CAPSA/ACOR
Canadian Association of Pension Supervisory Authorities
Association canadienne des organismes de contrôle des régimes de retraite

Communique
Review of Leverage Use within Pension Plans

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Overview

Leverage in the context of pension plan investments exists in many forms and is not new. In simple terms, leverage can involve borrowing from one asset class to obtain exposure to another asset class, or to hedge one or more risks to the investment portfolio or to pension liabilities.

What makes it of particular interest to pension regulators now, is that it is being used more commonly and more intensively by pension plans, principally as a component of investment strategies aimed at achieving better asset-liability matching (through higher exposures to fixed income assets) while allowing pension plans to retain significant exposure to return-seeking assets.

Some pension plans may have been prompted to use leverage due to the current low interest rate environment, which has depressed the future return prospects of fixed income and also reduced return expectations for a number of other asset classes. Leveraging pension plan assets enables the plan to obtain asset exposures, which it otherwise would be less capable of achieving, given traditional asset allocation approaches and methodologies.

CAPSA Leverage Working Group

To study the use of leverage by pension plans, CAPSA established the Leverage Working Group (the "Working Group") in 2016. The mandate of the Working Group is to:

- conduct research, review existing rules, evaluate guidance and reporting requirements relating to the use of leverage;
- engage with industry experts and plan administrators that actively employ leverage; and,
- provide pension regulators with a better understanding of pension plans' use of leverage, including the extent of its use, and its potential benefits and risks.

The Working Group has shared the preliminary results of its research with CAPSA. The results of its findings are summarized in this Communique.

Key Findings Regarding Leverage Use

The Working Group identified the following key findings and challenges regarding leverage use:

1. Leverage exists in many forms, but generally falls into one of two categories:
    i. "financial leverage" which involves borrowing funds, and

    ii. "synthetic leverage" which is created through the use of derivatives.

Leverage can exist at the pension fund level and/or be embedded in the fund's investment holding.

2. While leverage is often associated with higher risk (increasing exposure to riskier asset classes to seek higher returns; amplifying exposure to potential gains and losses), the risk profile of leveraged investment strategies can be quite different when viewed from the perspective of a pension plan's balance sheet rather than from an asset-only perspective. Leverage can be aimed directly at reducing certain risks in investment portfolios and pertaining to the liability side of the balance sheet.

3. Key risks associated with leverage use include credit risk, liquidity risk, counterparty risk, refinancing risk, and governance risk.

4. There is no simple measure of leverage that effectively captures either the extent or the risks associated with its use. Current disclosures and regulatory reporting including a pension plan's annual report, do not provide sufficient clarity regarding its use.

5. Leverage, especially the use of synthetic leverage, requires sophistication and a considerable understanding of the risks involved and how to actively manage them.

6. While a pension plan's use of leverage must be considered in assessing the riskiness of its investment activities, that assessment requires a more holistic analysis of the overall quality of its risk management strategy (i.e. the procedures and controls in place for managing the risks associated with leverage use).

The Working Group concluded that, given the complex relationship between leverage use and investment risk, regulators cannot rely only on regulatory disclosures to identify potential problems. Regulators could enhance their risk assessment and oversight of pension plans by also reviewing the processes and procedures in place to manage investment risk, including the risks related to the use of leverage.

It is expected that regulators' expectations with respect to effective risk management by pension plan administrators, would focus on:

- **plan governance**, including investment, accounting, and risk management policies and procedures, and appropriate decision-making and reporting structures, from the investment department up to the Board;
- **expertise** to support investment activities and Board oversight;

- **stress testing** that provides assurance that risks facing the plan under a variety of scenarios are well understood and are not excessive; and
- **communication with stakeholders** concerning the plan's use of leverage and how leverage risk is communicated to stakeholders.

Next Steps

CAPSA will consider whether further research is required. The Working Group will continue to examine the research of other regulators (such as the Canadian Securities Administrators and the International Organization of Securities Commissions).

The Working Group will make recommendations to CAPSA on the form and nature of guidance that may be needed in this area.

This could include high-level guidance for regulators and plan administrators about the use of leverage and its associated risks, and regulators' expectations on effective risk management and oversight by plan administrators.