Please cite this paper as:

Stewart, F. (2007), "Pension Fund Investment in Hedge Funds", *OECD Working Papers on Insurance and Private Pensions*, No. 12, OECD Publishing.
doi:10.1787/086456868358

OECD Working Papers on Insurance and Private Pensions No. 12

Pension Fund Investment in Hedge Funds

Fiona Stewart*

JEL Classification: G11, G18, G23, J31

*OECD, France

OECD PUBLISHING

PENSION FUND INVESTMENT IN HEDGE FUNDS

Fiona Stewart

September 2007

OECD WORKING PAPER ON INSURANCE AND PRIVATE PENSIONS

No. 12

Financial Affairs Division, Directorate for Financial and Enterprise Affairs
Organisation for Economic Co-operation and Development
2 Rue André Pascal, Paris 75116, France
www.oecd.org/daf/fin
www.oecd.org/daf/fin/wp

ABSTRACT/RÉSUMÉ

Pension fund investment in hedge funds

Having outlined the potential concerns relating to pension fund investment in hedge funds, the OECD carried out a survey to investigate what information pension fund regulators have on these investments and how they are being controlled. The survey confirms that pension fund regulators have little information regarding how pension funds in their jurisdiction are investing in hedge fund products (in terms of size of investments, the types of hedge funds pension funds are exposed and to what type of product).

Only the Slovak Republic and Mexico (for the mandatory system) prevent pension funds from investing in hedge funds. Although the level of such investment is still very low in other countries, it is almost universally expected to increase. Few countries impose specific quantitative investment restrictions on pension fund investment in hedge funds, with most regulators exercising control via general investment restrictions and requirements (for diversification, transparency, through the prudent person rule etc.). Some regulators have provided pension funds with further guidance as how to handle these instruments.

In terms of policy issues, most concern centre around financial risk control and how to improve transparency and disclosure in relation to these investments.

JEL codes: J31 G11 G23 G18
Keywords: hedge funds, pension funds, quantitative limits, qualitative restrictions, transparency, risk control.

*****

Les investissements des fonds de pension dans les hedge funds

Après avoir décrit les problèmes potentiels liés aux investissement des fonds de pension dans les hedges funds, l'OCDE a lancé une enquête pour savoir de quelles informations les régulateurs des fonds de pension disposent sur ces investissements et comment ils sont contrôlés. Une étude récente de l'OCDE confirme que les instances de réglementation des fonds de pension ont peu d'informations sur les investissements des fonds de pension relevant de leur juridiction en produits de hedge funds (taille des investissements, types de hedge funds auxquels les fonds de pension sont exposés et types de produits).

Il n'y a qu'en République slovaque et au Mexique (pour le système obligatoire) qu'il est interdit aux fonds de pension d'investir dans les hedge funds. Le niveau de ce type d'investissement est certes encore très limité dans les autres pays, mais on s'attend presque partout qu'il augmente. Peu de pays imposent des restrictions quantitatives spécifiques aux investissements des fonds de pension dans les hedge funds, la plupart des instances de réglementation exerçant leur pouvoir de contrôle par le biais de restrictions et d'exigences d'ordre général (diversification, transparence, règle de la personne prudente, etc.). Certaines instances de réglementation, toutefois, ont communiqué des orientations complémentaires aux fonds de pension sur la façon de traiter ces instruments.

Dans l'optique gouvernementale, l'essentiel des préoccupations porte sur la maîtrise du risque financier et la façon d'améliorer la transparence et la divulgation d'informations concernant ces investissements.

JEL codes : J31 G11 G23 G18
Mots clés : hedge funds, fonds de pension, limites quantitatives, restrictions qualitatives, transparence, maîtrise du risque.

TABLE OF CONTENTS

PENSION FUND INVESTMENT IN HEDGE FUNDS 1

I. Introduction 5
II. Initial Discussion 5
1. To what extent and why are pension funds investing in hedge funds? 5
2. Are hedge funds appropriate investments for pension funds? 6
3. Are policy responses required? 7
III. OECD Survey Results 8
1. To what extent are pension funds investing in hedge funds? 9
2. How are pension funds' investments in hedge funds controlled? 10
3. What are the major policy concerns and responses surrounding pension funds' investment in hedge funds? 15
IV. Conclusions 18

PENSION FUND INVESTMENT IN HEDGE FUNDS

F. Stewart[1]

I. Introduction

1. Given the increasingly high profile nature of hedge fund products, the OECD's Working Party of Private Pensions held a discussion on the topic, looking at the pros and cons of such investments for pension funds. Following this discussion, it was decided to survey the group's delegates in an attempt to establish whether pension regulators had more specific information on the extent to which pension funds in their jurisdiction were investing in hedge funds, the type of pension funds which are exposed, and what type of hedge fund they are investing in. In addition, a survey of quantitative and qualitative investment restrictions on pension fund investing in hedge funds was undertaken, including whether pension fund regulators provide any guidance on this topic. Finally, delegates were asked to outline their particular concerns relating to pension funds investing in hedge funds, and what policy action, if any, they were taking or thinking of introducing.

II. Initial Discussion

2. This section outlines the initial discussion of pension funds' investments in hedge funds held by the OECD's Working Party on Private Pensions. It provides a brief assessment of the current position of such investments why these institutional investors are allocating assets towards them. It goes on to discuss whether hedge funds are appropriate investment vehicles for investors such as pension funds, and to initiate a discussion as to whether policy makers and regulators need to respond to this trend.

1. To what extent and why are pension funds investing in hedge funds?

3. Before considering the question of to what extent pension funds are investing in hedge funds, the definition of these investments needs to be addressed - not a simple a task as the term is now applied much more broadly than its original usage 50 years ago (i.e. for funds which took off-setting positions to hedge market risk). Generally these are pooled investment funds, structured as private partnerships which charge performance related fees. They have a great deal of investment flexibility, often employing short-selling and leverage techniques and focusing on 'absolute returns' as opposed to beating a benchmark index. Applying a more detailed description to hedge funds is difficult as they invest in a wide range of assets and apply a broad range of 'strategies'.

[1] The author would like to thank the delegates to the OECD's Working Party on Private Pensions who provided responses to the OECD questionnaire which provided the material for this paper

Contact information: Fiona Stewart, Private Pensions Unit, Financial Affairs Division, Directorate for Financial and Enterprise Affairs; Organisation for Economic Cooperation and Development. 2, rue André Pascal, Paris 75116, France. Email: Fiona.stewart@oecd.org.

4. What is undoubted is the growth in the hedge fund market in recent years, with estimates putting assets under management of the 10,000+ funds at over $1trillion.[2] Much of this increase has come from institutional investors, and pension funds in particular. Though estimates vary, up to 20% of European and American pension funds and 40% of Japanese pension funds are thought to invest in hedge funds. Despite a great deal of coverage in the press, the amount of total pension assets dedicated to hedge funds is still small, with their adoption relatively cautious. As the IMF and others estimate,[3] few funds allocate more than 5-10% of total assets to these investments and much exposure remains via 'fund of hedge funds'. What is more important is that surveys globally all show pension funds intending to raise these weightings.

5. What is driving these increased weightings? Following a period of poor performance (and consequent underfunding) after the collapse of equity markets around the millennium, many pension funds adopted a new way of investing – which increasing involves investment in hedge funds for two main, interconnected reasons. On the one hand, many pension funds are attempting to match assets and liabilities more closely to avoid under-funding in future (a trend which is being supported by regulatory and accounting changes). Hedge funds can be used to manage, reduce and indeed hedge such liability risks. Hedge funds also allow for risk reduction via increased diversification away from traditional equity market holdings (via holding in commodities, property etc). On the other hand, this asset liability matching is provoking a move into bonds which, coupled with the low-interest rate environment, means that pension funds are also been forced to think harder about how to generate return. Rather than holding traditional equity portfolios, generating most of their return from 'beta' or market return (which can be easily and cheaply obtained via passive, index products), pension funds are increasingly rethinking their investment approach and searching for 'alpha' or excess return over the market. More absolute return mandates are being given to fund mangers, who are also allowed to go short as well as long. In addition, pension funds are progressively more prepared to invest in a broader range of products – from emerging market debt or equity, high yield fixed income, property, commodities, illiquid investments etc. Hedge funds are increasingly used as instruments to facilitate this new investment approach.

2. Are hedge funds appropriate investments for pension funds?

6. Given pension fund managers' intensions to increase their exposure to hedge funds - albeit for the positive strategic reasons of reducing risk, increasing diversification and improving asset returns – regulatory and other market authorities have expressed concern about the appropriateness of hedge funds for investors such as pension funds. Some of these concerns are outlined below:

7. ***Operational Risk:*** Due to the potentially risky nature of their investments, hedge funds were originally designed for high-net worth individuals. Given that individuals still cannot invest their discretionary savings in these products, is it right that their potentially 'subsistence' pensions savings of low-risk tolerance pension beneficiaries should be exposed to them? The justification is that pensions are managed by 'knowledgeable investors', but do pension fund trustees really understand these complex products? Even if they do, the fact that hedge funds are not offered directly to the public means that they are exempt for much regulation and reporting requirements - allowing them to operate in an often highly opaque fashion, which implies a greater level of 'operational risk' for investors. This is not to say that all hedge funds are necessarily highly geared or risky. Rather that their very lack of transparency makes the level of risk and type of exposure hard to gauge (not helped by the fact that their strategies can change)[4].

---

[2] Estimates from OECD's Committee on Financial Markets

[3] See 'Global Financial Stability Report', September 2004, Chapter III p. 34 http://www.imf.org/External/Pubs/FT/GFSR/2004/02/pdf/chp3.pdf

[4] As the high profile collapse hedge fund Amaranth Advisors shows - investors did not realise that the fund held up to an estimated 10% of the global market in natural gas futures.

The lack of transparency has also allowed fraudulent trading to take place within hedge funds (though it should be said that the number of cases is small compared with the overall size of the hedge fund industry). With lock in periods and high exit charges, pension fund investors may also find it difficult to extricate themselves from their hedge fund investments if and when problems are detected.

8. ***Return Measurement:*** As pension funds' investments are often being attracted into hedge funds by potential higher returns, concerns have also been raised as to whether these instruments are really able to deliver the results they claim. Though data measurement is improving as the hedge fund industry grows, performance data is only available for a maximum of around 10 years and returns are difficult to analyse as headline numbers include a vast range of instruments with different strategies and levels of risk. Extremely strong performance by a few highly leveraged funds may well mask poor returns by the majority. In addition, there is much 'survivorship bias' in the numbers, as funds which do not perform well simply do not publish their numbers and many (estimated around 5% a year and rising[5]) fail early on – raising the question of whether such funds, often employing 'trading' strategies, are appropriate for long-term investors such as pension funds. Even if past performance numbers can be believed, it can be questioned whether they will be repeated in future, as increased flows into hedge funds make it harder to find 'alpha' opportunities and exploit market inefficiencies. If hedge fund returns may be lower in future, this also makes their high fees difficult for pension fund investors to justify (typically 1-2% and 20% of profits – with an additional fee for 'fund of fund' investments).

9. ***Diversification measurement:*** The claim that hedge funds reduce risk via diversification as they have low correlations to traditional assets, particularly equities, is also disputed as hedge fund returns have reduced along with global equity markets. For example, long-short equity funds have been estimated to have around 60% exposure on the long side, offering higher 'beta' correlations than investors expected. The problem of 'stale pricing' of hedge funds' non-liquid, non-listed assets may also effect correlations. For example, an illiquid investment may show little correlation with intra-month market moves, but this may be due to the fact that the instrument was priced at the end of the month. Finally, as more and increasingly 'institutionalized' hedge funds have entered the market, their correlations with each other have increased.

10. ***Risk Measurement:*** Even accepting that hedge funds can generate extra return, the question is whether they are doing so at an acceptable level of risk? Do traditional risk measurement techniques really capture the risks to which hedge funds are exposed? For example, many funds target risks such as liquidity, making traditional volatility risk measures inappropriate and indeed they often deliberately target low probability events which traditional, standard distribution type measures overlook. The highly leverage and dynamic nature of many hedge fund strategies also makes their risk exposure difficult to predict. Though risk-management techniques of the hedge funds themselves have developed rapidly, there is still a question as to whether the tools many pension funds employ can adequately handle such sophisticated investments.

3. Are policy responses required?

11. The question raised by the OECD Working Party on Private Pensions was whether regulators need to react to pension funds increasing exposure to these instruments? Two response routes could be considered:

12. ***Supply side:*** Some financial authorities have considered imposing restrictions on hedge funds. For example, the Securities and Exchange Commission in the USA introduced a listing requirements for hedge funds (later struck down by a Federal Court), whilst other authorities are considering greater disclosure or closer monitoring of funds. However, many authorities conclude that such restrictions

[5] See FSA Discussion Paper 05/04, p.11.

(admittedly difficult to impose in practice on a global basis) would be damaging to financial markets and economies worldwide. Hedge funds do make a positive contribution – increasingly liquidity, improving market efficiencies and indirectly they have done a great deal to ‘shake up’ the institutional investor community, provoking new and more efficient means of managing risk and generating returns. Restricting hedge funds from the ‘supply side’ could limit such benefits. Financial authorities do already have some monitoring and control over hedge funds via investment banks (their major counter parties) and through existing fraud laws.

13. ***Demand side:*** The alternative is whether pension fund regulators need to look at the ‘demand side’ of the equation – i.e. regulating pension funds’ ability to invest in hedge funds? This could be done in several ways such as: limiting investments in unregulated investment instruments; limiting investment in geared instruments; limiting investment to ‘fund of funds’; monitoring investment via governance requirements (e.g. requiring trustees undertake training before investing in such instruments and disclosing how they manage their exposure to hedge funds).

14. The final question raised was whether new regulation is required to exercise such ‘demand side’ controls, or whether existing regulations already provide suitable protection? For example, the ‘prudent person’ rule already requires pension fund fiduciaries to invest -*“in accordance with the prudential principles of security, profitability, and liquidity…”*[6] OECD guidelines also recommend that “*certain categories of investment may be strictly limited (as for instance…investments that lack sufficient transparency).”* What maybe required is greater guidance and clarification from regulators regarding the appropriate use of hedge fund investment by pension funds, and more attention to ensure that pension fund trustees understand these investments and have suitable risk-management systems in place to monitor them.

III. OECD Survey Results

15. Following this discussion, it was decided to survey the group’s delegates in an attempt to establish whether pension regulators had more specific information on the extent to which pension funds in their jurisdiction were investing in hedge funds, the type of pension funds which are exposed, and what type of hedge fund they are investing in. In addition, a survey of quantitative and qualitative investment restrictions on pension fund investing in hedge funds was undertaken, including whether pension fund regulators provide any guidance on this topic. Finally, delegates were asked to outline their particular concerns relating to pension funds investing in hedge funds, and what policy action, if any, they were taking or thinking of introducing.

16. Responses were received from the following countries: Australia, Austria, Belgium, Canada[7], Colombia, Czech Republic, Denmark, Estonia, Finland, Germany, Greece, Ireland, Israel, Italy, Luxembourg, Mexico, Netherlands, Poland, Portugal, Slovakia, Spain, Switzerland, Turkey, UK and are summarized in this report.

[6] See OECD’s ‘*Guidelines on Pension Fund Asset Management’* http://www.oecd.org/dataoecd/59/53/36316399.pdf

[7] Please note that the responses from Canada cover federally regulated plans.

1. To what extent are pension funds investing in hedge funds?

Table 1: Pension Fund Investment in Hedge Funds (% of AUM)

Country	Average Exposure
Finland	3.1%
Portugal	3%
Netherlands	Approximately 2-3%
Switzerland	2% in 2004
Canada (federally regulated plans)	1%
Israel	1% (estimation)
Estonia	Under 1%
Czech Republic	Estimated up to 1%
Germany (Pensionskassen)	0.6%
Ireland	Thought to be extremely low
Italy	Negligible
Greece	0%
Poland	0%
Slovakia	0% (not allowed)
Mexico	0% (voluntary – mandatory funds are not allowed to invest in hedge funds)

17. The first conclusion which can be drawn from this survey is that pension fund regulators have little information on the level or type of investment pension funds in their jurisdictions are making into hedge fund products.

18. Slovakia was the only country which indicated that pension funds are not allowed to invest in hedge funds, based on the stated obligation of increasing the safety of individuals' savings in personal pension accounts. Mandatory pension funds in Mexico are similarly restricted. Investment in Colombia is allowed indirectly[8], whilst pension funds in Finland have only been authorized to invest in hedge funds from 1st January 2007. Italian pension funds may only invest in closed-end hedge funds (which are considered UCITS).

19. Accurate figures for the level of investment are only available in Finland, at 3.1%. The pension regulator (the Ministry of Social Affairs and Health) obtained this number by surveying a limited number of large pension funds in the country (which account for 75% of pension assets and are known to be the main pension funds investing in hedge funds). The extent of pension funds exposure to hedge funds in other countries is estimated to be still very limited – Portugal reporting the highest numbers at 3%, the Netherlands between 2-3%, Switzerland at 2% and Canada, Czech Republic, Estonia and Israel at 1% or less. Some countries noted that the pension funds in their jurisdiction are not yet investing in hedge funds, even though regulations allow them to do so (Greece, Poland, Turkey), whilst Israel notes little difference

[8] Direct investment in hedge funds is not permitted for mandatory pension funds. However, these funds can invest in structured products that have a fixed and a floating rate component, indexed to some asset or indicator. The floating rate component may be invested in hedge funds.

between old DB funds and new DC funds, even though the latter are allowed to invest in hedge funds to a greater extent.

20. The Swiss authorities made the point that it is not the overall level of investment in hedge funds which is important to them, but individual pension fund's ability to manage the risk of these investments (which must be laid out in a written report, approved by the supervisory authority).

21. Yet, where stated, countries saw pension funds investments in hedge funds increasing – albeit modestly in some countries. Increased supply is expected to be the driver in some countries, such as Turkey or Mexico (where the Securities and Banking Commission is expected to approve domestic hedge funds). Meanwhile Denmark noted specific demand side drivers such as increased returns and diversification, which was also noted as worldwide trend by the Belgian regulator. Investment in hedge funds is also expected to increase in Belgium due to the deregulation of investment restrictions in 2006. It is, however, also interesting to note that the Committee on Financial Markets, as part of the discussion on hedge funds which it held during its meeting on 11th May 2007, found that some of the largest flows into hedge funds were coming from pension funds (in some cases amounting to up to one-third of fund inflows). Therefore, although the percentage of investments in terms of total pension fund portfolios is still small, the absolute amounts of money may be large[9].

22. In terms of what type of pension funds are particularly investing in hedge funds, Canada and the Netherlands note that large funds tend to have more exposure, with the Australian authority making the same assumption (though lacking evidence to support this). In Luxembourg only the two largest pension funds (which are defined benefit funds) have a small exposure to hedge funds. Finland noted a higher exposure for private than public funds (4% vs. 1%), with Israel also noting a distinction along these lines. The Belgian regulatory authority note that they will be gathering this type of information from pension funds from this year onwards.

23. Only the Czech Republic was able to supply information on what type of hedge fund strategies pension funds are particularly attracted to (equity, event driven, complex trading strategies). Only the Finnish authority provided a breakdown by individual hedge funds vs. fund of funds (58% vs. 42%), with the Dutch authorities noting that smaller pension funds are naturally more likely to invest via fund of funds, with the largest Dutch pension funds sometimes running their own hedge fund strategies. The two pension funds which are exposed to hedge funds in Luxembourg also invest via fund of funds with a variety of trading strategies (including long/short equity, event driven, special situation, multi-strategy and emerging market funds). Both these funds exposure is via onshore hedge funds. The authorities from the Czech Republic and Finland also provided data showing a prevalence of investment in off-shore funds (60% of Czech investments, 82% of Finnish). The limited number of pensionkassen in Germany which invest in hedge funds divide their exposure 50/50 between on and off-shore funds.

2. How are pension funds' investments in hedge funds controlled?

A). Quantitative Restrictions

24. The only countries which have direct quantitative limits on pension fund investment in hedge funds are Spain (under the new 2007 pension legislation), Greece and Portugal - all at 5% (rising to 10% in Portugal for closed funds and open funds with collective membership). The Czech Republic has the same limit for alternative investments in general, with the added proviso that they must be managed with care.

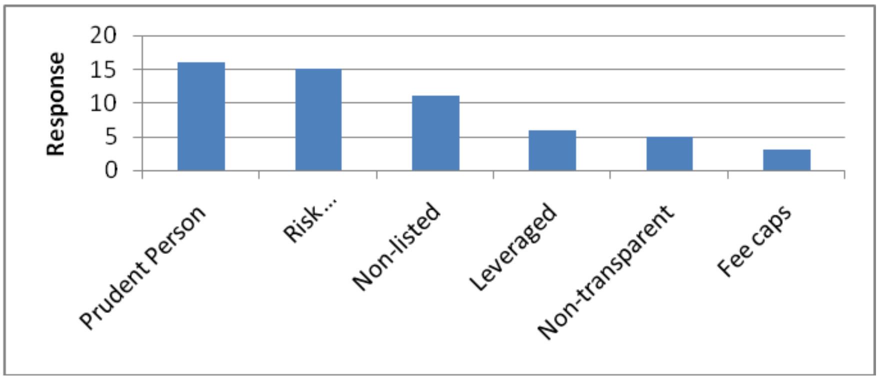
9 For example, according to OECD Global Pension Statistics, 2% of pension fund assets in the Netherlands amounts to US$15bn.

25. Some respondents indicated other quantitative limits which apply to hedge fund investments. Unlisted securities are limited in Ireland, Estonia (10%), and Austria (30%). Limits on collective investment schemes apply in Turkey (10% in total, 2% per fund), Poland (10%), Estonia (closed end funds limited to 50% of voluntary funds, 30% of mandatory) and Italy (20% of a pension fund's Net Asset Value, 25% of closed-end fund's Net Asset Value). General diversification limits were specifically noted as applying in Israel (10% in one company) and Luxembourg. Germany imposes a limit of 5% for pensionskassen and 10% for pension funds on investment in restricted assets.

26. General limitations on asset classes were noted in Denmark and Finland. However, it could be questioned as to how applicable such asset class restrictions are, given the investments and strategies of hedge funds are often non-transparent and indeed can change rapidly. The Danish and Finnish categorization is according to risk levels, in the Danish case these investments always being treated as 'maximum-risk' investments, with a similar approach adopted in Austria.

B). Qualitative Restrictions

Figure 1: Qualitative Restrictions



27. Qualitative restrictions on pension fund investment in hedge funds applied in some form in all responding countries except Mexico, Poland and Turkey.

28. The most usual application (16 responses) was via the 'Prudent Person Rule', followed by general risk management qualifications (15 responses). 11 countries mentioned restrictions on non-listed investments, 6 responses were found for leveraged instruments, 5 for non-transparent. Only 3 countries (Israel, Spain and German pensionskassen) restrict hedge fund investment via caps on fees or costs.

29. Other qualitative limitations mentioned were via the 'traffic light', solvency requirements in Denmark and the solvency requirements in the Netherlands. Israel also only allows investments in investment funds, including hedge funds, incorporated as a partnership where there is a detailed agreement in respect of the pension fund's rights (including the unconditional right to sell the pension fund's share). Short selling by pension funds is prohibited in Estonia, as it is in Italy, along with lending and borrowing. Italian pension funds are also limited to a maximum of 1x leverage.

30. By country, Israel imposed the most restrictions (covering 6 categories) with most countries restrictions falling into 3 of the above categories.

C). Guidance

31. Given the particular challenges pension funds face in relation to their investment in hedge funds, some regulatory authorities have provided guidance, over and above these general qualitative restrictions,

as to how these investments should be managed. For example, how does the prudent person rule apply to hedge fund investments?

32. The Swiss authorities (Federal Social Insurance Office -FSIO) provide guidance on investing in derivative instruments which may also apply to hedge fund investments[10]. In Luxembourg, the CSSF informs pension funds that investment in hedge funds must be kept to very prudent limits and must only take place where the risk management structure of the pension fund is appropriate. Germany also produced a specific circulator in 2004 which specifies the management selection process, reporting and clarification rules for an investment in hedge funds[11].

33. Likewise, APRA in Australia provides general guidance to trustees on issues to consider prior to making hedge fund investments, stressing the need for trustees to understand the risk of these investments in advance. APRA have drafted the following list of questions for trustees to ask in relation to hedge funds[12] - with the investment likely to be considered poorly informed or inappropriate if they cannot be answered.

- *Is the hedge fund a regulated entity? What are the disclosure requirements of the fund and what legal jurisdiction is the fund subject to, and is that legislative environment comparable to the Australian system?*
- *Has the trustee developed confidence in the adequacy and robustness of the fund's resources and risk management systems?*
- *Has the trustee assessed, and formed confidence in, the integrity of key service providers of the fund such as the prime broker, dealers, auditors, legal advisors and external administration?*
- *What is the level of due diligence performed on the underlying fund manager, especially where the investment is via a fund of hedge funds structure? Has external professional advice been taken?*
- *What is the level and frequency of reporting received by the trustee from the fund? For example, if the fund is an equity long/short strategy, are short and long positions disclosed to the investor? Are the number and value of positions disclosed? Is the level of gearing reported? Will the extent of reporting from the fund enable the trustee to manage and monitor the level of risk inherent in the fund's portfolio?*
- *What disclosure statements are trustees receiving from hedge funds with respect to the use of derivatives? Is the derivative charge ratio disclosed? Does the use of derivatives adhere to APRA Circular II.D.7?*
- *How are hedge funds classified in the fund's investment strategy in terms of asset classes? That is, does an investment in a hedge fund represent a component of equities or is it classified into a separate asset class?*

---

[10] See http://www.bsv.admin.ch/themen/vorsorge/00039/index.html?lang=deFachempfehlung_zum_Einsatz_und_zur Darstellung der derivaten Finanzinstrumente (Art. 56a BVV 2)

[11] See http://www.bafin.de/rundschreiben/90_2004/040820_en.htm

[12] http://www.apra.gov.au/Media-Releases/03_25.cfm

- *Is there a lock-up period for the investment in the hedge fund? Can the investment be redeemed within an acceptable period of time? What is the regularity of the fund striking a unit price?*

- *What benchmarks do trustees utilise to measure the risk weighted performance of a hedge fund? Are performance fees set at realistic levels?*

- *Is the trustee confident that the hedge fund will not impair the ability of the trustee to comply with reporting obligations to Australian regulatory bodies, including APRA?*

34. Though not respondents to the WPPP questionnaire, the US Department of the Treasury published *'Principles and Guidelines* regarding *Private Pools of Capital'* in February 2007[13]. As well as general advice to investors in such assets, the following specific guidelines are provided for fiduciaries of funds (such as pension funds) through which less sophisticated investors are exposed.

- *Fiduciaries should consider the suitability of investment in a private pool within the context of the overall portfolio and in light of the investment objectives and risk tolerances. Fiduciary evaluation should include the investment objectives, strategies, risks, fees,liquidity, performance history, and other relevant characteristics of a private pool.*

- *Fiduciaries should evaluate the pool's manager and personnel, including background, experience, and discipline history. Fiduciaries also should assess the pool's service providers and evaluate their independence from the pool's managers. Fiduciaries should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.*

- *Fiduciaries should conduct the appropirate due diligence regarding valuations methodology and performance calculation processes and business and operational risk management systems employed by a private pool, including the extent of independent audit evaluation of such processes and systems.*

- *Fiduciaries that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification.*

35. The Dutch Central Bank, as well as providing guidance on the prudent person rule (based on article 18 of Directive 2003/41/EC, article 135 of the Dutch Pension Act), has also drafted the following 'High level principles for assessing the risk management for alternative investments'[14:15]

- *The assessment of alternative investments should take appropriate account of the specific risk and return characteristics of these investments.*

- *Investing in alternative forms fits in with the institution's overall strategy, due account being taken of the institution's total risk profile, including the relation between alternative investments*

---

[13] http://www.treasury.gov/press/releases/hp272.htm

[14] http://www.dnb.nl/dnb/home/file/High%20level%20principles%20alternative%20investments%20-%20website_tcm47-145129.pdf

[15] http://www.dnb.nl/dnb/home/file/High%20level%20principles%20alternative%20investments%20-%20website_tcm47-145129.pdf

on the one hand and the total investment portfolio and the nature and extent of the liabilities on the other hand.

- *Institutions check at regular intervals that the diversification across investment strategies is adequate and avoid undesirable concentrations in the portfolio.*

- *The institution analyses at regular intervals the risk profiles of the investment strategies and the capacities of the managers of the funds in which the institution has invested or intends to invest. The analysis is based on timely and sufficient information about the funds and their managers, so that an independent assessment can be made.*

- *The reports provided by (funds of) funds use proper valuation principles, are submitted in time, and have sufficient quality assurance. The institutions hold sufficient information about the underlying funds.*

- *An assessment of funds of funds also includes a judgement of the quality of risk management conducted by the fund of funds manager and the standards and criteria of conduct observed.*

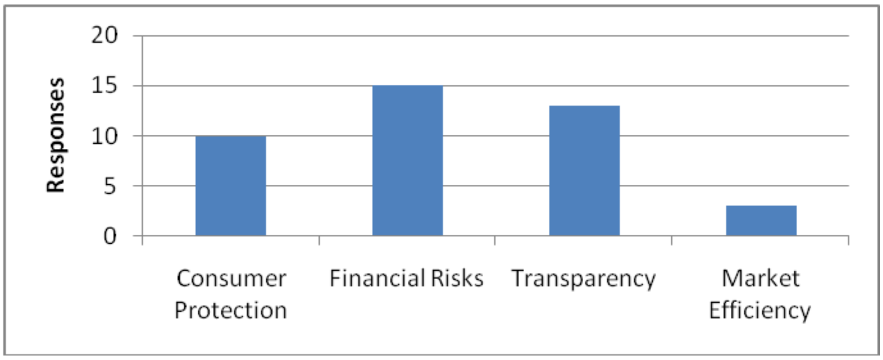
- *Alternative investments cannot do without adequate contract terms. Broadly speaking, these provide for an unambiguous limitation of risks, the measures to be taken in case of thresholds being crossed, adequate disclosure, a clear description of lock-up periods, and explicit cancelation and termination conditions. Compliance with contract terms is monitored systematically.*

- *No institution can adequately manage its reputation risk without being clear and plain in its communications with stakeholders about the reasons for its policy regarding alternative investments and the objectives which it seeks to achieve in this respect.*

36. The DNB also notes that hedge fund investments are regarded as the second most risky investment class and that a pension fund's solvency requirements under the Bank's prudential approach to supervision are calculated accordingly. Only if hedge fund investments are sufficiently transparent may the solvency requirements be based on the underlying investments of the hedge fund (i.e. look through principle). In addition to these 'restrictions' regarding the investment portfolio, there are qualitative (principles based) requirements regarding the management of risks that are associated with outsourcing – i.e. outsourcing (of hedge fund investments) is not allowed if it undermines a sound operational management of the pension fund. The DNB is investigating how these regulations can be further geared to the supervisory daily practices concerning hedge funds investments.

3. What are the major policy concerns and responses surrounding pension funds' investment in hedge funds?

Figure 2: Policy Concerns



37. Though the level of pension funds' exposure to hedge funds is still low, most respondents to the questionnaire did note policy concerns surrounding these investments. These mostly centred on financial risks and transparency issues, and to a less extent consumer protection and market efficiency.

38. In terms of the action which policy makers are taking, most of these focus around financial controls and transparency requirements.

39. Direct financial policy responses relating to hedge funds come in the form of changing investment regulation and quantitative restrictions. These include altering investment restrictions to better reflect changing market conditions (as will be the case in Switzerland by the end of 2007). The Czech Republic has introduced a limit of 5% on risky investments and restrictions will be raised to 10% for some funds in Portugal. Meanwhile, Colombia is moving in the other direction, deregulating investment to allow pension funds to invest in new asset classes. Other financial policy responses apply to pension fund investments more generally, including hedge funds. Such responses were mentioned (though details were not necessarily provided) by Belgium, Israel and Spain, with the UK and Ireland noting that for European countries such requirements fall within the context of the European Union's IOPRS Directive (2003/41 EC). Regulatory authorities which employ risk-based solvency requirements (i.e. Australia, Denmark and the Netherlands), have directed financial policy responses within these frameworks (i.e. risky assets such as hedge funds entail more capital requirements). Finland also requires the amount of solvency capital of the pension fund to be compatible with the risk of portfolio investments in hedge funds.

40. In terms of transparency related policies, again these apply to pension fund investments more generally as well as to hedge fund instruments. Australia and Denmark have targeted consumer product disclosure, with detailed investment policy requirements for pension funds laid down in Austria (included in the table below). Policies dealing with pension fund investment in hedge funds via transparency requirements have also been (or are being) adopted in Belgium, Italy, and Mexico (and in Denmark, Israel and Finland though details were not provided).

41. Suggestions for future policy action and requests for further work by the WPPP focus on two main issues: how to increase the transparency of hedge fund investments and how to measure risks accurately?

Table 2: Policy Action

Country	Details of Policy Action
	Direct Financial Policy Action Relating to Hedge Funds
Colombia	Investment Limits are broader and it has been allowed to make other types of investment.
Czech Republic	According to the amendments of the Act No. 42/1994 Coll., State-Contributory Supplementary Pension Insurance Act, in 2004 it was stated that at most 5% of a pension fund's assets may be placed into more risky instruments including hedge funds. Financial means accumulated by a pension fund must be placed with due care and attention in such a way as guarantees the safety, quality, liquidity and profitability of the composition of the financial portfolio as a whole.
Germany	The planned liberalization of 5% restricted assets to 10% could have an impact on the volume invested by insurance companies in hedge funds.
Portugal	Quantitative limit will be raised to 10% for closed pension funds and open funds with collective membership.
Switzerland	It is foreseen that the Swiss Government will adapt the regulation on investment restrictions (including hedge funds) to the development of the financial markets in the past years. A group of experts should present a report on this issue by the end of 2007.
	Indirect Financial Policy Action Relating to Hedge Funds
Australia	A strong risk management assessment and control regime adminstered via the APRA licensing requirements.
Denmark	Risk adjusted capital requirements (traffic light system) + Internal Capital adequacy
Netherlands	Implementation of (risk based) Financial Assessment Framework.
Finland	The amount of solvency capital of the pension fund should be compatible with the risk of portfolio investments in hedge funds. The professional skill of the management and personnel in investment activities of the pension fund is the most essential requirement.
Ireland	Implementation of investment aspects of EU IOPRS Directive
UK	Transposition of EU Directive 2003/41 EC on the activities and supervision of institutions for occupational retirement provision.
	Indirect Transparency Policy Action Relating to Hedge Funds

Country	Details of Policy Action
Australia	Strict product disclosure regime regulated by ASIC.
Austria	First, increased responsibility of the investor, who has to act as a prudent person. Second, investment in funds have to be split up according to their components, which provides a high degree of transparency. Third, Pensionskassen have to declare their investment policy principles. Section 25a. (1) The Pensionskasse shall draw up a written declaration on the investment policy principles for every investment and risk sharing group. At any rate, said declaration shall include: 1. the procedures for assessing the investment risk; 2. the risk management; 3. the strategies with regard to the selection of assets as well as in relation to the mix and diversification of assets depending on kind and length of the liabilities undertaken; 4. the admissibility and the strategies of investments in derivative products; 5. the admissibility and the strategies of investments in assets which are not admitted to trading on a regulated market and/or are traded on venture capital markets; as well as 6. the potential selection of assets according to ethical, ecological and/or social criteria. (2) The declaration on the investment policy principles shall be immediately updated following a significant change in the investment policy, however, it shall be revised at least every three years. (3) The FMA shall be immediately notified of the declaration on the investment policy principles as well as of any changes to it. (4) The declaration on the investment policy principles for the respective investment and risk sharing group shall be immediately submitted to the employers paying contributions, the beneficiaries and the competent works councils at their request.
Belgium	Concerning consumer protection, financial risks and transparency, the prudent person principle, which is the cornerstone of the investment rules stated in the Law, implies that pension funds have a good view on all their investments in order to be able to make a thorough evaluation of the risks (and the returns) associated with their investments. Therefore, it is essential that they have a clear view on the investments made by the hedge funds they invest in.
Italy	Recently, the pension fund sector has been reformed again following the Law no. 243 of 2004 and its implementation

Country	Details of Policy Action
	according to the Legislative Decree no. 252 of 2005. Amongst other aspects, this reform provided for a levelling of the playing field among all different pension schemes, with specific attention to transparency, cost-comparability and the increase of information as a support to individual members' decisions. In this context, the exposure of pension funds to hedge funds will be monitored by COVIP, the supervisory authority, as a potential risk factor.
Mexico	A mandatory registration of funded occupational plans has recently been created. A summary of the statistics is published on CONSAR's website.

IV. Conclusions

42. This survey clearly highlights that pension fund regulators have limited information regarding how pension funds in their jurisdiction are investing in hedge funds. However, some regulators have been able to gather such information from surveys (for example of the largest pension funds under their supervision), suggesting that other regulators could also gather such information, which would help the understanding of this trend on both a national and international level.

43. Most regulators do have a range of methods through which to control pension funds' investments in hedge funds – ranging from strict quantitative limits to the prudent person rule. However, as these can be particularly complex instruments for pension fund fiduciaries to understand, regulatory authorities may wish to provide further guidance on how qualitative investment rules should be interpreted in relation to hedge fund investment.

44. Finally, regulators remained concerned that as pension funds exposure to hedge funds rises (as is expected) further policy responses will be required. These are likely to focus mostly on transparency and risk management requirements. Regulators may therefore wish to encourage greater transparency on the part of hedge funds themselves in order to help pension fund investors assess and manage risks appropriately. Further work to improve risk management systems should also be encouraged.