IOPS/OECD work on risk-management

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Structure of the presentation:

- Introduction
- IOPS/OECD dedicated work in the are 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;
- Joint OECD/IOPS “Good Practices for Pension Funds’ Risk Management Systems”, issued in January 2011;

➢ 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";

- 2011: OECD/IOPS Good Practices on the Pension Funds' Use of Alternative Investments and Derivatives.

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 mange (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.

	Total (% of Total Assets)	Hedge Funds (%)	Private Equity (%)	Infrastructure (%)	Securitised Real Estate (%)	Others (%)
Belgium	7.12	1.3 (including private equity)			2.27	0.25 Derivatives 3.30 Swaps
Bulgaria				0.96	1.75	3.49 Investment property
Chile						
Columbia			12.18			
Costa Rica	3.23				3.20	0.03
Czech Republic	2.07	0.39	0.03		0.10	1.55
Estonia	1.0 - 2.0					
Germany Pensionkassen[1]	1.80	0.70	0.20[3]			0.90 ABS and CLN
Israel	1.62	0.63	0.20		0.14	0.65
Japan	7.40[3]	5.70	0.40		1.10	0.10
Mexico[2]	1.51		0.75	0.50		0.26 Derivatives
Netherlands	6.20	3.40	2.80			
Poland	3.20			3.10		0.10
Portugal	1.90	1.36			0.54	
Romania	0.0		0.0			
Serbia	1.10					1.10
Spain	1.02	0.09	0.40		0.53	
Swaziland				2.80	31.0	20.40 Currency
Switzerland	5.69	3.27	1.0			1.42
UK	1.50	1.50				

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;
- 6. Supervision.

IOPS/OECD work in the are of risk-management

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