Risk Management
Closed Pension Fund Administrators

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May 2007

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1. Introduction

1.1 We have prepared this short article with the aim of providing Risk Management Committee members a basic insight into the risks faced by Pension Funds.

The article is presented in four (4) sections:

Section	Description
1	Introduction
2	Types of Risk
3	Mitigating Measures
4	Risk Quantification

1.2 A key **objective** of a Pension Fund is to meet its financial obligations as and when due and consequently meet the expectations of:

- Current and retired employees, and
- The Regulator

Risk Management is the process of identifying circumstances that can hinder this **objective** being fulfilled and putting mitigating actions in place.

2. Types of Risk

The Pension Fund is exposed to both **Financial** and **Non-financial** risks which we briefly discuss below:

2.1 Financial Risks

Market Risk	This is the risk that there could be an adverse change in the value of, or income from the Fund's Assets, e.g. a sudden significant fall in equity prices and/or change in interest rates Such changes will decrease the value of assets. To the extent that, the value of liabilities does not similarly fall, the change will lead to financial strains.
Credit Risk	This is the risk that a counter party to a financial transaction fails to perform its obligations as agreed, e.g. government defaults on interest payments.
Liquidity Risk	This is the risk that the Fund, though solvent, cannot meet its obligations because its assets are relatively illiquid.
Funding Risk	A non timely payment of the contributions due - leading to cashflow problems
Longetivity Risk	This is the 'risk' arising from the Fund Pensioners living longer than expected.

2.2 Non Financial Risks

These are the potential 'losses' arising from the CPFA's internal operations – incorrect system entries, inadequate processes, wrong recruitment/appraisal policy etc.

3. Mitigating Measures

We highlight ways of mitigating risks below. PenCom investment guidelines discuss Financial Risks and should be read by all Committee members.

3.1 Market Risk

- Diversify portfolio: sector allocation*****
- Diversify stocks within sector
- Limit the extent of self investment
- Establish a written down basis for choosing and disposing of stocks within each sector
- Limit the exposure to **any one** company – within each sector **and** across sectors (e.g. bank shares + deposits in the bank)

*** This should have close regard for the profile of the liability portfolio and the Fund's cashflow needs. (The Fund should have at least a 2 years cashflow projection).**

- We would be pleased to discuss market risks in more details if required.

3.2 Credit Risk

Establish the minimum credit ratings of banks where **deposits** can be placed. Such ratings should not be more than 6 months old. **We propose minimum rating of 'A'.**

Presently, there are no quoted corporate bonds. Once they are available the committee should recommend a minimum rating for bonds the Fund will deal in.

The risk rating of the Federal and State Governments should be reviewed at each Risk Committee meeting. Governments do default, hence this aspect should not be overlooked.

3.3 Liquidity Risk

Measures taken under the market risk would have helped address this risk.

However, in addition, we propose that the Fund should have at least 100% of its net cashflow needs in liquid assets.

Net cash flow	=	Contribution + Interest income + dividend + rent etc	Less	pension outflow + other benefit outflow + other outgo(e.g fees)

This should be projected on a moving quarterly basis.

3.4 Longetivity Risk

If pensioners live longer than expected their 'assets' (i.e. Pension Reserve) may be insufficient to meet their 'obligations', leading to extra funding needs.

Hence the valuation basis should be prudent, anticipating some improvement in mortality. The Committee should require valuations to illustrate the sensitivity of the Pension Reserve to changes in mortality and interest assumptions.

3.5 Operational Risks

Operations risks broadly fall under three headings – people/systems/processes.

- ✓ People

  Company policies should apply - recruitment, training, supervision, performance, compensation etc.

  The Risk Committee should enquire at its meetings if the enterprise is at risk from people issues. (staff turnover rate, details of operational errors incurred etc).

- ✓ Systems

  Operational IT systems have to be secure and reliable. The MD should comment on experience at Risk committee meetings. Examples of security risk are the adequacy of the failure of:

  

  - internal and external backup functioning facilities
  - password authorisation at different hierarchical levels

- ✓ Processes

  - The MD should identify key processes and illustrate to the Risk Committee that the processes are adhered to and **verified**.

4. Risk Quantification

   Quantifying the impact of risks on solvency is an increasing component of the advice and disclosures currently required in the International Financial Community, and the practice is gradually creeping into Nigeria.

   Examples of risk questions are:

   - What will be the effect on the Pension Funds Solvency if the market drops by X% or interest rates change by Y% etc.
   - What are the chances of these happening?
   - To what extent should can we mitigate (reinsurance, purchase options) etc.

   Presently, the broad measures highlighted in section 3 above will suffice for most CPFAs. However as in the banking and insurance industries, we foresee the quantification and advice on risk, soon being needed in the Pensions Industry in response to anticipated investment and annuity product developments.

5. We trust you find the above helpful. For further information please contact Rotimi Okpaise (rotimi.okpaise@hractuaries.com) or Paul Odofin (paul.odofin@hractuaries.com)

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