By Muriël van den Berg

GUIDELINES TO DEVELOP AND IMPLEMENT A RISK APPETITE FOR DUTCH PENSION FUNDS

dr. Muriël van den Berg AAG is Corporate Risk Manager at MN. This article is written as part of the authors MBA-thesis. The author likes to thank prof. Murray Bryant for supervising this thesis.

Summary

Board members of pension funds should be able to explicitly express their risk appetite, which is defined as the willingness to take risk in order to meet their strategic objectives[1]. In this article, a framework is presented which assists Board members of Dutch pension funds in developing and implementing a risk appetite. The article focuses on strategic decisions and the cultural mindset of pension funds. The full risk appetite framework is available at: http://riskappetitepensionfunds.wordpress.com/. It is concluded that insights from strategic management theories and change management can guide Board members and that a risk manager/Actuary can guide the Board members on their risk appetite journey.

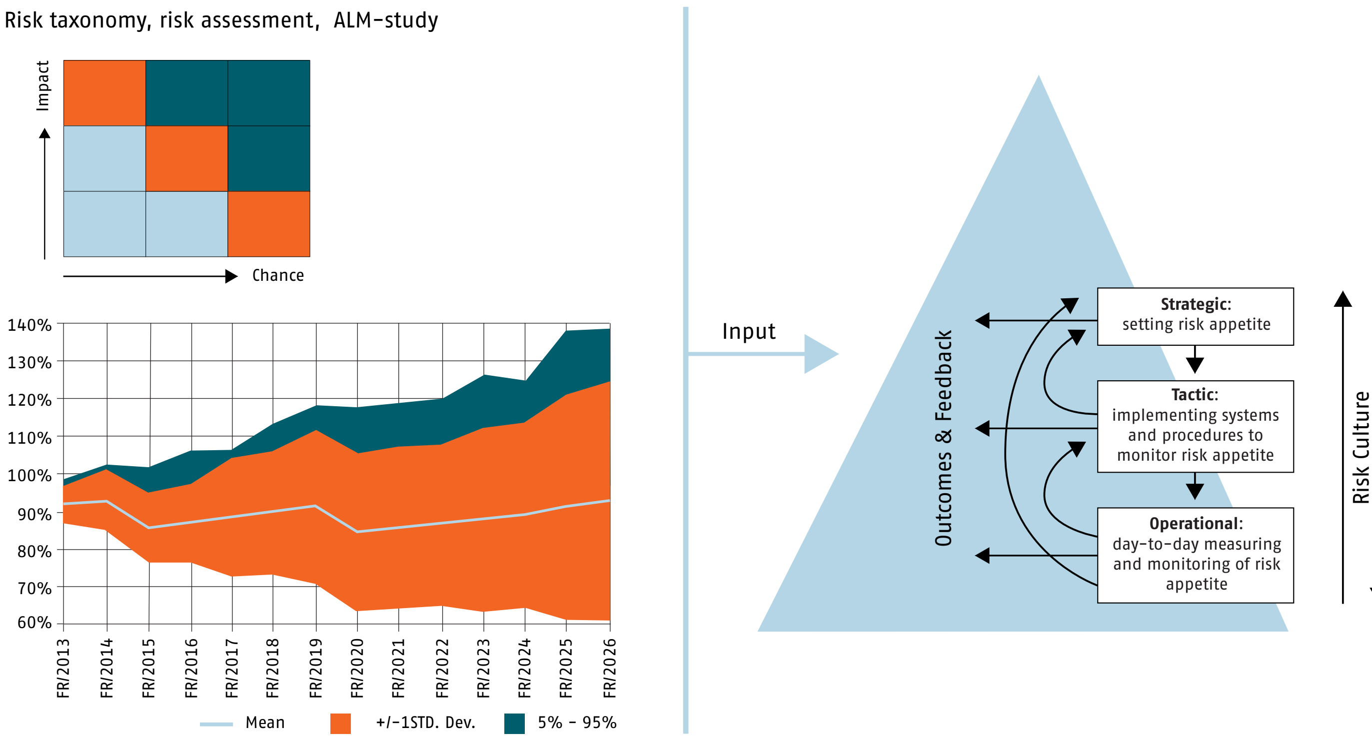
Are pension funds ready to develop a risk appetite?

Before introducing the framework, the current risk management activities of Dutch pension funds are summarized: where does the sector stand when it comes to risk assessments, stress tests/scenarios and developing a risk appetite? An internet survey among twenty top-100 pension funds (response rate 38%) reveals that these pension funds already quantify their financial risks like market risks and credit risks. Regarding non-financial risks such as operational risks and reputational risks, it feels that some funds still have to develop quantitative measurements. The reported use of (self-developed and/or standard) stress tests is remarkably positive. As is the notion that almost all respondents report to have a qualitative and quantitative idea of the pension funds' risk tolerance and risk appetite. The respondents indicate that ALM-studies play an important role as a facilitator and/or decision tool when developing a risk appetite. It is concluded that the sector is ready to further develop and implement a risk appetite.

Risk Appetite Framework

Based on experiences of the Dutch pension industry and theoretical insights from COSO, the Institute of Risk Management (hereafter: IRM), the Pensioenfederatie, KPMG and Atos Consulting, a risk appetite framework is presented in Figure 1.

Figure 1: Risk appetite framework for pension funds



The framework incorporates the insights the pension industry already has developed in the past years regarding ALM-studies and risk assessments frameworks (e.g. based on FIRM[2]). Since the risk appetite should be embedded in the organization, the model covers the strategic, tactic and operational levels of the organization. It is stated that a risk appetite cannot be implemented without a proper risk culture[3]. Therefore, the organizational culture forms an integral part of the model. Furthermore, feedback loops are added to the model. These loops indicate that developing and implementing a risk appetite is a continuous and context specific process[4].

Developing a risk appetite

The risk appetite is developed at the strategic level. ALM-studies and insights from strategic management theories can provide guidance to the Board.

Typical guidance questions from an ALM-session cover aspects of both risk tolerance and risk appetite:

- Which nominal or real pension is pursued and with which level of certainty?
- What is the maximum loss (in funding ratio or Euro's) the Board is willing to take?
- What is the variability in pension outcomes that the Board accepts/pursues?
- What is the sensitivity of pension outcomes due to economic/ demographic risks in normal and stressed economies?

Inspiring Board room questions regarding the various stages of developing, implementing and monitoring the risk appetite can be found at e.g. the IRM[5].

Furthermore, (ALM-)games can assist to create Board members' awareness – and desirability – of chosen risk-return profiles. Several pension funds, subcontractors and academic researchers have developed these games. An easy way to develop a relative simple ALM-model is @Risk, a build-in statistical tool for Microsoft Excel[6].

Generally, in the past years the developments of ALM-studies were the first steps to discuss economic scenarios with pension fund Boards. A handy tool to improve scenario thinking can be found in books on Strategic Management[7], which focuses on external developments (risks) regarding economics, politics, social/demography, ecological, technological and law/regulations, which may affect pension funds (PESTLE analysis)[8]. Practical information regarding various financial and non-financial emerging risks can be found in publications of the World Economic Forum[9]. After a first assessment of many risks (long list), the pension fund Board can decide to rank a short list of risk scenarios, which could be quantified (impact analysis). The pension fund Board can summarize which threats and opportunities it foresees and which risks it is willing to take to achieve the funds' objectives. This analysis (SWOT)[10] is an important exercise to decide on the future strategy on the fund – in which the risk appetite should be embedded.

Risk culture

The aspect of 'risk culture' is very important when developing a proper risk appetite. Some years ago, a study by Frijns[11] had a massive impact in pension funds Board rooms. The study concluded that Board Members of pension funds failed to take into account all stakeholders' interest when taking investment decisions. Instead of focusing on risk-return profiles, their primary concern was on expected returns.

An 'asset only' view was accepted in a pre-crisis environment. The post-crisis 'risk-return' view is probably taking root, concluding from the observation that pension funds nowadays have a qualitative and quantitative sense of the risk appetite. Generally, changing a risk culture is a huge project, which requires Board time (and willingness!) and resources[12]. In terms of Organizational Behavior theory, it is expected that the pre-crisis culture of pension funds probably tends to be competitive or even 'aggressive' and that an effective corporate culture to implement a risk appetite is more focused on achieving stability and more 'rule-oriented'[13].

To measure the 'cultural health' of an organization, Hindson developed a tool which covers four subjects: the tone at the top, governance, decisions and competency[14]. The IRM listed Board room questions for each of the subjects[15]. It states that the tone at the top deals with expectations set by the senior management and the level of transparency with regard to risk management information. According to the IRM, a key question regarding governance is, whether accountability for risk management is clearly defined in role descriptions throughout the organization. The questions also stress the importance of risk knowledge dissemination, and how risk management knowledge can support the organization's decision making[16]. Needless to say, that the risk manager forms a crucial role in revealing the risk knowledge, and can support the Board in using the risk knowledge as a decision tool.

Role of the Risk Manager

The pension fund Board might benefit from using a facilitator to develop and implement the risk appetite. A facilitator can be an ALM-specialist, a Risk Manager, Actuary or Change Manager (when discussing culture and maturity of the organization). In all instances, there is one rule. The Board must ensure that it is in charge, i.e. it is 'countervailing' against the external or internal advisors[17].

To conclude, it is expected that the biggest hurdle when developing a risk appetite is the human factor. The required cultural reforms can be massive and should be dealt with like any large change management project[18]. As often, the risk manager/Actuary has a nice opportunity to apply both his technical and people skills. ⏮

Literature

1 – Institute of Risk Management (2011). Risk appetite & tolerance guidance paper. Published by the Institute of Risk Management, London. Hereafter quoted as IRM, 2011.
2 – De Nederlandsche Bank (2005). Handboek FIRM.
3 – IRM (2012). Risk Culture. Under the microscope guidance for Boards. Published by the IRM, London. Hereafter quoted as IRM, 2012.
4 – IRM, 2011, p.16.
5 – IRM, 2011, p.10.
6 – Albright, S.C. and W.L. Winston (2012). Management Science Modeling (4th edition).
7 – E.g. Johnson, G., R. Whittington and K. Scholes (2011). Exploring Strategy, text & cases (9th Edition). UK: Pearson Education Limited. Hereafter quoted as Johnson et al., 2011.
8 – Johnson et al., 2011
Andersen, T.J. (2007). Strategic Risk Management: Outlining the Countours of the 'New Risk Management' paradigm. Herafter quoted as Andersen 2007.
Hopkin, P. (2012). London: the Institute of Risk Management.
9 – World Economic Forum (2012). Global Risks 2012 (seventh edition), an initiative of the risk response network.
10 – E.g. Johnson et al., 2011; Andersen, 2007.
11 – Frijns, J.M.G., J.A. Nijssen en L.J.R. Sholtens (2010). Pensioen: 'onzekere zekerheid'.
12 – IRM, 2012.
13 – McShane, S.L. and M.A. Von Glinow, 2010 (5th edition). Organizational Behavior, p.419.
14 – Hindson, A. (2010).
15 – IRM, 2011, p.10.
16 – IRM, 2011, p.22.
17 – E.g. De Nederlandsche Bank (2011). Resultaten beleggingsonderzoeken 2010.
18 – IRM, 2012, p.13.
Kotter, J.P. and D.S. Cohen (2002). The Heart of Change. Real-life stories of how people change their organizations.

Implementing an enterprise risk management (ERM) program can enable federal CFOs to unify and improve their agencyâ€™s risk management capability.Â Learn how CFOs can develop a risk appetite framework aligned to the agencyâ€™s mission and the amount of risk the agency is willing to tolerate to achieve its strategic goals and objectives.Â Developing a risk appetite statement which clearly and concisely articulates an agencyâ€™s attitude towards risk taking allows senior leadership to effectively communicate the agencyâ€™s risk appetite throughout the organization. â€”Resource alignment. Developing prioritization tools that allow senior leadership to more effectively allocate resources to manage risks and make enterprise-wide strategic decisions. â€”Measurement. Learn about the Dutch pension system, the retirement age in the Netherlands and the pillars that determine the pension expats receive when they retire.Â In the individual investment system collectives and individuals make high- and low-risk investments to supplement what they will receive from the state pension. These different models can be defined as the three pillars of the Dutch pension system. The 3 pillars of the Dutch pension system.Â Pension funds are mostly mandatory. By making pension funds compulsory in most industries, the Dutch government aims to provide solidarity, stability and a good pension scheme for all employees. Dutch pension funds are evolving into such stand-alone pension schemes. Some directions for future reforms are sketched. Keywords Stand-alone pension schemes Â· Netherlands Â· Risk.Â Also Eastern European countries and several emerging economies are developing a funded pillar to supplement public PAYG systems. All of these countries have to develop efcient funded pension institutions that the population can trust. This constitutes a major challenge. Indeed, the next subsection documents the way in which funded corporate pension plans in the Anglo-Saxon world are crumbling, while Sect.