

**Comments on**  
**“Draft OECD/IOPS Good Practices on Pension Fund’s Use of Alternative Investments and Derivatives”**

This document includes comments from various FIAP members, belonging to different countries. These do not necessarily represent the organization’s official position.

**I. General comments**

**1. Alternative Investment**

When talking about Alternative Investments it important to differentiate among them on their characteristics and risk profile. As the document establishes, Alternative Investments may include a wide variety of products such as commodities, hedge funds, managed futures, financial derivatives, private equity, venture capital, real estate, infrastructure, distressed assets, structured products, luxury valuables and collectibles or even fine art or fine wine.

For purposes of most of the comments included in this document, Alternative Investments are defined as:

- Private equity funds in their different varieties or sector specialization. Such investments are generally managed by investment professionals who specialize in investing in equity or debt into specific sectors in companies in different conditions and stages, real estate projects, infrastructure projects, distress assets.
- Direct private equity or private debt investments.

The Alternative Investments increase the diversification of the total portfolio, generating returns that are not correlated to those of traditional stocks and bonds, which are linked to the economic cycles. So, when added to a traditional portfolio they can increase overall portfolio returns while reducing risk.

Even so, Alternative Investments have the following disadvantages:

- Alternative investments may be relatively illiquid;
- It may be difficult to determine the market value of the asset;
- There may be limited historical risk and return data;
- A high degree of investment analysis is required before buying;
- Costs of purchase and sale may be relatively high;
- They may imply an important source of conflict of interest.

So investing in Alternative Investments requires addressing risk management matters such as: liquidity risk, integrity risk, limited information risk, valuation risk, conflicts of

interest, what implies that pension funds must have the following concepts clearly defined and established:

- Investment Policies;
- Specialized analysis procedures;
- Standardized authorization procedures;
- Specialized risk control and monitoring procedures.

All the concepts stated above should be aligned in an established policy that takes into consideration the best practices that may be found in this industry, especially those outlined by institutions as OCED and regulating entities.

## **2. Derivatives**

The document considers derivatives as an isolated instrument on which separate arrangements should be established. An alternative approach would consider the sensitivity of pension plans portfolios, including derivatives together with the rest of investments, to different risk factors that need to be identified. Taking that into account, derivatives are the most flexible and quick answer to adjusting the sensitivity of the total portfolio to the desired risk profile.

Portfolio sensitivity to the different underlying risk factors should be calculated with derivatives included and so should risk limits be established in the investment regime. Consistent with this, the use of a Var (Value at risk) limit for the whole portfolio seems to be more appropriate.

Being aware of the complexity of derivatives, IT systems and skilled human resources become extremely important. For the correct control of risk associated to derivatives, specially options, systems should calculate delta in real time so as delta changes (Gamma) in order to control that the total position in an asset (underlying + derivatives) will be never negative.

With this approach the classification of derivatives as hedge or speculative does not make much sense, because the important point is the global exposure that the pension funds have in each underlying and the risk factors that the management team has identified.

To achieve this primary objective and in line with several ideas that are reflected in the document, an appropriate approach should match on the following aspects:

- Importance of team's skill and robust technology systems that will help in the control of risk.
- Importance of invest in derivatives through plain vanilla products and negotiated through clearing houses.

### **3. Different degree of development of capital markets and investments opportunities**

En algunos países con sistemas de pensiones de capitalización individual todavía no se ha expandido suficientemente el menú de inversión de los fondos de pensiones, lo que ha influido en la existencia de un limitado desarrollo del mercado de capitales. Por otra parte, los fondos de pensiones pueden no estar habilitados para efectuar operaciones de cobertura con contrapartes del exterior y operaciones de derivados con fines especulativos, así como inversiones en capital privado o fondos de cobertura. Para estos casos podría no justificarse toda la batería de pautas delineadas.

## **II. Comments related to good practices**

### **1. Investment Policy and Risk Management Strategy**

We suggest adding the following as themes to be covered within the Investment Policy and Risk Management Strategy for alternative investments:

- Outlining the type of Alternative Investment;
- The general level of risk that may be allowed;
- The percentage of the total portfolio investment limits;
- The minimum general qualitative and quantitative requirements to be fulfilled in order to accept any Alternative Investment;
- To clearly establish the type of Alternative Investments not allowed;
- The general asset allocation within the different types of Alternative Investments, defining sector limits in consideration of the risk profiles and correlations between them;
- The maximum leverage limits to be allowed in each of the investment;
- To settle general minimum terms and conditions to be accepted for any investment.

### **2. Pension Fund Internal Governance**

We suggest adding the following as themes to be covered within the Internal Governance:

- The governing board of a pension fund must be sure that there exist a compliance procedure within the investment process that verifies and ensures that any investment to be made in Alternative Products should comply with the Investment Policy, the Standardized Analysis and Standardized Authorization Procedures to grant the quality of investments to be done.
- Revisar el sistema de incentivos o de compensaciones que se establece para las personas que tienen la responsabilidad definir e implementar las políticas relacionadas con inversiones alternativas y derivados, para que no contengan

eventuales componentes que los puedan incentivar a adoptar decisiones que vayan en contra del interés de los fondos de pensiones.

### **3. Due Diligence of External Asset Managers**

We suggest adding the following as themes to be covered for alternative investments:

- Extend the due diligence into the particular private equity fund to be analyzed for investment.
- To verify that the promoted fund complies with the general minimum terms and conditions authorized in the Investment Policy.
- To include the analysis of the macroeconomic situation of the region, sector and sub-sector in which the potential Alternative Investment is to be done, and, to match this analysis with the investment strategy of the fund.

### **4. Communication**

It is suggested adding the following as themes to be covered:

- To communicate any kind of Conflict of Interest that may arise within the Alternative Investments in the portfolio.
- To establish monitoring reporting procedures to the decision making board of directors on a quarterly basis.
- Las comunicaciones dirigidas a los miembros de los fondos de pensiones deben ser claras y adecuadas para sus características. Es necesario tomar en cuenta que la complejidad del tema, por una parte, y la preparación y conocimientos de los miembros de los fondos de pensiones, por otra, pueden conspirar contra la eficiencia de las comunicaciones. Se debe asegurar que estas últimas cumplan con el objetivo de mantener informados a los miembros de los planes de pensiones y de entregarles los antecedentes necesarios para que puedan tomar decisiones fundadas.

### **5. Regulation of Pension Funds**

#### **5.1 Alternative Investments**

We suggest adding the following as themes to be covered:

- Considering that for Alternative Investments it may be difficult to determine the current market value, which may provoke distortions of the price of the instruments, we suggest including in the pension fund's regulation, that for any private investment to be made it has to be required the use of external independent verification on assets' valuation.
- Asegurar que las regulaciones de las inversiones, y específicamente de las inversiones alternativas y derivados, contribuyan a alinear la gestión de los fondos de pensiones con sus objetivos de largo plazo y a evitar que la competencia de corto

plazo entre administradoras genere distanciamientos significativos respecto a tales objetivos.

## **5.2 Derivatives**

We fully agree with GP 5b that unlimited commitments should be prohibited, but not only for derivatives. If derivatives linked to their underlying is used, it should be avoided unlimited losses on the global position and of course it should be controlled the global results of underlying plus derivatives.

Annotation 5.4 is crystal clear when said net short positions should be prohibited in order to avoid unlimited losses, but , again, why only for derivatives?

And about leverage, the problem is not the leverage in itself, but the negative gamma. If derivatives with positive gamma are used, the leverage could be a strong plus for the management.

In line with this, it's necessary to include maximum potential loss in the global activity (GP 5c), and regarding derivatives, where many different inputs will affect (Volatility, time decay, etc), is necessary to have adequate system for calculating that.

Finally we agree with GP 5d in order to control counterparty risk, so annotation 5.6 is really important when recommending "only trading via a Clearing House". We think that the organized market is the place for Pension Funds when they want to use derivatives, because counterparty risk is not an issue in that case and also because there is official valuation for premiums and deltas, and the funds use only plain vanilla options.

## **6. Supervision of Pension Funds**

### **6.1 Alternative Investments**

We, in general, agree with the stated concepts in the document.

### **6.2 Derivatives**

We are also agree with GP 6a,b, c and d. Especially important the statement that supervisory oversight should be risk-based what requires a good understanding of the risk profile of the derivative products and the portfolio as a whole.

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