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To Whom It May Concern:

RE: CAPSA Guideline – Leverage and the Effective Management of Associated Risks

ACPM is the leading advocacy organization for a balanced, effective and sustainable retirement income system in Canada. Our private and public sector retirement plan sponsors and administrators manage retirement plans for millions of plan members, including both active plan members and retirees.

As an association devoted to supporting the development of an effective and sustainable retirement income system in Canada, ACPM supports the development of CAPSA's new Guideline on Leverage and the Effective Management of Associated Risks. We think this new guideline will support the development of appropriate processes for managing leverage related risks at Canadian pension plans. It is ACPM's belief that leverage is an important investment tool that can assist pension plans in delivering the pension promise to members. As with any investment product or tool, prudence must be used in using leverage as it can expose pension plans to different types of risks. ACPM agrees that for a pension plan to be successful over the long term, it is critical that these risks be properly understood and managed.

As pointed out in the guideline, pension plans use leverage in a multitude of ways. Indeed leverage is so pervasive, it exists in virtually all investments found in pension funds[1]. One of the primary uses of non-embedded leverage is to control other risks. The use of currency forwards to manage foreign exchange risk that results from investing globally (which is part of diversifying equity market exposures) is an example. Another example is the use of interest rate derivatives or repurchase agreements to manage interest rate risk in a Liability Driven Investment (LDI) strategy. These examples highlight the important role that leverage plays in managing risks and in delivering pension benefit security to plan members. While leverage can expose a pension plan to different types of risks, it is frequently used to reduce the overall risk of the pension plan. It is therefore critically important that the regulatory guidance on the use of leverage be structured in such a way as to manage the risks of leverage without significantly hindering the use of leverage for these types of roles.

[1] Leverage exists in publicly listed and private equity, real estate, infrastructure and other real assets, currency hedging and interest rate hedging strategies, not to mention hedge funds and other more complex investments.

The guideline also notes the there are many types of leverage and that they have different levels of risk. The types of leverage used by Canadian pension plans ranges from simple leverage such as a mortgage on a building, to very complex leverage exposures that result from the exposure to combinations of derivatives. Given that the risks of different types of leverage are fundamentally different, it is appropriate that the risk management practices be aligned with the type of leverage. That is, extensive risk management processes for more complex forms of leverage and simple risk management processes for simple forms of leverage. Creation of a single complex risk management standard for all types of leverage may dissuade smaller pension plans from using leverage to manage other risks and could result in the overall risk of pension plans increasing.

It is important to note that many pooled investment funds, such as one that hedges its foreign currency exposures or a real estate fund with mortgages, would be classified as levered. Even publicly traded equity will involve leverage, as very few companies can operate without ever borrowing. Therefore, most pension plans in Canada would be using leverage and would be expected to comply with the requirements of this guideline. (We note that the footnote no. 3 on page 6 of the guideline should be revised to a more accurate statement. Embedded leverage is found in pooled funds, often favored by smaller plans, listed equities, real estate and other real asset investments.)

Section 3.2 of the guidance acknowledges the different levels of risks associated with different types of leverage. However, section 5 then goes on to define quite extensive oversight and risk management requirements that would typically only be required for the more complex forms of leverage. Section 5 outlines additional monitoring, reporting and documentation requirements for plans that use any type or level of leverage. These requirements would place a burden on smaller pension plans using simple forms of leverage.

In Section 4.3, it would be helpful to emphasize the importance of diversifying counterparty risk (having agreements with more than one counterparty).

The opening paragraphs of Section 5 could be improved by recognizing that an Administrator may delegate oversight of leverage investments to a competent third party, for example, an outsourced chief investment officer. The Administrator’s duty in that case is to select and monitor the third party charged with those duties. In the second sentence of Section 5.1, we suggest that it be changed to read “Plan administrators that do not have the required expertise <u>should</u> seek advice from external advisors…”. The last sentence of section 5.2 should be deleted as the strategy without leverage is an impractical reference point. The use of explicit leverage is evaluated together with selecting a target asset allocation. If explicit leverage were not used, then the administrator may well select a very different target asset allocation that best fits its risk and return objectives while conducting its asset allocation review. Therefore, comparing expected risks and returns with and without leverage is extraneous information.

While not a requirement of the guideline, two of the three leverage risk metrics identified in Appendix A are significantly beyond the capabilities of all but the largest pension plans.

It is also not clear how these metrics are conducive to understanding the level of risk associated by the level of leverage found in a pension fund's investment strategy or the management of day-to-day operational risks. By including them in the guideline, CAPSA is communicating to pension plans that this is the level of leverage risk metric calculation and monitoring that they expect. We recommend that CAPSA explore the use of simpler, easier to use ratios such as the Liquidity Coverage Ratio (LCR). The article from the Investment Innovation Institute on "The Impact of Liquidity on Pension Funds" outlines the process and benefits of using an LCR at a pension plan. It is ACPM's belief that simpler, easier to calculate risk metrics are more likely to be produced on a regular basis and to used in the risk management process. In that vein, ACPM fully supports the use of simple stress tests as a way of understanding the risks associated with the chosen investment strategy and how leverage helps or hinders in those stress tests.

In summary, it is ACPM's belief that having a "one size fits all" guideline is not appropriate, and the guideline should explicitly differentiate between different forms of leverage. Pension plan administrators already have a fiduciary duty to understand, monitor and manage the risks of all their investments, including investments with embedded leverage. They also do not have an infinite capacity to do risk management, so need to focus their risk management activities on the biggest risks. By better aligning the leverage oversight expectations with the level of leverage risk, the guideline could help avoid the scenario where smaller pension plans avoid using forms of leverage that might otherwise reduce risk for fear that they are not compliant with CAPSA expectations. This would be a loss for plan members as it could increase investment risk and pension benefit funding costs alike.

Thank you and please feel free to contact us if you would like to discuss.

Sincerely,

R Marrero

Ric Marrero
Chief Executive Officer
ACPM