) when inflation falls (rises). Other assets, however, respond in more varied ways, either rising or falling in parallel with inflation or being neutral. Interest rates affect accounting liabilities in the same direction as fixed income assets, with values rising (falling) when interest rates fall (rise), but to a much greater extent. Since the late 1980s, sponsors following IFRS or FASB have calculated liabilities by discounting the full horizon of cash flow payments at rates of high-quality corporate bonds of similar maturity (or government bonds, if corporate bonds are not available). Demographic factors, which generally do not have a clear influence on assets (except for net cash inflows and outflows), include plan document-related benefit changes, hiring and salary practices, cost-of-living adjustments, mortality, and medical cost trends for health and welfare plans.

The differing influences and impacts on accounting assets and liabilities result in variability in their performance, which in turn represents volatility in the sponsors' FS. For instance, if economic growth rises, inflation and interest rates usually rise as well, positively impacting risk assets (equities, real assets, credit fixed income), while causing fixed income assets and liabilities to decline (discounting cash flows at higher rates results in smaller present values of liabilities). Conversely, in economic downturns, the opposite impacts occur: risk assets tend to decline, while fixed income assets and liabilities often rise. As a sponsor's own conditions often correlate positively with economic growth, the DB plans can have a procyclical impact on the sponsor: as economic growth improves, both the entity and its plans' assets perform well and liabilities decline; in declining economic conditions, the entity and its plans' assets suffer while liabilities increase.

Key Risk Appetite Policy Metrics:

Given the placement of DB plans' assets and liabilities within sponsors' FS, and the impact of net values and annual changes, plan-related RA Policies should recognize the multivariate influences on plan assets and liabilities, align with the broader parameters of the organization's risk policies, including capital adequacy (CA) and income management (IM), and include metrics which are relevant to the sponsors FS, can be managed, monitored and mitigated by the plans' management and the sponsor organization.

Given the plans' impact on employee talent, organizational finances and risk, the RA Policies should be designed by a diverse team including the plans' investment and actuarial teams, finance, human resources and risk personnel. The multi-faceted team assessed the drivers of growth and volatility in assets and liabilities, as well as the varying relationships between these factors and the organization's capitalization, asset quality, earnings, and liquidity. This analysis identified both pro-cyclical and counter-cyclical relationships, internal and external trends, and areas where policies had negatively impacted the sustainability of both the plans and the organization.

In the organization whose plans' investments I oversaw, the process resulted in the selection of two metrics and associated risk triggers which recognized the relatively large size of the plans' assets and liabilities compared with the sponsor's equity, high cost to fund the plans compared with sponsor's annual budget. Accordingly, the metrics included: i) maximum short-term volatility between the performance of the plans' assets and liabilities, as this volatility impacts the sponsors' FS equity; and ii) maximum range around the plans' long-term actuarial funding required rate of return (ROR) and the sponsor FS' intermediate-term expected ROR for the plans (which incorporates market and economic expectations). The two metrics, once adopted by the Board, effectively set the plans' range of permitted SAAs, given the impact of SAA on asset-liability active risk (relating to the first metric) and asset performance and volatility (relating to the second metric).

Integration within Sponsor and Plan Governance Structure:

Organizations with strong risk cultures incorporate any risk with the potential to impact an organization's operations and FS in their risk management framework and in RA Policies, both set and overseen by the organization's Board of Directors and implemented by Management. Each business unit risk (including an organization's DB plans, for which long-term funding is required and whose assets and liabilities are incorporated in the organization's FS) must include the elements of the organization's risk management framework namely: i) strategic, credit, market, liquidity, operational and business risks; ii) risk data and analytics, systems and controls; and iii) identified metrics, measured, monitored and mitigated. Key risk management framework metrics, those with the greatest impact on the organization, are set, with limits identified, within the RA Policy, approved by the Board of Directors. The RA Policy includes, beyond the metrics: i) a comprehensive background of the source of the risks, in the DB plan example, the plans' purpose, funding responsibility and methods, exogenous and endogenous risks, and actions taken up to the date of the RA Policy; ii) methods to manage and mitigate the identified risks, including resource tradeoffs; iii) consideration of peer organizations' RA Policies; and iv) the method and frequency of reporting conditions and trends, responsibilities for risk management and mitigation, and strategy options when metric limits may be/are breached. The risk management framework and RA Policy governance process should align with the organization's overall governance structure, process and timeline.

Conclusion and Further Resources

This article has briefly reviewed the criticality of organizations' incorporating key risks within their risk management frameworks and developing RA Policies which identify and measure the risks' top influences on the organization, setting metrics and permitted limits, management and mitigation methods, and governance structure around these risks. The article demonstrated this process through DB plans' impact on organizations' FS, the multi-functional assessment of the sustainability of the plans and organization, the short- and long-term metrics to be measured and mitigated, and the governance structure to oversee and manage DB plan risks within the organization.

For RA Policy Commentary and DB Policy examples, see:

The Global Fund, Risk Appetite Framework: https://www.theglobalfund.org/media/7461/core_riskappetite_framework_en.pdf

IRM Risk Appetite Statements: https://www.theirm.org/media/6878/0926-irm-risk-appetite-12-10-17-v2.pdf

EBRD Risk Appetite Statement: www.ebrd.com

International Organisation of Pension Supervisors: https://www.iopsweb.org/rbstoolkit/Module3identifyingrisks.pdf

Local Authorities Pension Plan (LAPP, Alberta): Risk Appetite https://www.lapp.ca/page/risk-appetite

London Pensions Fund Authority Risk Appetite Statement:

https://www.lpfa.org.uk/download/LPFA%20Risk%20Appetite%20Statement%20VF%2013042022.pdf

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