



Comments on “Draft OECD/IOPS Good Practices for Pension Funds’ Risk Management Systems”

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

Good Practice 1: Appropriate Mechanisms

1.4 States: “...systems should be commensurate with the size and complexity of the pension fund, reflecting the scope and degree of sophistication of its activities.”

Comment 1:

This clearly reflects the reality of our markets (within each country) in particular in Mexico participants within the markets have different sizes and complexities. Hence the differences in the organizational structures of the small ones compared to the largest ones is huge, as well as the requirements of the most complex ones compared to the most simple ones in systems, teams and processes.

Indeed, having a more complex portfolio implies having more risks of all sorts within a portfolio; hence a more robust/effective risk management system needs to be established within the pension fund. This can be done at a higher cost for the pension fund, compared to its peers that manage simpler portfolios. A portfolio that can invest in more asset classes and more trades (simple or complex) will have a broader universe of investable asset and more options to implement their investment strategy in a more effective way. Though, if the manager of this sophisticated and complex portfolio has an adequate risk management system to manage this portfolios and its risks, this portfolio has a better advantage to achieve its investment objective granting the affiliates a better chance to obtain a higher retirement income.

That is why the most sophisticated pension funds should have an incentive to spent resources in controlling all its risks in order to have all the benefits stated in the previous paragraph. Our suggestion to IOPS is to include in this Good Practice 1 that, the pension funds that become more sophisticated and at the same time achieve a robust risk management system will have the right to have a smaller (proportionally to their size) capital or reserve named “encaje” in Chile, Peru, Colombia, Uruguay and “reserva especial” in Mexico.

Besides, on the ongoing monitoring from the authorities, if a pension fund wants to be initiated in a more sophisticated trading or asset class, it should be forced to have a better risk management system or a higher reserve or capital requirement.

As a resume, we believe the required capital and reserve to make upfront to management errors within a pension fund, should be in proportion to the robustness of the risk management system accordingly to the sophistication of the portfolio being managed.



Comment 2:

In Costa Rica, each institution is entitled to establish its own risk-management mechanisms, provided that these meet the minimum standard stipulated by the regulations and the legislation governing the pension industry. The effect of the size of the institution's business is therefore clearly seen in the development of its own risk-management mechanisms and not in its compliance with the minimum regulations that have to be met.

Good Practice 2: Management Oversight and Culture

Comment 1:

This Good Practice is very clear about the functions and responsibilities of the governing board and how it should structure an organizational chart to help them implement, oversight and control the risk management system. However, this Good Practice does not mention what would be the best structure to achieve this in a complex manager, nor anything related to compliance with corporate governance best practices.

It would be desirable to have a base structure set for a complex pension fund that assures a clear division of responsibilities defined within this document. A suggestion would be to have committees that assist the governing board and list them such as, investment committee, financial risk management committee, operational risk management committee and compliance committee.

Regarding the best practices of corporate governance, it is desirable to have mandatory independent board members, at least one for each committee within the governing board, and that each one participates uniquely in each committee with vote.

We suggest setting strong and clear personal penalties to the board members and senior management in case of not acting with the most ethical standards.

Comment 2:

In Costa Rica there is a body of rules that regulate and establish general policies of good practice for achieving good corporate governance performance.

Good Practice 3: Funding and Solvency Risk Control

Comment 1:

The financial sustainability of the pension plan must be evaluated before it is established, with a clear identification of the potential risks that might threaten its solvency and the adjustment mechanisms that will be used when imbalances occur. The design of the pension plan, especially the benefits to be provided, the funding mechanisms and the structure of incentives that exists (the relation between contributions and benefits, early retirement, etc.), must be consistent with that



plan's long-term financial sustainability. Once the plan has been set up, the practices described in the document must be applied.

Comment 2:

The Superintendence of Pensions of Costa Rica has established a body of rules focused on calculating "Capital Adjustment", a method developed to evaluate possible solvency risk. In addition, the supervisory authority has set up a six-monthly valuation mechanism for the operating risk which affects the "Capital Adjustment" index.

Good Practice 4: Investment/ Market Risk Control

Comment 1:

In 4.1 a written investment policy to manage investment risk is requested. We suggest naming it an investment risk policy or even better an investment/market, counterparty/credit and liquidity risk policy to avoid misunderstandings.

As stated in the Annotations: "*...At the heart of the risk management system of any pension fund or plan is the investment strategy – investment, counterparty and liquidity risks being major challenges for any fund...*" This sentence clearly stated two functions, first the investment strategy and second the investment, counterparty and liquidity risk management. Both functions are dependant from each other but should be managed with complete independence, given these are incompatible functions, a strict separation is important to avoid conflicts of interest (as stated in Good Practice 2).

Based on the previous paragraph, we suggest to make clear that each function (risk management and investment management) should have it's own policies and that should be approved by different governance committees. The risk management policy should establish the (market, credit and liquidity) risk appetite through quantitative limits based on the metrics that better measure the different risks. These limits should be consistent with the legal provisions, the performance objectives of the funds and the strategic asset allocation. The investment policy should state the way in which the investment strategy will be established and implemented within the restrictions of the risk management policy.

Comment 2:

4.4 states: "*... pension funds should only invest in assets and instruments whose risk the pension fund concerned can properly monitor, manage and control...*" and in 4.5 make an emphasis that this is even more relevant in complex financial instruments such as alternative investments and derivatives. On the other hand, 4.2 suggests permitting having external investment managers. In order to properly monitor, manage and control the risk of the investments of external investment managers, we suggest to specify that this external investment manager should share timely and enough information of the investments they manage to be able to properly monitor, manage and control the risks of these investments individually and as part of the complete portfolio; more over,



given that Good Practice 5.3, states the governing board will still be accountable for the outsourcing of these investments.

Comment 3:

In 4.3 it is important to establish conditions and procedures to avoid the occurrence of unwanted transfers of wealth in which, for example, certain better-informed members change their investment options with a view to taking advantage of mismatches between the valuation prices of the plan's assets and the market prices, producing benefits for themselves and adversely affecting other members.

In the annotations part, we suggest adding the elements that make up the investment policy, the markets in which financial instruments or other investment can be traded, and the maximum risk level that can be tolerated for specific securities (risk category).

Comment 4:

The body of rules currently in force in Costa Rica state that every institution must have a risk unit, together with a committee to deal with risks and another with investments. Furthermore, it establishes the minimum inter-relations that must exist between them and the specific functions that they have to perform. Among these functions are the management of market risk and the follow-up of risks related with investments.

Good Practice 5: Operational and Outsourcing Risk Control

Comment 1:

The annotations state: “...Models which attempt to quantify the level of future operational risk could be developed. Quantification can be used to assess the efficiency of the fund in controlling risks and/or in providing an estimation of the capital required to absorb potential losses from operational risk events...” Pension funds regulatory minimum capital is set by the regulators; however the quantification of the operational risk is not taken into account when these capital requirements are set. We suggest that if the pension fund manager is capable of proving their effectiveness in their operational risk quantification, they should be allowed to use their numbers to assess capital. This will create an incentive to develop a robust operational risk management, which will need a considerable spending by the pension fund manager.

The effectiveness of the operational risk management quantification could be measured through statistic tests or by a back testing of the models outputs in a reasonable time horizon. Regulators should monitor this as part of their regular oversight activities.

Comment 2:

In Costa Rica the supervisory authority evaluates the operating risk of each institution every six months. Nevertheless, each pensions operator must establish a methodology through the risk unit, in addition to that implemented by the Superintendence.



Good Practice 6: Control and Monitoring Mechanisms

The control and supervision of the risk mechanisms are carried out by the Superintendence of Costa Rica in its monthly evaluations, and also in spot checks. The internal auditing department also evaluates these controls and, in addition, engages an external auditor at least once a year with the aim of reviewing these matters. A system of internal control must also be included, and this must be evaluated at least once a year.

Good Practice 7: Information, Reporting and Communication

Comment 1:

7.1 states: “...A policy should also be in place to ensure that confidential information is treated appropriately...” We suggest including more detail in the annotations for clarity.

This good practice focuses more on reporting and communication than on confidential information. Although we recognize the importance of adequate reporting and accurate information, we consider important to have minimum standards regarding the use of confidential information. In that sense, we suggest including requirements on how to control the information, which are referred to collectively in the securities industry as “Chinese Wall” or “Ethical Wall” policies (i.e. documents control, restricted lists, etc.), as well as on how to avoid conflicts of interests.

Comment 2:

The operators in Costa Rica, in coordination with the supervisory authority, must set up communication systems and tools at both external and internal level. At the internal level, these are included in the development of the management information systems, which are evaluated every six months by the Superintendence. At external level, the Superintendence must be given daily, monthly, etc. reports, dealing with finance, accounting and risk.

Good Practice 8: Supervisory Oversight of Pension Funds’ Risk Management Systems

Comment 1:

8.5 states: “...Pension fund supervisory authorities should aim to adopt a risk-based approach in their supervision of risk management systems...” Given that on the introduction states “...risk-based approach to pension supervision. This can be recognized as a structured process aimed at identifying the most critical risks that face each pension fund and, through a focused review by the supervisor, assessing the pension fund’s management of those risks and the pension fund’s financial vulnerability to potential adverse experience...” we suggest to include in the annotations that this risk-based approach in supervision will approve complete asset classes investments or financial instruments instead of asset by asset or trade by trade.



Comment 2:

The annotations state: “...*In some jurisdictions, if the pension supervisory authority does not have expertise in particular areas to conduct in depth analysis of the internal control of the governing board, it may engage the services of independent, external experts...*” We suggest that this measure ensures that the most sophisticated pension funds won’t be delayed by any limitation of the pension supervisory authority. This will guarantee that the pension funds that invest more in educated professionals and technology and, therefore, will be able to deliver the state of the art risk management system to their affiliates regardless of the supervisory authorities’ capabilities or budget constraints.

Consider the possibility of using in-house expertise when the pension fund managers have it. That could be done via committees coordinated by the supervisor/authority.

Comment 3:

Among the different regulatory guidelines issued by the maximum supervisory body in Costa Rica, there is a set of rules that must be strictly kept by the supervised institutions, in order to minimize possible “oversights” on the part of the supervisory body. Regulation has moved towards a level in which a culture of self-regulation occurs; the participation of other instances of control, such as internal and external audits, is included; and compliance with the rules is regularly validated.