Toezicht pensioenfondsen en
beleggingsondernemingen

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1000 AB Amsterdam

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Zijl, B.J. van
Doorkiesnummer

Bijlage(n)
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Subject
Re: Results of DNB investment surveys into alternative investments by pension funds

This is an informal English translation of "Resultaten DNB onderzoeken innovatieve beleggingen" in Dutch which can be found on www.dnb.nl[1].This translation is provided to you for your convenience. The Dutch version of "Resultaten DNB onderzoeken innovatieve beleggingen" is leading under any and all circumstances.

Dear members of the board of trustees,

In 2011, within the scope of thematic supervision, De Nederlandsche Bank (DNB) conducted investment surveys at various pension funds into the policies and control environment in respect of alternative investments.[2] In this letter we inform you in greater detail about the generic results of those surveys. The purpose of this information is to provide guidance to the pensions sector and to promote the development of good practices.

In recent years the share of alternative investments in pension funds´ portfolios has expanded. In practice, a wide range of alternative investment categories is involved, such as private equity investments, hedge funds, life settlements, infrastructure, sustainable forestry and micro credits. The increase in alternative investments of this kind is driven mainly by the pursuit of diversification gains and higher expected return. At the same time, alternative investments are usually associated with a large degree of complexity, higher management costs and a lack of liquid and transparent market prices. In 2007, DNB published the Policy Rule on Key Principles for Assessing the Risk Management for Alternative Investments [*Beleidsregel uitgangspunten beoordeling risicobeheer van alternatieve beleggingen*] to aid its assessment of risk management in respect of alternative investments. In the Policy Rule, DNB drew attention to the specific risk

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[1] http://www.dnb.nl/binaries/Brief%20Resultaten%20DNB%20onderzoeken%20innovatieve%20beleggingen_tcm46-274786.pdf

[2] Within the framework of the thematic survey of innovative investments and the survey on investments in private equity and hedge funds, investment surveys were conducted at a total of 35 pension funds.

and return characteristics of these investments and to the importance of a suitable financial risk management framework. The experiences during the financial crisis once again underlined the importance of such a framework.

The fact that alternative investments set high requirements for a pension fund´s policies and control environment was recognised not only in the report by the Frijns Commission, but also in the investment policy guidance published by the pensions sector umbrella organisations in 2010. DNB welcomes the sector´s on-going effort to improve its control environment. On the basis of experiences in ongoing supervision and the results of the surveys, DNB nevertheless finds that the risk management level not always corresponds to the complexity of the investments. It therefore remains essential for pension funds to further tighten the policies and control environment related to alternative investments.

DNB is aware of the major differences between pension funds in terms of their investment policy. Supervision is therefore on a case by case basis. The investment surveys of the past twelve months have nonetheless resulted in several sector-wide points for attention in relation to alternative investments. These can be outlined as follows.

- <u>Investment policy</u> Many pension funds lack sufficiently detailed strategy and investment guidelines with respect to alternative investments. Moreover, the added value of alternative investments in the portfolio is not always sufficiently substantiated. For example, the cost structure of alternative investments is not always assessed relative to the added value of the investment category. DNB has noted that this may cause the diversification gains to be overestimated and the management costs and specific risk characteristics such as tail risks and liquidity risks to be underestimated.
- <u>Selection and assessment procedure</u> Some pension funds lack a proper and predetermined selection procedure for alternative investments and asset managers. This makes them vulnerable to unexpected losses, because the risk profile of the actual investments may differ from the risk profile required by the board of trustees as predetermined in the investment policy. In addition, the functioning of the investment advisory committee, external asset managers and fiduciary managers is not always assessed periodically. Incidentally, DNB welcomes the improvements made by some pension funds in the recent past, e.g. by hiring independent experts in the field of alternative investments.
- <u>Monitoring</u> The reports which pension funds receive from fiduciary managers or asset managers often contain insufficient detail on performance and risk attribution. Moreover, if the investments in a single asset class are divided across several asset managers, aggregate reports are often lacking. This makes it more difficult to timely identify unwanted similar risk exposures among asset managers within the portfolio. Pension fund board of trustees are also often too dependent upon the asset manager to value their alternative investments, thus being unable to effectively and independently value their alternative investments.

- Governance A considerable number of pension funds lack a clear division of roles and recording of duties and responsibilities of the various bodies in the investment process, including the pension fund board of trustees, the investment advisory committee, the external advisers and asset managers. Given that in some cases the risk control system is not independently and effectively structured, a countervailing power vis-à-vis the fiduciary manager or asset managers cannot be safeguarded. As a result, external subject matter experts, acting as non-board members on investment committees, may unintentionally be given a policy-making role in the process. Similarly, fiduciary managers may have too much discretion in implementing the investment policy.

Please find attached an annex elaborating on these points for attention in more detail. Below, you will also find a list of relevant questions as applied by DNB in its regular supervision accompanied by examples of good practice. It is recommended that you use these questions to assess whether these points for attention are relevant to your pension fund or not. This might help you to identify any potential shortcomings and address these properly.

Based partly on the attachment to this letter, DNB will submit a self-assessment to the pensions sector regarding the process of investing in private equity and hedge funds. After publication, DNB expects pension funds to draw up a plan of action using the self-assessment with a view to addressing any policy or control shortcomings. Naturally, the overall results of the self-assessments will be shared and discussed with the sector to promote the development of good practices. The results of the self-assessments may also give rise to a review or further elaboration of the Policy Rule on Key Principles for Assessing the Risk Management for Alternative Investments. DNB will inform you about this at a later date. In addition, DNB will continue its thematic surveys in the coming twelve months, also covering investments. In doing so, it will focus specifically on investments in commercial property and on outsourcing of investment activities. These topics are included in DNB's supervisory themes for 2012, which can be found on the DNB website.[3]

[3] See http://www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/nieuws-2012/dnb267718.jsp.

Please contact your fund´s supervisor or contact person should you have any questions about this letter.

Yours sincerely,
De Nederlandsche Bank NV

Prof. O.C.H.M. Sleijpen
Divisional Director, Supervision of Pension Funds and Investment Firms

Annex – Points for attention in the investment policy and risk management of pension funds in respect of alternative investments

This annex contains an explanation of each of the four identified points for attention and an accompanying list of relevant questions. Although these lists of questions are non-exhaustive, they aim to provide guidance in identifying any potential shortcomings so that, where necessary, appropriate adjustments can be made within your pension fund in respect of alternative investments. The questions are related to a wide range of investment categories including private equity and hedge fund investments by means of a direct participating interest or via so-termed umbrella funds (fund of funds), but also via life settlements, infrastructure, sustainable forestry and micro credits. Incidentally, a number of questions focus specifically on hedge fund and private equity investments because those categories of alternative investments are most frequently included in the investment portfolios of Dutch pension funds.

For each point for attention, a number of good practices is listed which DNB observed in the course of its investment surveys. By providing these examples, DNB seeks to contribute to the development of sound investment policies and control control environments with regard to alternative investments.

1. Investment policy

Pension funds increasingly invest in alternative investments. Broad common features of these alternative investment categories are a large degree of complexity, an asymmetric risk profile, a higher and sometimes opaque cost structure and a lack of liquid and transparent market prices. This is why alternative investments are subject to relatively high requirements on the quality of the investment policy and risk control. It is important to note in this context that, in principle, there are no legal or regulatory restrictions on this type of investment.

DNB expects pension funds to adopt a strategic investment policy based on sound research, and in keeping with their risk appetite and risk-bearing capacity. Asset classes or specific investments are included in the portfolio only if, after a thorough critical analysis, they prove to be consistent with the pension fund's investment strategy and risk profile in relation to the nature and scope of the liabilities. In addition, the added value in terms of risk and return, diversification and correlation with the pension fund’s liabilities must be assessed in advance. The pension fund assesses not only whether risks can be managed prudently, but also whether the management costs and fees are in proportion to the added value. The cost structure should also guarantee the absence of adverse incentives for the external asset manager. Within the framework of the principles for sound remuneration policies, DNB expects pension funds to exercise their influence via the outsourcing relationship to bring the service provider's remuneration policy into line with these principles.[4]

It is not sufficient for pension funds investing in alternative investments to merely provide a simple risk measure or an ex post control environment in their risk management. In this context,

[4] The AFM and DNB principles for sound remuneration policies can be found on the DNB website.

effective risk management requires a proactive risk management function which also uses for example scenario analyses and stress tests. This will enable pension funds to effectively be in control throughout the investment process, from determining strategy, implementation and monitoring to adjusting the operational investment policy.

Points for attention relating to the investment strategy

1. In determining the investment strategy, do you assess to what degree your pension fund is *willing* and *able* to run risks? In doing so, do you take sufficient account of fund-specific characteristics such as its maturity, the liabilities and the opportunities to make adjustments by means of contributions?
2. Do you adopt a sufficiently critical and independent basic attitude when deciding whether or not to add an investment category to your investment portfolio?
3. Is the added value of an investment category assessed by means of a sound analysis? Are the results of scenario analyses and stress tests also taken into consideration in the analysis?
4. When considering adding an investment category to the investment portfolio, do you verify whether the required control environment is present? In doing so, do you consider the following questions:
   - Can the risks be managed prudently?
   - Are the required management costs acceptable relative to the added value of the investment category?
   - Does your pension fund have sufficient expertise and capacity available?
   - Does the fee structure safeguard the required alignment of interests?

Specifically with respect to hedge fund and private equity investments

1. Do you take the specific risk characteristics of hedge fund investments, such as their non-linearity and tail risks, into account in your analysis (for example ALM study)?
2. In your analysis do you also factor in the specific risk characteristics of private equity, such as the use of leverage and liquidity risks?
3. In your analysis, do you take account of the wide variety of hedge fund and private equity strategies? In doing so, do you specify what strategy or style is compatible with the assumptions made in your analysis (in terms of return, volatility, correlations and liquidity)?

Points for attention relating to the investment plan and guidelines

1. Does your pension fund have a well-documented investment plan (elaboration of the investment policy) which is sufficiently in keeping with the strategic investment policy?
2. In the investment plan, do you take sufficient account of the specific risks of alternative investment categories such as private equity and hedge fund investments?
3. Does the investment plan include explicit and detailed risk limits, criteria and benchmarks for each investment category?
4. Does your pension fund have investment guidelines containing a sufficiently detailed specification of the required allocation to specific investment categories?

Specifically with respect to hedge fund and private equity investments

1. Are the required strategies for hedge fund and private equity investments sufficiently clearly described and recorded in your investment plan or investment guidelines?
2. Does your investment plan contain an explicit choice for a direct participation or a participation in umbrella funds (fund of funds)?
3. Do your investment guidelines contain proper and detailed risk limits in respect of hedge fund investments, including a liquidity restriction, optimum use of leverage, a minimum degree of transparency and a maximum standard deviation?
4. Have you developed a policy for the desired diversification of private equity investments across regions, sectors and vintages? Do you also take the use of leverage and liquidity risks into consideration?

Good practices relating to investment policy

- Strategy After analysing the available capacity and level of expertise within the pension fund and the required level of control for hedge fund investment, the board of trustees has decided to further tighten the policies regarding hedge funds. Consequently, the fund invests only in hedge fund types and strategies whose risks can be properly understood and controlled.
- ALM study The pension fund board of trustees was aware of the specific risk and return characteristics of hedge fund investments and realised that the results of an ALM study are sensitive to the assumptions made. The board of trustees therefore ensured that the ALM study was not excessively optimistic about the return and risk parameters of the strategies it had adopted.

2. Selection and assessment procedure

A formalised and predetermined procedure to select external asset managers forms an integral part of the investment process. By assessing investment proposals in advance, pension funds can avoid making investments which are not in keeping with their policy. At the same time, predetermined procedures guarantee that the selection is made in a uniform, structured and transparent manner. This ensures that the investment mandates given are sufficiently consistent with the investment strategy chosen by the board of trustees.

The selection procedure usually starts by laying down the mandate. In addition to the scope, the mandate specifies the investment category involved, the potentially required geographical diversification, the return objective and, if applicable, the eligible investment styles. Subsequently, a long list is prepared of asset managers qualifying for the specific mandate. From this long list, a short list of preferred candidates is selected. A due diligence investigation is conducted of one or more of the candidates with a view to assessing whether they satisfy the pension fund's external asset management requirements. A due diligence investigation calls for an exhaustive analysis of an asset manager's performance data, strategy and financial, operational and legal risks. This involves more than asking a few critical questions and attending a presentation. The required level of detail of the due diligence process depends on the complexity of the investment. Due diligence is especially important when investing in illiquid securities, to avoid only being faced with unforeseen risks after the commitment . A site visit (i.e. an operational audit covering at least the set-up and operation of the governance structure and risk control) may provide added value in such cases. If the results of the due diligence investigation are positive, an investment proposal is drawn up. An investment proposal must have sufficient level of detail to enable the pension fund board of trustees to independently balance the alternatives properly against one another and take a substantiated decision.

In addition, within the framework of sound conduct of business and outsourcing, DNB expects pension funds to frequently evaluate the effectiveness of the investment advisory committee, the administrative agency, the fiduciary manager, the external asset managers and the external advisers as well as the suitability of the relevant investment categories within the strategic investment portfolio.

Good practices relating to the selection and assessment procedure

- Expertise brought in The pension fund in question has brought in expertise to be better able to assess innovative investments without losing control of the process.
- Decision-making The pension fund board of trustees based its decisions to make alternative investments on comprehensive investment proposals of the fiduciary manager, accompanied by the advice of its investment advisory committee and in-depth due diligence reports on the preferred candidates. The entire selection procedure was recorded in detail.
- Investment advisory committee The pension fund board of trustees develops a set of predetermined objectives for the investment advisory committee on an annual basis. Each year in retrospect, the investment advisory committee as a whole and its external members individually are formally evaluated, on the basis of the objectives.

Points for attention relating to the selection procedure

1. Does your pension fund have a detailed description of the selection procedure? For example, is there a clear division of roles and recording of duties and responsibilities of the various bodies in the investment process?
2. Has the selection procedure been approved by the pension fund board of trustees?
3. How do you determine whether a proposed investment is in keeping with your pension fund´s policies and strategies?
4. In practice, is the pension fund board of trustees effectively responsible for the critical assessment of and ultimate decision on investment proposals?
5. Are audit trails available of all your pension fund´s selections?

Points for attention relating to selection and assessment criteria

1. Has your pension fund laid down selection criteria to determine which asset managers qualify to carry out a mandate? For example, is there a scoring methodology or assessment framework comprising both qualitative and quantitative criteria?
2. Have these selection criteria been drawn up or approved in advance by the pension fund board of trustees?
3. Are the selection criteria consistent with your pension fund's objectives and policies? To what degree are these criteria in keeping with the assumptions underlying your investment strategy?
4. When determining selection criteria, do you take sufficient account of the specific characteristics of investment categories? For example, in the case of hedge fund investments, do you also consider the degree of transparency of underlying positions, the effectiveness and transparency of the cost structure and the asymmetric risk profile?
5. How does the pension fund board of trustees evaluate the performance of the external asset manager? Are the asset manager's net proceeds as you expected?
6. Do you verify whether there is a proper diversification of the investments in, for example, private equity to avoid undue concentrations?
7. After deduction of all costs, do the individual investment categories provide sufficient added value?
8. Do you have an understanding of the total investment fees of the external asset managers?

Points for attention relating to due diligence

1. Has the due diligence process within your pension fund been formalised, laid down in advance and approved by the pension fund board of trustees?
2. Does your pension fund´s due diligence process have a sufficient level of detail? For example, do you regularly use site visits?
3. Does the level of detail of your pension fund´s due diligence process depend on the complexity of the investment? In the case of a complex investment, do you bring in external expertise for the legal, financial and strategic due diligence investigation?
4. Does a due diligence investigation require the production of a report containing well-substantiated and clear recommendations?

3. Monitoring

One of the prerequisites of risk control is that pension fund board of trustees and investment advisory committees timely have the relevant and complete information about strategy, positions, performance and risks at their disposal. This requires adequate reporting. Adequate insight means that the reports should enable the pension fund board of trustees to assess the performance and gain an understanding of the relevant ex ante risk characteristics of the investment portfolio. The latter is even more important for alternative investments because of their specific risk profile. A comprehensive description of the risk characteristics in reports includes position statements with a sufficient level of detail, performance attribution, relevant risk parameters, insight into tail risks through stress tests and scenario analyses, statements of counterparty and liquidity risks and information about limit use and limit excess.

The monitoring of alternative investments is based not only on regular reports but also on frequent formal contacts with the asset managers of the various investment products during regularly scheduled conference calls and site visits, for example to review the reports received or to ask ad hoc questions. It is recommended that the results of these calls and visits are recorded in writing. In addition, other elements relating to the external asset managers should be reviewed regularly, for example staffing changes (key person risk), changes in the strategy or mandate, changes in the ownership structure (redemptions, subscriptions, side letters) or the existence of operational issues (court cases, fraud, operational errors).

Monitoring the valuation process in respect of alternative investments is also of major importance. In practice, alternative investments usually entail illiquidity and complexity. This increases the risk of valuation problems. Moreover, in many cases pension funds depend on third parties valuations, sometimes even from the asset manager itself. This poses as a challenge as it is expected that a pension fund is able to perform an independent valuation. An unchallenged valuation performed by the asset manager may be biased and can ultimately result in a misinterpretation of the pension fund´s financial position and, consequently, misinformation of the members and supervisors.

Points for attention relating to reports

1. How has your pension fund´s need for information in respect of alternative investments been identified?
2. Are clear reports available from the external asset managers matching your pension fund´s needs and the nature of the investments in terms of detail and frequency?
3. Are the reports on and accountability for alternative investments such that you are effectively able to check, assess and possibly adjust the implementation of the policy?
4. Does your pension fund have sufficient knowledge to properly understand reports on alternative investments? If not, do you bring in the expertise of an independent third party to be able to gain critical insight into the information provided?
5. In addition to the reports of the external asset managers, are aggregate reports for each individual investment category and for the total investment portfolio available?
6. How and to what degree is the reliability of the reports monitored (independently)?

Points for attention relating to performance and risk characteristics

1. Are the reports on and accountability for alternative investments such that you gain an understanding of the underlying factors affecting the performance and specific risks?
2. Do you perform a plausibility check on the reports to verify whether the realised performance can be largely explained on the basis of actual market movements and sensitivities known in advance?
3. Do the submitted reports include the following information:
   a. benchmarks used for each individual investment category;
   b. comprehensible and suitable performance indicators;
   c. sufficiently detailed position statements;
   d. relevant risk parameters for hedge fund investments;
   e. insight into tail risks through stress tests and scenario analyses;
   f. a comprehensive statement of the management costs; and
   g. a statement of instances in which the investments limits have been exceeded?

Points for attention relating to the valuation process

1. Does your pension fund have robust and independent valuation models for alternative investments in place? How have these methods been validated?
2. Are the valuations within your pension fund performed frequently enough?
3. Does your pension fund have a valuation manual describing the valuation methods used? Has this manual been reviewed by the external auditor?
4. How do you prevent your pension fund from having to depend on selling parties (second parties) for the valuation of alternative investments?
5. If your pension fund is unable to value alternative investments objectively, do you bring in the expertise of an independent third party to obtain a proper valuation?

Good practices relating to monitoring

- Adequate risk reports In this example, the pension fund board of trustees considered in advance what information it wanted to receive from its providers in order to gain a proper understanding of the investment portfolio and the related risks. In the board of trustees's opinion, the provider's standard reports were insufficient for that purpose. The asset manager therefore ultimately designed the reports to match the pension fund board's need for information.
- Valuation The pension fund board of trustees has sufficient insight into the valuation process of innovative investments. To that end, the pension fund has a valuation manual at its disposal which has been reviewed by the external auditor. The reports also break down the investments by the valuation method used, i.e. on the basis of i) direct market prices, ii) inferred market prices, and iii) valuation models and techniques.

4. Governance

Controlled and sound operations within a pension fund require a balance between the complexity of the investments and the level of risk control. The pension fund´s organisational structure should safeguard this balance, for example through effective and independent risk management.[5] ´Effective´ implies that the level of risk control is tailored to the complexity of the investment portfolio. ´Independent´ means that risk management does not depend on the sponsor, fiduciary manager or external asset managers. A factor to take into consideration is that the more complex the investment policy, the greater the shift in risk management requirements, from an ex post control environment to an ex ante proactive risk management function. With a view to organising sufficient countervailing power within the pension fund, the available knowledge and expertise in the field of investments should also match the complexity of the investments. At any rate, the pension fund board of trustees should have a proper understanding of the strategy, performance and major risk characteristics of the investments in the portfolio and the related risk management. First and foremost, this requires investment policy and risk management expertise (knowledge, skills and professional conduct) within the pension fund board of trustees.

To maintain sufficient grip on the entire investment process, it is important to clearly divide and record the duties and responsibilities of the various bodies within the pension fund (board of trustees, investment advisory committee, external advisers and asset managers). This requires not only a clear division of duties and responsibilities but also a clearly described division of the roles within the various bodies. This helps prevent external members of the investment advisory committee, such as fiduciary managers, from being unintentionally given a policy-making role in the investment process. Minutes also play an important role in this respect. Not only should they reflect all the steps taken in the decision-making process but also discuss the division of roles among the members of the investment advisory committee. This helps prevent the board of trustees from assuming that certain issues are addressed by the investment advisory committee while they are unaware that they are not.

Good practices relating to governance

- <u>Countervailing power</u> In this example, the pension fund board of trustees gathered a group of critical internal and external experts around it to have a counterweight to the fiduciary manager or external asset managers. In other words, the board of trustees not only brought in advisers on the investment policy but also sought the advice of an independent party on risk management. By doing so, the board of trustees put into practice the principle of challenging asset managers.
- <u>Independent and effective risk management</u> The board of trustees has created a risk management function within its own organisation which operates independently of the sponsor, pension provider and external asset managers. A number of risk management duties, including the preparation of reports and analysis of data, have been outsourced.

[5] In this context, see also DNB's integral risk management framework (http://www.toezicht.dnb.nl/3/50-223998.jsp).

Points for attention relating to the pension fund board

1. Is the board of trustees involved throughout the investment process relating to alternative investments?
2. In your opinion, what are the most important risk characteristics of the alternative investments in your portfolio? Do you know how these risks are managed and monitored?
3. Is the board of trustees able to independently balance the policy options presented by the advisers or providers and take a substantiated decision?
4. How do you ensure that the expertise available within the board of trustees matches the complexity of the investment portfolio?
5. Has the required level of expertise of board members within your pension fund been laid down? Do regular assessments take place to determine to what degree the current board members satisfy these requirements?
6. How do you ensure that all key duties regarding the investment process have been assigned? How do you prevent any overlapping of duties among the various governing bodies?
7. Do the minutes of board meetings and meetings of other relevant governing bodies provide sufficient insight into the decision-making process within your pension fund?

Points for attention relating to the investment advisory committee

1. Does the investment advisory committee within your pension fund have a clear mandate in respect of investments in general and alternative investments in particular?
2. Is there a clear description and definition of the scope of the investment advisory committee´s duties and responsibilities?
3. Does the investment advisory committee only have an advisory function or is it also involved in policy-making in practice? If the investment advisory committee is authorised to take decisions, is it clear in advance to what decisions that authority applies?
4. How likely or unlikely are potential conflicts of interests on the investment advisory committee due to a combination of advisory and policy-making duties?
5. Have you taken measures to avoid integrity risks or conflicts of interests, for example by drawing up a code of conduct or compliance rules for internal and external members of the investment advisory committee?

Points for attention relating to risk management

1. Is the board of trustees involved in the risk management policy, for example in the context of setting up the risk framework and determining the risk parameters and limits?
2. Is the risk management function within your pension fund able to properly identify and quantify the risks of alternative investments? In that context, do you make effective and sufficient use of stress scenarios? What do you subsequently do with the results of these stress scenarios?
3. Do the duties and responsibilities relating to risk management within your pension fund match the complexity and scale of the investment portfolio?
4. Does your pension fund have an independent risk management system in place which is unrelated to the sponsor, external providers or asset managers?
5. If you have outsourced specific duties, are you sufficiently able to act with sufficient initiative and have a counterweight to the provider or asset manager and any advisers and experts retained?
6. If you have outsourced the risk management function to an external party, do you have a proper understanding of the degree of independence and expertise of the external party´s control environment?