IOPS/OECD work on risk-management

Nina Paklina– IOPS Secretariat

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Structure of the presentation:

- Introduction
- IOPS/OECD dedicated work in the area of risk-management
- Main results/conclusions
- Special focus on Pension Funds’ use of alternative investments and derivatives
- IOPS/OECD good practices in the area
Introduction

- Sound Risk-Management Systems (RMS) are essential for prudent operation and stability of the financial system;

- Importance of strong RMS highlighted by the recent financial crisis;

- Links to Risk-Based Supervision - as a move away from a rules based approach to supervision;

- In risk-based regulation much of responsibility over risk management lies with the individual pension fund companies;

- One of the roles of pension supervisors is to carefully check pension funds’ risk-management systems (both quality of risk-management and accuracy of risk assessment) and to clearly state their expectations towards RMS.
Risk-management systems of pension entities

- Risk-management frameworks/processes are implemented by an organisation’s Governing body/board of directors to provide assurance in relation to achieving of the following objectives:

  - Effectiveness and efficiency of operations;
  - Reliability of financial reporting;
  - Compliance with laws and regulations;

Not one single policy or procedure/ but an ongoing process at all levels of the organisation, involving all staff
IOPS/OECD Work on risk-management

- IOPS WP 11 “Pension funds’ Risk-management Framework”, issued in November 2009;


- Examine and provide guidance on main features that risk-management frameworks of pension funds should have in place and direct supervisory authorities how to control that risk management systems are in place and operate efficiently.
4 Broad categories of risk-management frameworks

- Risk-management frameworks are broken down into four main categories with the implementation guidance provided in recommendations:
  - Management oversight and culture;
  - Strategy and Risk assessment;
  - Control systems;
  - Information, reporting and communication.
4 Broad categories of risk-management frameworks: Management control and culture

- Key role of the Governing Body (GB) of a pension fund (pf) to define, implement and improve pension fund risk management system (RMS);
- GB also needs to review its overall RMS (discuss its effectiveness, identify weakness, correct them) and evaluate/record risks affecting the achievement of its goals;
- Management of pf should also ensure that RMS are suitable and proportional to the size and scope of organisation;
- GB needs to ensure effective division of responsibilities;
- GB need also develop a strong internal control culture within pf;
- RMS needs to be well documented and communicated between all levels of management;
- Conflict of interest policy and code of conduct should be in place.
4 Broad categories of risk-management frameworks:

**Strategy and Risk Assessment:**

- Within the RMS, a process of identifying risks should be established, covering all material (operational risks) and investment risks:
  - To measure likelihood and consequence of each;
  - To outline control mechanisms for each risk;
  - To monitor them on on-going basis;

- Operational risk management and outsourcing control: admin errors, IT errors, fraud, natural disaster risk and outsourcing risks;

- Investment risk management: written investment strategy (investment objectives, diversification, liquidity, valuation, use and monitoring derivatives, ALM, performance measure, control, reporting); use of internal/external managers and their costs;

- Funding and Solvency risk controls: pf that offer DB or guarantees need to establish and review regularly funding and solvency policy consistent with legal provisions.
4 Broad categories of risk-management frameworks:

**Control systems:**

- Control mechanisms are at the heart of any RMS both internal and external:
  
  - Internal control of IT systems (security of data, information processes, operational software systems, accounting/financial reporting systems);
  
  - Monitoring systems (part of daily activities + periodic evaluation of internal control process);
  
  - Internal audit and compliance function - effectiveness of operations, financial reporting, investigating fraud, safeguard of assets, compliance with laws/regulations;
  
  - External audit - external parties: ext auditors, custodians, actuaries;
  
  - Performance measurement and compensation mechanisms - regular assessment of persons involved in operation/oversight of pf.
4 Broad categories of risk-management frameworks: Information, Reporting, Communication

- Proper channels of reporting and communicating internal financial, operational and compliance data and external market data;
- Organisational structure should facilitate adequate flow of information - ⬆️ ⬇️ ↔️
- Information to be released to the correct parties in understandable format and on a timely and consistent basis (easy in access);
- Special treatment of confidential data;
- Internal control deficiencies, ineffectively controlled risks should be reported to concerned persons and the serious matters to GB;
- Appropriate reporting mechanisms to the supervisory authority are also required (on-going, regular basis) - informing on major developments/changes relating to pf activities.
Supervisory oversight of risk-management frameworks

- Supervisors should have powers to evaluate the work of directors/GB, determine if appropriate corporate governance, RMS, internal controls and code of code are in place;

- Evaluate effectiveness of the RMS and overall internal control systems + assess controls over high-risk areas;
- Supervisory authorities to provide guidance/expectations on how RMS should look like (ex: UK, Australia);
- Appropriate actions taken in case of deficiencies detected;
- Supervisory control over RMS of service providers (especially when pfs outsource their major functions);
- Address requests for necessary information from service providers.
Supervisory oversight of risk-management frameworks (cont.)

- To perform evaluations of RMS and internal control systems, supervisors can:
  - Own investigation by supervisors (off-site monitoring);
  - Rely on self-assessment, performed by pf management of RMS and which adequacy is certified/confirmed to the supervisors;
  - As a part of licensing process (Hungary, Poland, South Africa, Thailand, Turkey);
  - External Audit - periodic examinations by external audits which scope is defined by supervisors;
  - On-site Inspections - directed to conduct a full-range assessment of RMS or key areas of internal controls (internal procedures, decision-making process, major control points, etc);
  - Use of combined techniques.
Pension funds’ use of alternative investments and derivatives: joint IOPS/OECD work

- 2011: IOPS WP 13 on “Pension Funds’ Use of Alternative Investments and Derivatives: Regulation, Industry Practice and Implementation issues”;

Pension funds’ use of alternative investments and derivatives

- Advantages:
  - Better risk management possibility;
  - Better diversification (lowering overall risk on portfolio);
  - Allow to benefit from illiquidity premiums;
  - Offer more efficient investment mechanisms and thereby could improve risk-adjusted returns on investment portfolio;

- Major risks:
  - Complex;
  - Illiquid and opaque;
  - More expensive to manage (than traditional investments);
  - Valuation weakness;
  - Control issues: Require more rigorous review and monitoring;
Pension funds’ use of alternative investments and derivatives

Table 2 summarises the exposure of pension funds to alternative investment assets in various respondent countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Total (% of Total Assets)</th>
<th>Hedge Funds (%)</th>
<th>Private Equity (%)</th>
<th>Infrastructure (%)</th>
<th>Securitised Real Estate (%)</th>
<th>Others (%)</th>
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<td>Belgium</td>
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<td>1.3</td>
<td>2.27</td>
<td>0.25 Derivatives</td>
<td>3.30 Swaps</td>
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<td>1.75</td>
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<td>3.49 Investment property</td>
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<td>0.10</td>
<td>1.55</td>
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<td>Germany Pensionkassen¹</td>
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<td>0.70</td>
<td>0.20</td>
<td>0.90 ABS and CLN</td>
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<td>1.10</td>
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<td>0.75</td>
<td>0.50</td>
<td>0.26 Derivatives</td>
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1. Pensionkassen
2. Mexico

¹ Pensionkassen include private equity
² Mexico includes derivatives

(continued on page 16)
Pension funds’ use of alternative investments and derivatives: major conclusions/recommendations

- Overriding responsibility of pension funds to establish alternative investment and derivative policies in a responsible manner;
- RMS should include:
  - Written policies and procedures
  - Clear responsibilities for risk-management
  - Sufficient diversification
  - Adequate systems for analysis and measuring risks (e.g.: market risk, counterparty or credit risk, leverage)
  - Limits on risks taking
  - Timely risk monitoring and reporting
  - Effective independent internal control system and audit
  - Regular review of all related documents
IOPS/OECD Good Practices on Pension funds’ use of alternative investments and derivatives

1. Investment policy & Risk-Management Strategy - alternative investments and derivatives should be addressed specifically;
2. Internal Governance - Governing Body, senior management need to have sufficient expertise and knowledge; compensation policies;
3. Due Diligence of External Asset Managers - based on contracts and extensive checks;
4. Communication - policy of use of alternative investments and derivatives towards stakeholders should be clear;
5. Regulation;
IOPS/OECD work in the area of risk-management

- www.iopsweb.org
- www.oecd.org/daf/pensions