Is your pension fund board ready for the next financial crisis? Here's how to prepare with six steps

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Financial crises are permanent fixtures of the investment industry. For a pension fund board, when you encounter a challenge like a financial crisis, you either learn new ideas and behaviors, or you fail to be successful or even fail in the long term. So, what are the new ideas and behaviors we have learned from financial crises? Academic literature has identified the drivers of financial crises[1] and their interaction with investor behavior. However, what subsequently should be changed in practice is somewhat discarded and left to practitioners. This article therefore suggests six practical changes to decision making that will help pension fund boards adapt behavior and should make a positive difference in the event of a future crisis.

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FINANCIAL CRISIS

"Finance is not merely prone to crises; it is shaped by them" (Economist, 2014). A financial system, depicted in economic textbooks as a vehicle to match savings and investments, plays a crucial role in postponing consumption, accelerating investments, matching surpluses, and shortages of capital over time, regions, or different risk preferences. As such, it lies at the heart of any society and when it spirals out of control it causes considerable damage. Economists have proposed different theories to explain these crises, ranging from business cycles or Marxist theories that focused on the economic cycle as inevitable conflicts between capital and labor. In recent years, Minsky's framework has gained traction for those who theorized that financial fragility is a typical feature of any capitalist economy: high fragility leads to a higher risk of a financial crisis.

Even though we are gaining more insights into the drivers of financial crises, the timing and the impact of financial risk is very difficult to predict.[2] This is worrying, given that the size of the financial markets has increased steadily, as its interwovenness with the real economy increases, and can wreak havoc if not handled correctly. Also, the occurrence of crises has not subsided over centuries, as Rogoff and Reinhart (2009) have documented. One of their messages has come across clearly: financial crises are here to stay.

Equally worrying is that handling a financial crisis as a pension board or institutional investor is not part of financial training. A typical textbook discusses the investment process with calm, clarity, and rationality: with the right investment policy, well thought-out assumptions on risk, return and correlations, the long-term investment outcomes will be within reach. In real-life, however, it matters what you do during a crisis, by testing the limits of an investment process. CalPERS is a famous case (Abrams and Ang, 2012). In 2008-9, the Californian pension fund, CalPERS, mishandled rebalancing, where the pension board seemed to have no understanding of what the underlying assumptions of the investment process were for which they were responsible, let alone how these could be challenged during a crisis. Financial losses, and a multi-year restructuring of funds followed. In the Netherlands, most large pension funds did not fare much better. Unprepared for crises, many de-risked when markets dropped, and re-risked hesitantly, structurally affecting the solvency ratios. Governmental review committees unearthed similar drivers for these unfortunate choices, pointing out the unawareness of underlying choices, lack of balance sheet management, or neglect of integrally considering risk.

WE HAVE TO REWRITE THE TEXTBOOKS TO PREPARE PENSION BOARDS HOW TO ACT IN A CRISIS

So many lessons have been drawn, and if crises remain a permanent fixture, we will have to focus on what new ideas or behavior should be adapted. Herein, the literature is scarce. This article therefore provides several forward-looking choices that boards can apply. First, a crisis is briefly described from the perspective of a pension fund board as a large institutional investor. Armed with these insights, we then discuss the avoidable mistakes or foreseeable events that a board can prepare for beforehand.

A CRISIS ERUPTS

A crisis begins with the knowledge of what constitutes a crisis. Crises are hard to predict but do encompass common elements. Crises start with a sudden worsening in solvency and asset values. The initial drop could be linked to a random event, like a bankruptcy or political crisis. After the initial shock, asset prices keep falling. Analysts start arguing that the random event is not that random after all but part of a bigger problem, and we should brace ourselves for more negative news.

Markets then seem to shift in one downward direction only: equity markets drop, and liquidity as a measure to honor obligations between financial organizations becomes top of mind. Credit spreads increase, indicating decreased liquidity as well as markets pricing in higher default probabilities for corporate loans due to worsening economic situations. The number of safe havens steadily reduces as many investment categories drop in value and no longer compensate for one another. Diversification, forming the bedrock of portfolio construction, becomes non-existent.

As negative news accumulates the hope for a swift resolution dwindles. The end-date for the crisis is nowhere to be found. Even worse, crises seem to give birth to new crises: lingering, half expected problems that exist tend to be followed and worsened by larger, unexpected problems. The Bear Stearns default was bad enough, but the failure of Lehman created widespread panic. The worldwide financial crisis of 2008-9 was dramatic but also ignited the Greek government debt crisis, which spiraled into the multi-year eurozone debt crises of 2010-12.

The pension fund board is confronted with increased uncertainty in a very short time and scrambles for information. They will ask: What is our exact position? Do we have a clear picture of why this is happening? What are our options? At the same time, the board must shift its focus on what information is relevant. Important chunks of management information become temporarily useless, especially measures which are based on stochastics such as Value at Risk, standard deviation, or tracking error. Information based on actual positions and risk measures based on deterministic risk measures or scenarios on the other hand provide some insights.

Feeling that they might lose the grip on what is happening, board members increasingly pay close attention to analysts or politicians. There especially is talk of “unprecedented situations”. This resonates and provides a seductive reasoning for a board to limit its own responsibility, also known as “circle of influence.” It signals that the circumstances are so unique that policy instruments the board controls have become ineffective and that it is now up to external forces, mainly central bankers and governments, to fix the problems. So it is no surprise that board members suddenly reappraise the role of the public sector, developing an almost unlimited faith in the healing powers of central bankers, or the deep pockets of politicians, as saviors.

To complicate matters further, as the crisis evolves, the board’s own risk appetite starts to deviate from the risk appetite of the fund. “This time is different” arguments are increasingly explored to postpone rebalancing, while derisking is considered in all kinds of areas: leveraging, tracking error, and concentration limits.

Of course, this describes a highly stylized picture of how pension boards experience a financial crisis, but at the same time many behavioral challenges identified in literature and reports are present.[3] So how should a board proceed?

SIX STEPS TO CHANGE THE WAY A PENSION FUND BOARD ACTS IN A CRISIS

An important aspect of decision-making is that the decisions that really matter to the continuity of the fund regularly must be made under pressure (Koedijk, Slager and Van Dam, 2018). Based on our discussion of the boards’ perception of the financial crisis, how can we change the board’s behavior in such a way that, while it cannot predict or prevent crises, it can allow the board to mitigate unnecessary negative consequences and “stay the course”? We identify six steps to create effective decision-making during a crisis, borrowing insights from other disciplines.

1. TAKE THE BOARD'S INSECURITIES SERIOUSLY

Having to decide under stress makes board members insecure and if unchecked will trigger well-documented behavioral biases (e.g., Ackert and Deaves, 2010). So, think beforehand of the pension fund board who must decide, and consider the insecurities that members will experience when making decisions during a financial crisis. These consist of:

a. Running behind on developments, instead of preparing for upcoming ones; the fear that they might become a forced buyer or seller due to the derivatives, outstanding commitments, pension pay-outs, or a stringent application of rebalancing policies;
b. A decrease in risk appetite, especially if the risk appetite is not formalized in any way;
c. A sense of regret that certain measures were not taken earlier;
d. Awareness that any risk-reducing measure suggested in a late phase of the crisis is too costly to execute, procrastinating sensible actions; and
e. Awareness that a sensible risk measure might deviate from what other funds are doing, leading to perceived peer pressure or the tendency to first wait and see what other organisations are doing.

Whatever plan is developed, the plan should not only develop a policy or measure to mitigate the risks, but also address these insecurities head-on. Otherwise, they will linger and erupt during crises, potentially frustrating the effectiveness of the measures.

2. PRE-COMMIT

Pension funds' boards, experts, nor advisors can predict financial crises, neither their timing nor their impact. However, boards can assess the impact that a financial crisis might have on its investments and balance sheet. So the board should determine what sort of impact is acceptable within the risk appetite of the fund, what sort of measures would be needed to achieve this and, most importantly, what this means for decision-making under stress.

They should already have a written plan in place to be used as soon as the crisis occurs. This is not only about how you establish a crisis committee. It is far more important to determine in advance financial scenarios that may affect your pension fund and confront these scenarios with the risk appetite that the fund has set up.[4] Then decide beforehand under which (solvency) levels to de-risk and re-risk. Be painfully specific in your actions though. It requires far less time to update scenarios than to have fundamental discussions and think of alternatives under (time) pressure. Hence, the usefulness of a well-thought-out to-do plan.

3. REWRITE YOUR INVESTMENT PROCESS TO FOCUS ON WHAT MATTERS

After you have pre-committed yourself as a board, the investment process needs to be adjusted to accommodate this. Balance sheet management is the key consideration during a financial crisis, adjustments in asset allocation when you have time on your hands after the crisis has subsided.

Start by separating asset allocation and balance sheet management. In the Investment Policy Statement (IPS), charter of the investment committee, and the reporting by staff or fiduciary managers. Typically, in a standard investment process, the difference between balance sheet management and asset allocation is blurred at best, but there is a crucial difference during a financial crisis.

Balance sheet management – the integral management of mismatch risk, matching vs. return assets, liquidity, derivatives overlay – is a separate step that tells you as an investor how much risk you want to or can take under different circumstances. This is a completely different question than asset allocation or portfolio construction. Asset allocation allocates within the decided amount of risk.

4. TRAIN, TRAIN, TRAIN

In my experience at the business school, students develop a steep learning curve when they simulate crises under different circumstances, and reflect on their choices, while adapting their behavior. Working with boards, the best and consistently implemented balance sheet policy came into existence through simulation. It is somewhat of a mystery why this is not obligatory for pension boards worldwide.

DISCUSSING THE DRIVERS BEHIND A CRISIS EASILY BECOMES AN EXCUSE TO POSTPONE DIFFICULT DECISIONS

It helps them train well in advance in a simulated environment and prepare for their duties. The simulation results provide a valuable tool to discuss the important issues. It helps uncover fundamental differences in how board members approach a crisis. Within a board some trustees might make a compelling case to buy more equities after a sudden drop in prices, while other trustees would prefer the opposite. Simulation addresses another insecurity as well: a discussion in the board that the circumstances might be so exceptional, that well thought-out-policies should be abandoned, instead of doing what was agreed upon. Also, a simulation helps the board challenge itself on its risk appetite. Is it constant throughout, or should it be rescaled when crises occur?

Today's board might have a simulation training day per year. Tomorrow's boards should simulate once per month, document their choices, then discuss how they fit in or deviate from the pension fund's policy, beliefs, and reflect on what they should improve. Instead of enduring the one day where the financial crisis hits, using 364 days to recover, tomorrow's pension fund board focuses its efforts on training 364 days for that one day when the crisis erupts, mitigating its effects.

5. DISMISS THE WHY, FOCUS ON THE HOW

Who really cares what caused the crisis we are in? That might be putting it a bit bluntly. But during a crisis the board needs to get to the heart of the matter. A crisis combines the negative impact of:

a. A sudden drop in equities, interest rates, leading to drops in reserves and/or cover ratio, a downward oscillation, in a very short period.
b. Markets shift: shortfall in liquidity. Spreads increase. Drop in asset prices. Diversification effects become non-existent.
c. Increased uncertainty in a very short time, increased talk of "unprecedented situations."
d. Follow up crises: half-expected problems that tend to be followed and worsened by larger, unexpected problems.

Figuring out *why* these happened takes a lot of time and leaves the board none the wiser on the course to follow. Skip this part and focus on the board's fiduciary responsibility. What will you do when equities drop, rating deteriorates, and liquidity dries up? Develop a sensible scenario beforehand and decide as a board what to do. When the crisis erupts, perhaps adjust a few parameters, but you are good to go as a board. It is a step-by-step protocol – as simple as that. Postpone a "this time is different" discussion until after the crisis. There might be genuine reasons to have this discussion. But you would hope that a fireman puts out the fire before he starts to investigate what caused it.

6. CHALLENGE ASSUMPTIONS WHEN APPROPRIATE

One way of avoiding difficult discussions during a financial crisis is having the discussion on assumptions beforehand. Be clear on which assumptions in the investment process are crucial to maintain during a crisis and determine your pain level. It generally boils down to a small set of assumptions. First: are you prepared to accept any risk to achieve your long-term goals? Pension fund boards with a static asset allocation answer this question with a "yes". Upholding rebalancing is then a key assumption, where buying securities at lower levels equate with higher expected risk premiums. This requires a strong stomach, buying stocks – in the eyes of the public – at the worst possible time. This makes board members insecure, even if they have pre-committed themselves to this, sometimes to a point that it endangers long term goals. Have this discussion beforehand, use the simulation results here extensively, be very explicit about the consequences, and agree to a very high hurdle to change this during the crisis.

Second, if you are not prepared to take any risk to achieve your long-term goals, can you identify beforehand how much risk you're willing to take under which circumstances, make this explicit and write this down in a plan and commit yourself to this? De-risking makes perfect sense during a crisis to preserve capital and is far more important than hunting for investment opportunities. And yes, it makes sense to buy investment credits when spreads are high. Either way, these are assumptions and trade-offs that should be dealt beforehand with when the board draws up the risk appetite of the fund. Best practice funds not only write down these assumptions, specify their consequences, but also describe how they are challenged during financial crises and what the (additional) board's actions are. When onboarding new board members, this discussion is part of the introduction program as well.

FINALLY

Whatever you do, avoid phrases like "these are exceptional times" or "this time is different" as an excuse to do nothing. We have been forewarned. We are heading towards a new management style of pension boards that might be closer to the job descriptions of firemen, ambulances, pilot fighters, and athletes. These groups have in common that they train 95% of the time, to excel in 5%, whether it is on the battlefield or the football field. This requires several practical changes in behavior, actions, and preparation that this article has outlined. Difficult, but doable and rewarding when the next crisis erupts. Participants should expect no less from their pension boards.

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Notes

1 See for example O. Merrouch and E. Nier (2010) on the causes of the Global Financial Crisis, Ackert and Deaves (2010) for a discussion of behavioral investor biases. The interaction between crises and investor behavior is analyzed by Minsky (1992), Cooper (2010) or in the documentary Boom Bust Boom by Jones and Kocken (2015).

2 Difficult, but not impossible, see for example, Bezemer (2010) or Shiller (2011).

3 See L. Ackert and R. Deaves, "Behavioral Finance" more formal discussion of behavioral theories and how it is embedded in finance.

4 See for a review on the pre-commitment of Dutch Pension Funds during financial crisis begin 2021, A. Slager and M. Vos, "Besluiten nemen in moeilijke tijden", Ortec Finance, 2020.