Survey: Few measure counterparty risk

Leverage, liquidity measurements also seen as lacking

Source: *Pensions & Investments*

Most pension funds do not measure counterparty risk, six months after the collapse of Lehman Brothers Holdings Inc., a survey by *Pensions & Investments* and Capital Market Risk Advisors shows.

The *P&I*/CMRA survey found that pension funds appear to be lacking in two other crucial risk areas: measurement of liquidity and leverage. About half of respondents said they do not measure leverage or liquidity in funds in which they invest. Given the collapse of the global financial system and the steep decline of capital markets over the past nearly 19 months, however, this lack of oversight and monitoring is going to change. The problem is, it's not like flipping a switch: Pension executives are going to have to either open up their wallets or simplify their asset allocations and eliminate exotic investments.

The survey was split into two parts: one for pension executives and one for plan board members or trustees. Roughly 40 people responded to each question on the survey.

The survey of pension executives and trustees found that 70% of respondents do not gauge counterparty risk for the overall pension fund. Counterparty risk, also known as default risk, is the possibility that one party to a trade will fail to meet its contractual obligations.

The results were “startling but not surprising,” said Leslie Rahl, president of New York-based Capital Market Risk Advisors. “It's a rather important finding when you consider that managing and measuring counterparty risk began to be raised in 1999” after the 1998 failure of Long Term Capital Management.

In addition, the disintegration last September of Lehman Brothers left money managers, pension funds, custodians and banks holding the proverbial bag, with hundreds if not thousands of trades unsettled. That should have pushed the issue of counterparty risk squarely to the top of investment committee agendas.

Ms. Rahl said even though more pension funds measure liquidity risk than counterparty risk, “that's something that should be moved up the priority scale” as well.

Overall, too few pension fund executives and trustees are fully plugged into their plan's risk management process and simply receive risk reports mostly on a quarterly basis, according to the survey.

“The main conclusion that I drew is that pension funds want and need more,” she said. “There seems to be a general understanding that what they're getting is not sufficient.”

In fact, while the majority of pension board respondents (58%) receive quarterly risk reports, 39% plan to increase the frequency of risk reporting.

“Clearly at the board level, they're crying out for information on a more frequent basis,” Ms. Rahl said. She added that the results largely confirm what pension fund executives have told her.

Collection difficult

At the $24.5 billion South Carolina Retirement Systems in Columbia, Allen Gillespie, a member of the investment commission, which oversees the state's six pension plans, agreed more information would have been helpful as markets imploded last fall, but said data collection can be difficult for a pension plan with assets in many different classes.

“For a pension plan with real estate, private equity, bonds, limited partnerships, there are all sorts of data delays, and data collection is tough,” said Mr. Gillespie, who participated in the survey.

He said “you can also go overboard” and try to collect too much data with too much detail that can just obfuscate, not clarify, the larger view of a plan's risk profile.

To combat this problem, Frank Nielsen, executive director of core equities for the Americas at MSCI Barra, New York said pension funds and money managers need risk managers “heavily” involved in plan and portfolio construction.

“Then, if something happens, you have the risk committee sit together and analyze the data and really use the expertise coming from all corners of the plan or firm,” such as the chief investment officer, portfolio managers and traders, as well as officials from the legal, compliance and governance departments.

“The risk management function,” Mr. Nielsen said, “needs to step up and become a more senior component of plan and portfolio construction.”

But that takes money, and some pension funds are unlikely to have the financial resources to make that commitment, in which case they need to take a hard look at their asset allocation.

The P&I/CMRA survey, however, found that on average, respondents spent just $150,000 on risk management in 2008, with the maximum of $500,000. They planned to increase that amount by an average of 20% in 2009.

In a related finding, respondents on average had 1.4 people assigned to risk management, with a maximum of 12. Only 10% of respondents said they planned to add more risk management staff.“If you can't either outsource some of it or invest in doing some of it yourself, simplify your life and simplify your portfolio,” Ms. Rahl said, suggesting that simplifying a portfolio meant taking a close look at asset allocation and possibly eliminating esoteric investments. “I believe very strongly that if you don't understand it, don't buy it.”

Separately, some pension funds are planning to implement risk budgeting, according to the *P&I*/CMRA survey. Currently, just 24% of respondents use risk budgeting, but another 12% said they planned to do so.

“That 50% increase caught my eye,” Ms. Rahl said. “There's generally a fairly high correlation” between planning something and doing it. “If someone says they plan to, that generally means it's on the agenda.”

When asked how the financial crisis and/or the Bernard Madoff scandal had changed their view of risk, respondents seemed to agree that the events shook them out of any sense of complacency and reinforced the need for strong due diligence as well as a broad view of the investment world.

“We now see that along with a risk system, we need a better way to look out at the big picture and find a better way to identify and manage tail risk,” one anonymous pension fund board member wrote.

Another board member said: “We are trying to control unnecessary risk. Every investment was more intertwined/correlated than anyone realized. Instead of seeing just one or two investment types being hit, every sector was affected.”

Several respondents said the crisis completely eliminated any belief that risk-free investments exist.

“We're more cautious about what previously appeared as no risk or remote risk, such as securities lending, stable value funds, money markets,” one anonymous board member wrote. “We were always wary of hedge funds and are more so now, especially funds of funds.”

With most pension funds still weak on risk management, the big unanswered question is: Will the credit crisis and ensuing drop in capital markets and global recession finally kick pension boards and executives into action?

“This is the event,” Ms Rahl said. “My phone's been ringing off the hook.”