

Commentary

JANUARY 2005

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Asset Liability Management Principles

The Society of Actuaries Board of Governors has approved the release, as an exposure draft, of a document: "Principles Underlying Asset Liability Management" to members of the actuarial profession and other interested parties. This ALM document is extremely important and deserves the attention of a wide audience both within the United States and in other countries. The full text of the document is available on the Society's web site at www.soa.org. The following are key points from the document:

- A task force that took up the call to finalize the ALM Principles unanimously recognized economic value as the central principle of ALM.
- ALM is a vital element within an Enterprise Risk Management framework
- A pension plan is an entity for which the plan sponsor has responsibility, but which is legally separate and managed in addition to the core business of the organization. The entity at risk is generally the plan but the entity bearing the risk is generally the plan sponsor, who must weigh the risks generated by the plan against other enterprise risks.
- Enterprise Risk Management (ERM) is the discipline by which an entity in any industry assesses, controls, measures, exploits, finances, and monitors risks from all sources for the purpose of increasing the entity's short- and long-term value to its stakeholders. ALM is an integral part of ERM.
- Risk tolerance of an entity is a degree of preference for a particular risk over a stated time horizon. For private pension plans, the risk tolerance considered is generally that of the plan sponsor. The plan sponsor's risk tolerance is influenced by regulatory and fiduciary constraints.
- Economic value represents the long-term inherent value of the portfolio. Economic value is based on the portfolio's future cash flows, as distinguished from values on a specific accounting framework or funding requirements. Funding requirements and accounting-based values serve as a constraint on future cash flows.
- Hedging is the technique of designing a portfolio with cash flows that offset or defease another portfolio's cash flows in certain scenarios. After hedging, the entity's risk profile is more aligned with the entity's risk tolerance. This technique allows the entity to become less concerned with which future scenario unfolds.
- ALM focuses on Economic Value. A consistent ALM structure can only be achieved for economic objectives. Economic value is based on future asset and liability cash flows. ALM uses these future cash flows to determine the risk exposure and achieve the financial objectives of an entity. Because ALM is concerned with the future asset and liability cash flows, the natural focus of ALM is economic value. Entities that focus on economic value tend to achieve their financial objectives more consistently in the long term.
- In an ALM context, the riskiness of a portfolio is determined by the net position of the combined assets and liabilities.
- The overall risk of a portfolio may be reduced through hedging. Hedging plays an integral role in the ALM process. Once the risks associated with a portfolio have been identified, the existing risks can be modified to suit the entity's risk tolerances and financial objectives. Hedging may be complete or partial. An asset with a matching liability is a natural hedge. The time horizon over which the hedge is in place may vary, but should

nevertheless be explicitly defined.

- In practice, many entities do not focus on economic value and focus instead on accounting earnings. However, ALM is internally consistent only if it is based on economic value. Many entities that managed assets and liabilities based on the accounting treatment ended up mismatching assets and liabilities and ultimately failed. There are still companies that do not focus on the economic value and permit mismatches on an economic value basis.
- The fundamental steps of an ALM process are: (1) Assess the entity's risk/reward objectives; (2) Identify risks; (3) Quantify the level of risk exposure; (4) Formulate and implement strategies to modify existing risks; (5) Monitor risk exposures and revise ALM strategies as appropriate.

As more pension plans and their sponsors gain an insight into the risks associated with the management of pension assets and liabilities, there will be a significant move to an integrated approach to asset and liability management and an acceptance of hedging techniques. The recent history of declining interest rates that produced substantial increases in the values ascribed to future pension cash flows, together with a period of substantial declines in the market values of equity investments, has significantly impaired the true economic value of the degree of benefit security provided by pension plans.

Buffin Partners Inc.

P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067

Email: commentary@buffinpartners.com

