



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

September 9, 2011

Ms. Fiona Stewart
Principal Administrator
OECD/IOPS Secretariat
Organisation for Economic Co-operation and Development
Paris, France

Dear Ms. Stewart

Re: IAA comments on the OECD / IOPS draft Good Practices on Pension Funds' Use of Alternative Investments and Derivatives paper

In response to the request for comments on the OECD / IOPS draft Good Practices on Pension Funds' Use of Alternative Investments and Derivatives paper, I am pleased to transmit, on behalf of the International Actuarial Association, our comments and recommendations.

These comments have been prepared by the Pensions and Employee Benefits Committee of the IAA. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the Vice-Chairperson of the committee, Esko Kivisaari, care of the IAA Secretariat. The IAA will be pleased to develop these ideas further with you.

Yours sincerely

Jean-Louis Massé
Secretary General

[Attachment](#): IAA comments

**A Commentary on the
GOOD PRACTICES ON PENSION FUNDS' USE OF ALTERNATIVE INVESTMENTS AND DERIVATIVES
Released by the Organisation for Economic Co-operation and Development
and the International Organisation of Pensions Supervisors: July 2011**

International Actuarial Association and its Due Process

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our sixty-three Full Member actuarial associations, listed in an Appendix to this statement, represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries.

The IAA is pleased to be given the opportunity to provide input to the OECD/IOPS draft Good Practices paper. These comments have been prepared by the Pensions and Employee Benefits Committee, the members of which are listed in an Appendix to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA's official web site.

Comments

The document identifies the following areas:

- Investment policy & Risk Management Strategy
- Internal Governance
- Due Diligence of External Asset Managers
- Communication
- Regulation of Pension Funds' Alternative Investments and Use of Derivatives
- Supervision of Pension Funds' Alternative Investments and Derivatives.

While we feel all these areas are important and while we strongly support the concept of proportionate risk-based supervision we only comment below on those areas where we feel actuarial comments can add most value to the document. This is in the area of investment policy and risk management strategy and its implications on the regulation of pension funds' alternative investments and use of derivatives.

We support the pragmatic characterization of alternative investments as something other than the so-called traditional investments (stocks, bonds, cash or property). Attempts to define alternative investments directly have proved inadequate, failing to describe the reality in a reasonable manner.

This characterization clearly also shows that it is essential for the pension fund to understand the risks of the subset of alternative investments a pension fund actually utilizes. Good practice should create a setting where stakeholders and supervisors can be certain the pension fund is able to manage its risks (in general but especially in the area of alternative investments).

A typical element of alternative investments is that their risk profile is more complex than traditional investments and therefore difficult for Pension Fund management and beneficiaries to understand. In particular, smaller pension funds will be resource constrained to analyze all the risks inherent in all possible investments. An established rule of thumb is that investors should not invest in instruments that they do not thoroughly understand, and pension funds are no different.

The document states (page 2) that:

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: liquidity risk; integrity risk; operational risk; limited transparency; valuation weaknesses; control issues and conflicts of interest.

We stress that many of the so-called alternative investments are very complex with non-linear risks and have often dangerous tail-properties. Analyzing these risks, when it is quantitatively possible, often requires sophisticated methods. Indeed, actuaries and quantitative analysts strive to keep in pace with developments. In practice this means that pension funds, especially the smaller ones, need to be extremely careful and cautious in making sure the risks are understood.

We generally agree with the approach in Part I, 1 (Investment policy & Risk Management Strategy). We think this sets the stage for sound risk management and requires that the fund understands what it is doing.

We have, however, doubts on GP 1e mandating risk limits to control exposures. If we understand correctly this seems to advocate quantitative limits instead of the prudent person principle. Quantitative limits are only as good as the model used to determine those limits, and how quickly that model can be revised to respond to changing economic and market conditions. Quantitative limits can give rise to systemic risk therefore.

These so-called alternative investments have often been tailored so that investors using them can circumvent quantitative restrictions in the hope of better returns. We feel it dangerous to advocate quantitative rules and have a strong preference for the use of principles, where the central principle is to use only instruments that one truly understands.

In Part II, 5 (Regulation of Pension Fund's Alternative Investments and Use of Derivatives), we feel the emphasis shifts from the risk-based approach to higher reliance on quantitative limits. In this area we feel that:

- There should be regulatory requirements for pension funds to set up adequate procedures to make sure that they understand and manage the risks of their investments both in absolute terms and relative to the liabilities of the Pension Fund that the assets exist to provide for. This could mean for example the requirement to maintain a rigorous risk management process subject of course to the proportionality principle, i.e., the process should be commensurate to the nature, scale and complexity of the fund and its investments.

- It is somewhat unclear what the restrictions mean in practice, for example, what it means to limit “speculative purposes”. So-called alternative investments have often been used by product providers to circumvent quantitative restrictions in their mandates to achieve better returns. For example, this can take the form of the provider taking investment risk it can hedge with alternative investments: the provider may not however enact the hedge, from the provider’s perspective it is sufficient that it can action the hedge if it needs to. The risk being run in the portfolio is not fully disclosed because in principle that risk is hedged/hedgeable.
- on issues like GP 5c and GP 5d we would again prefer principles-based regulation instead of quantitative rules.

Appendix A

Members of the IAA Pensions and Employee Benefits Committee

Gary Hibbard	Chairperson
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Erik Falk	Den Norske Aktuarforening
Yasuyuki Fujii	Japanese Society of Certified Pension Actuaries
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Kenneth F. Hohman	American Academy of Actuaries, Conference of Consulting Actuaries
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Pari Kandhai	Het Actuarieel Genootschap
Henry Karsten	Instituto de Actuarios Españoles
Sylvestre Konin	Institut des Actuaire de Côte d'Ivoire
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Åsa Larson	Svenska Aktuarieföreningen
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Konrad Niklewicz	Association Suisse des Actuaire
Masaaki Ono	Institute of Actuaries of Japan
Ieva Ose	Latvijas Aktuaru Asociacija
Irene Paterson	Institute and Faculty of Actuaries
Denis Plouffe	Canadian Institute of Actuaries
Gediminas Rackauskas	Lietuvos aktuariju draugija
Ana Margarida Da Silva Ramos Estrela	Instituto dos Actuários Portugueses
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K Subrahmanyam	Institute of Actuaries of India
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Full Member Associations of the IAA

Caribbean Actuarial Association
Consejo Profesional de Ciencias Económicas de la Ciudad Autónoma de Buenos Aires (Argentina)
Institute of Actuaries of Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Institut des Actuaire en Belgique (Belgique)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Bulgarian Actuarial Society (Bulgaria)
Canadian Institute of Actuaries/Institut Canadien des Actuaire (Canada)
China Association of Actuaries (China)
Actuarial Institute of Chinese Taipei (Chinese Taipei)
Institut des Actuaire de Côte d'Ivoire (Côte D'Ivoire)
Hrvatsko Aktuarsko Društvo (Croatia)
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Deutsche Aktuarvereinigung e.V. (DAV) (Germany)
Hellenic Actuarial Society (Greece)
Actuarial Society of Hong Kong (Hong Kong)
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Félag Íslenskra Tryggingastærðfræðinga (Iceland)
Institute of Actuaries of India (India)
Persatuan Aktuaris Indonesia (Indonesia)
Society of Actuaries in Ireland (Ireland)
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Istituto Italiano degli Attuari (Italy)
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Japanese Society of Certified Pension Actuaries (Japan)
The Actuarial Society of Kenya (Kenya)
Latvijas Aktuaru Asociācija (Latvia)
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Persatuan Aktuari Malaysia (Malaysia)
Colegio Nacional de Actuarios A.C. (Mexico)
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New Zealand Society of Actuaries (New Zealand)
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Academia de Actuarios de Puerto Rico (Puerto Rico)
Russian Guild of Actuaries (Russia)
Udruženje Aktuara Srbije (Serbia)
Singapore Actuarial Society (Singapore)
Slovenska Spolocnost Aktuarov (Slovakia)
Slovensko Aktuarsko Drustvo (Slovenia)
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Col.legi d'Actuaris de Catalunya (Spain)
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Association Suisse des Actuaires (Switzerland)
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