THE INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS (IOPS)

GOOD PRACTICES IN RISK MANAGEMENT OF ALTERNATIVE INVESTMENTS BY PENSION FUNDS

GOOD PRACTICES IN RISK MANAGEMENT OF ALTERNATIVE INVESTMENTS BY PENSION FUNDS

1 Introduction

1. The objective of pension supervision is to protect the interests of pension fund members and beneficiaries and safeguard the stability of the pension industry and financial system as a whole. Given the increasing speed and complexity of financial markets, pension fund supervisory authorities should be alert to developments which might pose a challenge to this objective. The increasing use of alternative investment forms, such as (funds of) hedge funds and private equity, are such a development. As pension entities are placing a share of their capital in these types of instrument, the potential risks flowing from these products justify specific attention from supervisory authorities. The way supervisors respond to these risks will vary depending on the supervisory approaches adopted. However, all supervisors expect that those responsible for managing pension plans and funds will apply their risk management approaches so as to take account of the risks arising from alternative investments. In order to support supervisors as they clarify and articulate these expectations, IOPS has developed a set of good practices (GPs) that are outlined in this document, drawing on the knowledge and experience of supervisors However, in many jurisdictions supervisors' responses are based on regulation. Compliance by plans and funds with this regulation is then monitored by supervisory authorities, e.g. via off- and on-site supervision and in-depth evaluation of pension funds.

2. There is no clear-cut definition of alternative investments. The concept is of a dynamic and ever-evolving nature, and closely linked to the development of financial markets. In practice, alternative investments are characterised by properties that distinguish them from traditional investments, such as: the application of innovative financial products and derivatives, the use of extensive leverage, illiquidity of underlying investments, a greater reliance on the skill of the manager and the absence of a meaningful benchmark. At this stage, a non-exhaustive list of commonly agreed types of alternative investments would typically include: hedge funds, private equity, securitised real estate investments, etcetera. The different characteristics of alternative investments have implications for their risk profile. Key issues that are typically more relevant for alternative investments and that may need to be addressed in a pension fund's risk management are e.g.: liquidity risk, integrity risk, operational risk, limited transparency, valuation weaknesses, control issues and conflicts of interest.

3. Supervisory authorities recognise that in principle there is a place for alternative investments within pension funds. Alternative investment funds may provide the opportunity to better manage or lower overall portfolio risk by proper diversification of assets, and allow pension funds, as long term investors, to benefit from the liquidity premium that may be associated with less liquid instruments. However, pension fund supervisory authorities recognize that riskier strategies are often inherent in alternative investments, given they were initially designed for high-net worth individuals (with a consequent high risk tolerance). Such investments may be complex, illiquid or opaque, and therefore require careful scrutiny and analysis, and in many cases, more rigorous review and monitoring than most traditional products - particularly when potentially vulnerable investors, such as pension fund beneficiaries, are involved. Fiduciaries should therefore very carefully consider the risks to which they are exposing their members' funds.

4. A pension fund itself has the responsibility to conduct adequate risk management for alternative investments and to comply with any statutory provisions[1]. The pension fund supervisory authority seeks to ensure that the pension fund fiduciaries properly identify and mitigate the risks associated with such investments. In light of the IOPS core principle of proportionality, the response of supervisory authorities to the risks arising from alternative investments should take into account the specific situations of the pension fund it supervises and the nature of the risks arising from the alternative investments it holds. This does not mean that supervisory requirements for small, simple pension funds need to be lower, but it could mean that there will be differences in the way pension entities individually apply risk management techniques in practice, or in the approach that the supervisory authority takes in relation to the adequacy and appropriateness of the risk management applied by a pension fund to these investments.

5. In accordance with the IOPS core principle of risk-based supervision, the supervisory efforts with respect to the risk management for alternative investments should be concentrated in those areas where problems are most likely to occur and the impact of problems is most likely to be extensive. A limited allocation to alternative investments should not automatically be associated with a substantial increase in the risk profile – indeed 'traditional' investment forms may carry a similar or even a higher risk. Supervisory authorities may find it beneficial to adapt their off-site monitoring to provide information or analysis on the level of alternative investment and risk management procedures applied by pension funds. They may also wish to include detailed investigations to ensure that pension funds are performing due diligence in relation to these investments within their on-site inspections (either regular inspections or targeted investigations of funds where investment in alternative assets seems particularly high, unusual or inappropriate given risk management systems) or on ad hoc basis.

6. The IOPS GPs in risk management of alternative investments by pension funds, outlined in this document, may help supervisory authorities to focus their general supervisory approach to the issues presented by pension funds and the risk management of these assets. The GPs provide assistance with the consideration of risk management for alternative investments, in particular the less liquid, less transparent, high-risk investment vehicles. The GPs are designed to assist such assessments in the context of a 'principles-based' approach to supervision.

7. The GPs reflect what supervisory authorities usually expect to look at when assessing the risk management of pension funds that invest in alternative investments. The character of the GPs emphasizes the overriding principle that it is the responsibility of pension funds to develop their own alternative investment policies in a responsible manner. As such, the GPs may also help and encourage pension funds to improve their risk management practices. Despite these supervisory GPs, the ultimate responsibility for the development of best practices and the proper operation of the pension fund rests with the pension fund management.

[1] In particular the OECD *'Guidelines on Pension Fund Asset Management'* require pension funds to establish a sound risk management process that measures and seeks to appropriately control portfolio risk, and to manage assets and liabilities in a coherent and integrated manner.

2 Good Practices in Risk Management of Alternative Investments by Pension Funds

1. Characteristics of alternative investments

GP 1: Supervisory authorities require that a pension fund acts with due diligence when assessing alternative investments to ensure they take appropriate account of the specific risk and return characteristics of these investments.

1.1 It is common for a supervisory authority to require that pension funds recognise the range of risks that they face so as to assess and manage them effectively. Given that alternative investments are often characterised by divergent, asymmetric risk and return profiles, limited transparency and illiquidity, the appropriate risk assessment and management of these instruments is particularly important and is likely to have substantially different and more complex characteristics from the risk management of more traditional investments. A number of risks are particularly relevant to alternative investments, including liquidity risk, operational risk, counter-party risk, reputation risk, and risks arising from outsourcing. In addition, for some types of product, returns rely to a great extent on manager skill rather than asset class performance. For these reasons traditional risk and return indicators do not necessarily give an adequate picture of the specific characteristics of alternative investments. Historical return figures are often distorted or not representative of specific investments. Consequently supervisory authorities have to consider how they can ensure and encourage pension funds to properly assess and manage the potential risks which these investments can pose.

2. Portfolio policy & investment strategy

GP 2a: Supervisory authorities expect that a pension fund's investment in alternative assets fits with the pension fund's overall strategy, due account being taken of the pension fund's total risk profile, including the relation between alternative investments on the one hand and the total investment portfolio and the nature and size of the liabilities on the other hand.

GP 2b: Supervisory authorities expect pension funds to check at regular intervals that diversification across investment strategies is adequate and that undesirable concentrations in the portfolio are avoided.

2.1 Supervisory authorities expect that pension funds will decide in advance the return and risk characteristics of investments in which it wishes to invest, including the extent of risk spreading. This decision should be made within the framework of the strategic investment policy. The selection process with regard to alternative investments should also be in line with the strategic investment policy of the fund. The divergent characteristics of alternative investments need to be given due consideration through the use of suitable infrastructure (e.g. capacity, systems). Risk analysis provides a basis to decide whether alternative investments fit with the nature and size of a pension funds' liabilities. The assessment of risks should consider the specific characteristics of alternative investments, e.g. by applying appropriate stress testing procedures. Other aspects that play a role in strategic investment choices include: the investment structure (umbrella fund or own management), the required liquidity, costs, but also the required knowledge level (which may be obtained in part from external parties).

2.2 Sufficient diversification of the investments is essential, both within the total portfolio and within the portfolio of alternative investments. Illiquid portfolios can often move in concert in certain stress events. Such common exposures might not be picked up in normal mean-variance analysis.

3. Due diligence

GP 3a: Supervisory authorities expect that, when pension funds decide to invest in alternative investments, they have a clear understanding of the risk characteristics of the alternative investments in which they are investing and that this understanding is supported by analysis at regular intervals of the risk profiles of the investment strategies and the capacities of the managers of the funds in which the pension fund has invested or intends to invest. The analysis should be based on timely and sufficient information about the funds and their managers, so that an independent assessment can be made.

GP 3b: Supervisory authorities pay particular attention to the information that pension funds obtain about the investments underlying (funds of) funds. The reports provided by (funds of) funds should use proper valuation guidelines, should be submitted in time, and should have sufficient quality assurance.

GP 3c: Supervisory authorities expect that any assessment of funds of funds includes a judgement of the quality of risk management conducted by the fund of funds manager and the standards and criteria of conduct observed.

3.1 The managers or fiduciaries responsible for a pension fund should not undertake alternative investments unless they fully understand the characteristics of the investment concerned, and their associated risks. They have to avoid investments they do not understand. The due diligence investigation is the most important process stage with regard to investments in alternative investment funds, not least because it enables those concerned to confirm whether their understanding is correct.
Because alternative investment funds are often based off-shore and may be subject to little supervision, if any, an extensive due diligence investigation is required.

3.2 When pension funds are assessing alternative investments, the points of attention in the due diligence process can be broadly divided into three: people, processes and performance. The assessment of people looks at both management and staff, key aspects being integrity risk and expertise of the management team. The assessment of processes looks at factors such as the organisation of the investment fund, operational and risk management processes, the investment process and the processes surrounding any outsourcing to third parties, including the use of appropriate systems and the availability of contingency plans. An assessment of performance should include an assessment of the way in which the fund valuation is effected and, to the extent possible, an analysis of the management's track record. For supervisory authorities it is relevant to check whether pension funds ensure that their alternative investments comply with industry good practice (in terms of risk management, reporting and internal controls), including to what extent independent evaluation of the alternative investment provider's processes and systems takes place. Due diligence should also include an assessment of fiscal and legal aspects of (the documentation of) the investments under consideration.

3.3 A key issue to be addressed in the evaluation of a pension fund's due diligence and monitoring processes is whether proper attention is paid to valuation. Pension funds need to assess the extent to which valuations are being produced independently and how this independence is maintained. Considerations include amongst others: (the appropriateness of) the valuation methodology used, validation and backtesting procedures surrounding pricing models, independent verification and the frequency of valuations.

3.4 If a pension fund participates in umbrella funds (i.e. an investment fund which itself invests in several distinct sub-funds), then the due diligence process considers several additional aspects, arising from the introduction of an additional management layer.

4. Contract terms and monitoring

GP 4: Supervisory authorities expect that the alternative investments of a pension fund are based on adequate contract terms. Broadly speaking, these terms should spell out an unambiguous limitation of risks in order to limit potential financial losses, the measures to be taken in case thresholds are crossed, adequate disclosure, a clear description of lock-up periods, and explicit cancellation and termination conditions and fees in general. Compliance with contract terms has to be monitored regularly and systematically by pension funds.

4.1 The specifications of adequate contract terms depend on the characteristics of the pension fund and the investment under consideration. The terms of any contract signed between a pension fund and an alternative investment provider should enable the pension fund to conduct adequate risk management. It is important to verify that the pension fund has come to a constellation of agreements, which leaves the pension fund as a whole 'in control'. A prudent investment policy should be defined, in line with the interests of the stakeholders and to obtain an income appropriate to the incurred risk and liabilities covered. In order to prevent losses due to third-party liability, the pension fund should use a limited liability structure.

4.2 Alternative investments cannot be regarded as passive investments. In order to ensure optimal operational flexibility in the financial markets, alternative investment funds may decide not to clearly define their strategies in their prospectuses. Checking the performance of the fund and the fund managers frequently and actively and by verifying the compliance with agreements, enables a pension fund to intervene at an early stage, if necessary. Timely intervention can prevent serious losses. The monitoring process covers not only investment aspects but also operational matters. When a pension fund participates in a fund of funds, the monitoring process is partly outsourced. In that case, the pension fund's focus shifts from the underlying funds to the fund of funds.

4.3 Having regular interaction with their alternative investment managers, especially where a material proportion of investments are with a particular manager, may strongly facilitate a pension fund's monitoring process. This could include regular questionnaires or on-site visits and may also include the engagement of specialist consultants to aid with the monitoring process.

4.4 The existence of side letters, offering preferential terms to certain investors, may significantly impact the risk profile of the investment. Therefore it is important for pension funds to make sure that their investment managers do not offer these facilities or that they are properly disclosed and compensated. This should be reflected in contract terms.

5. Communication

GP 5: Supervisory authorities expect that a pension fund is transparent in its communication with stakeholders about its policies regarding alternative investments and the objectives which it seeks to achieve in this respect.

5.1 Given the potential level of misunderstanding and debate surrounding alternative investments, pension funds need to communicate their investment policy and risk management practices clearly and adequately to stakeholders. Such communications form the basis for proper disclosure of key information on business development and financial soundness. It may help manage the pension fund's own reputational risk.

6. Outsourcing

GP 6: Supervisory authorities expect that where outsourcing is used, the pension fund remains responsible for, and thus ensures, adequate risk management for alternative investments.

6.1 Pension funds often outsource activities to third parties, possibly including other companies within the group to which the pension fund belongs. In case of outsourcing, supervisory authorities expect that pension funds ensure that the third party in question complies with the rules applying to the pension fund itself. In the event of outsourcing, a pension fund's risk management focuses on the selection process, the negotiation of a sound contract, the assessment and monitoring of the risk management process and other aspects of the parties to which tasks have been outsourced.

6.2 The basic principle is that a pension fund ensures that third party risk management is adequate. Therefore, for the supervisory authorities, the pension fund itself remains the main point of contact. The key issue to assess is how pension funds ensure that the outsourcing party conducts appropriate risk management for the delegated tasks.

6.3 If, on the basis of the information obtained from the fund (or on some other basis), it is not possible to determine whether the obligations for adequate risk management are fulfilled in respect to subcontracted activities, supervisory authorities may decide, where this is possible, to conduct further investigations into the parties to which tasks have been delegated. However, the pension fund remains responsible for, and thus ensures, adequate risk management for alternative investments.