

# Pension Funds Foreign Investment – How to handle the risks?

Solange Berstein

Superintendent of Pensions, Chile

Chair of IOPS Technical Committee

Seminar: Regulatory and Supervisory Challenges for Iceland  
Pension Industry

Reykjavik, Iceland

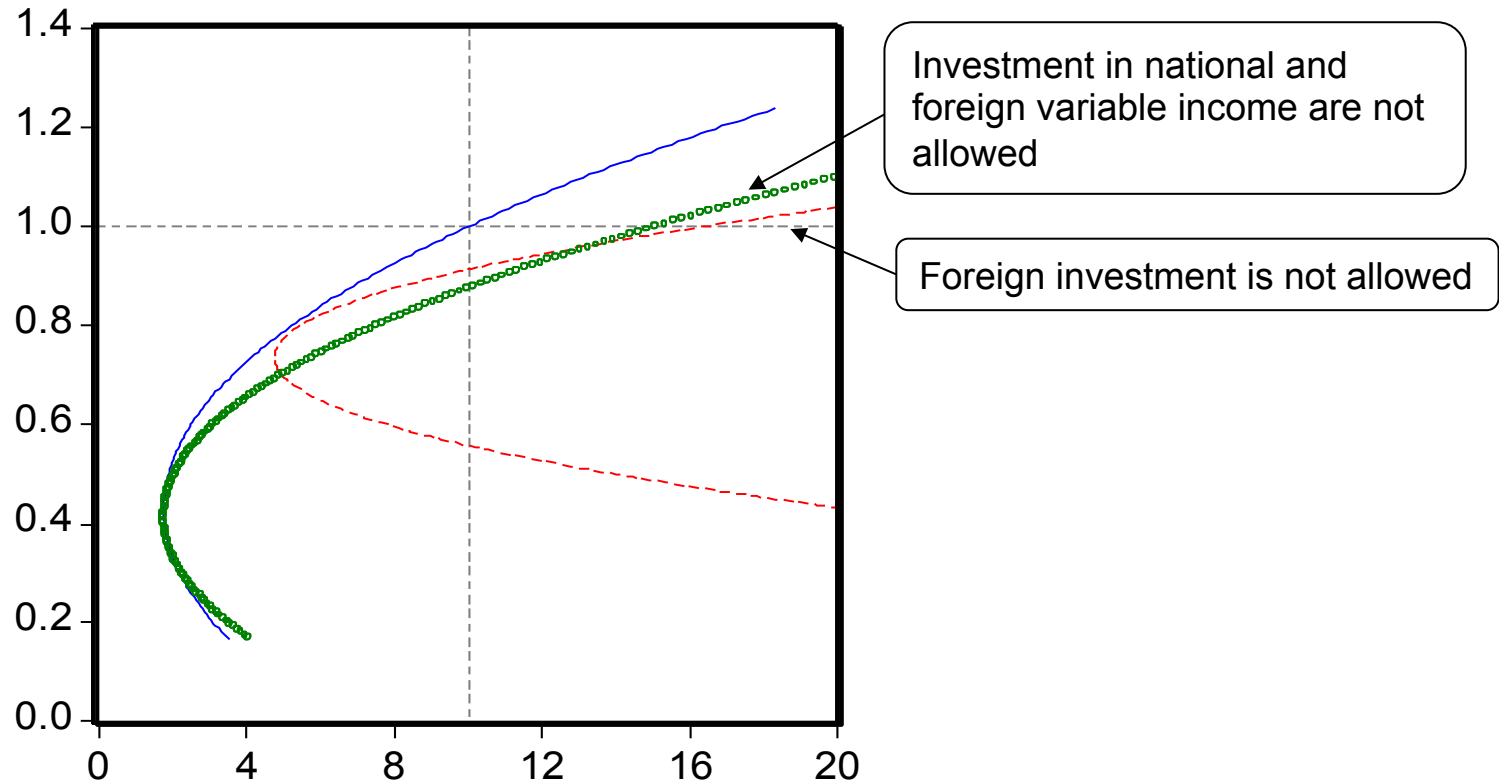
February 28, 2014

# Agenda



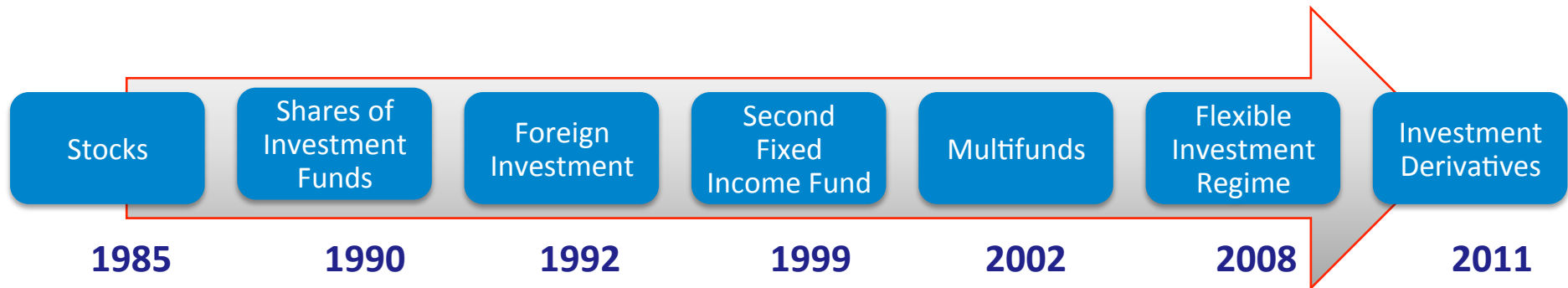
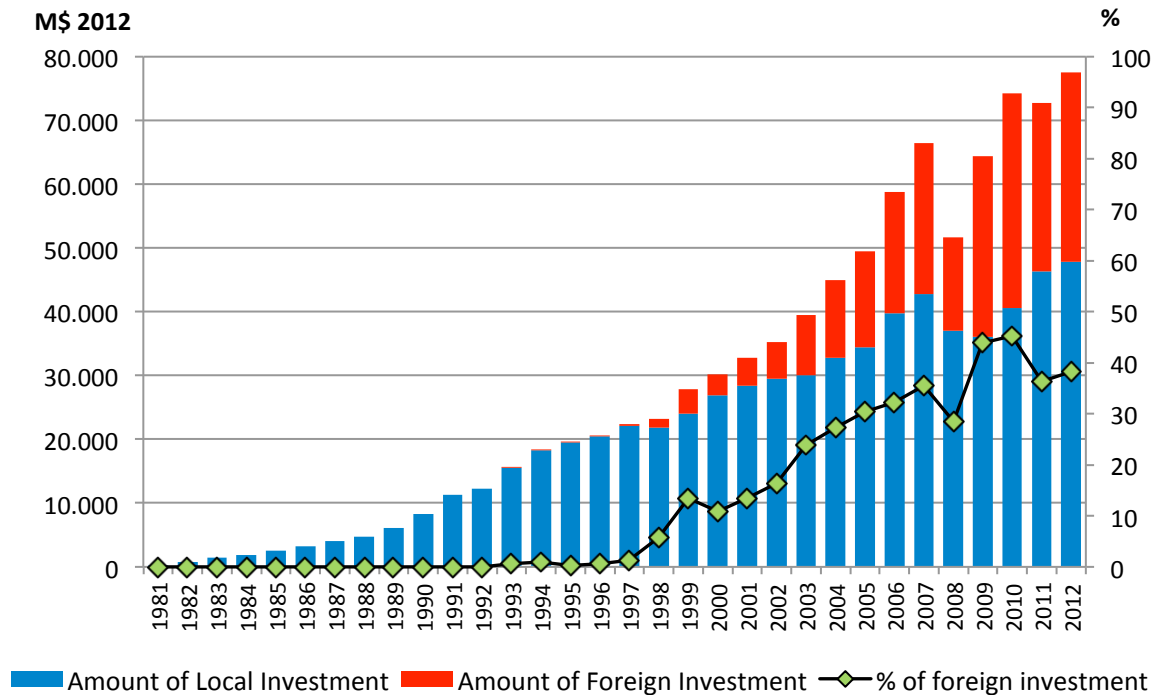
- Impact of restrictions on pension fund performance
- Pension fund growth and investment regulation in Chile
- Risk control
- Investment regulation challenges
- Conclusions

# Impact of Restrictions on Efficiency of Investment



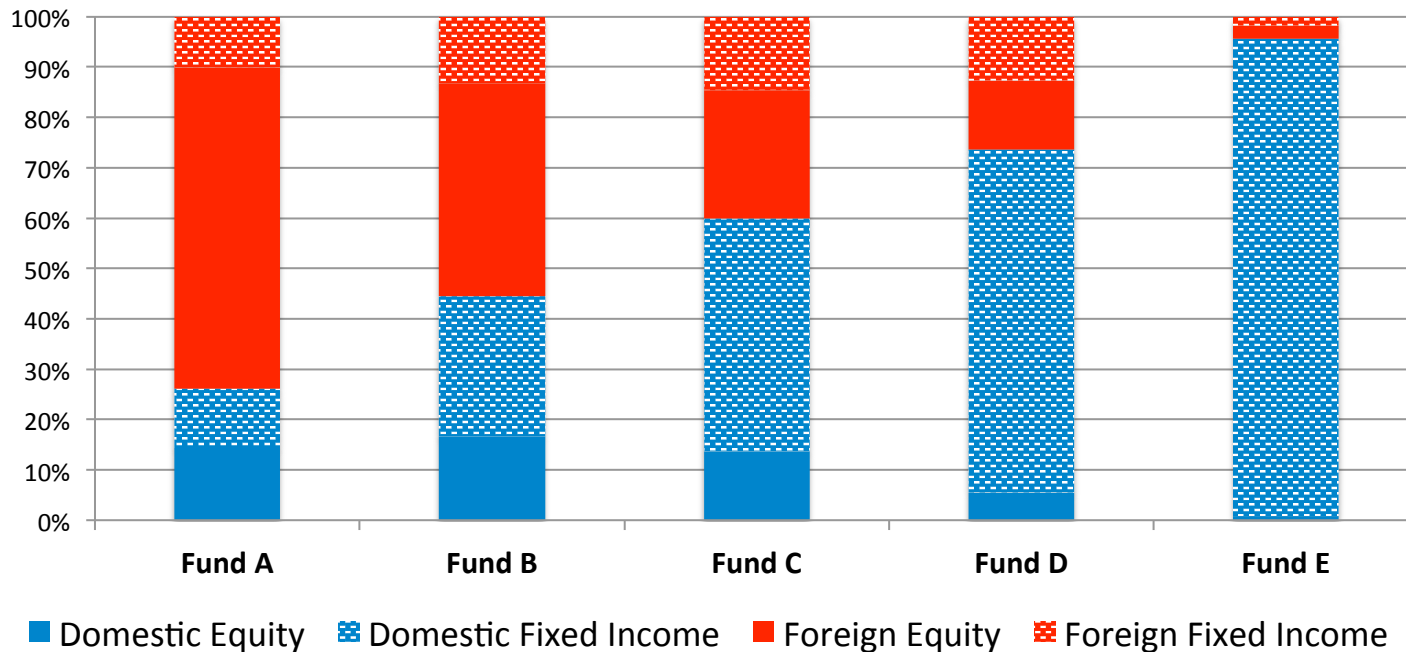
Berstein and Chumacero, Journal of Fiscal Studies (2006) shows that investment limits produce efficiency costs

# Pension Fund Growth and Investment Regulation in Chile



# Diversification of Pension Fund Investment

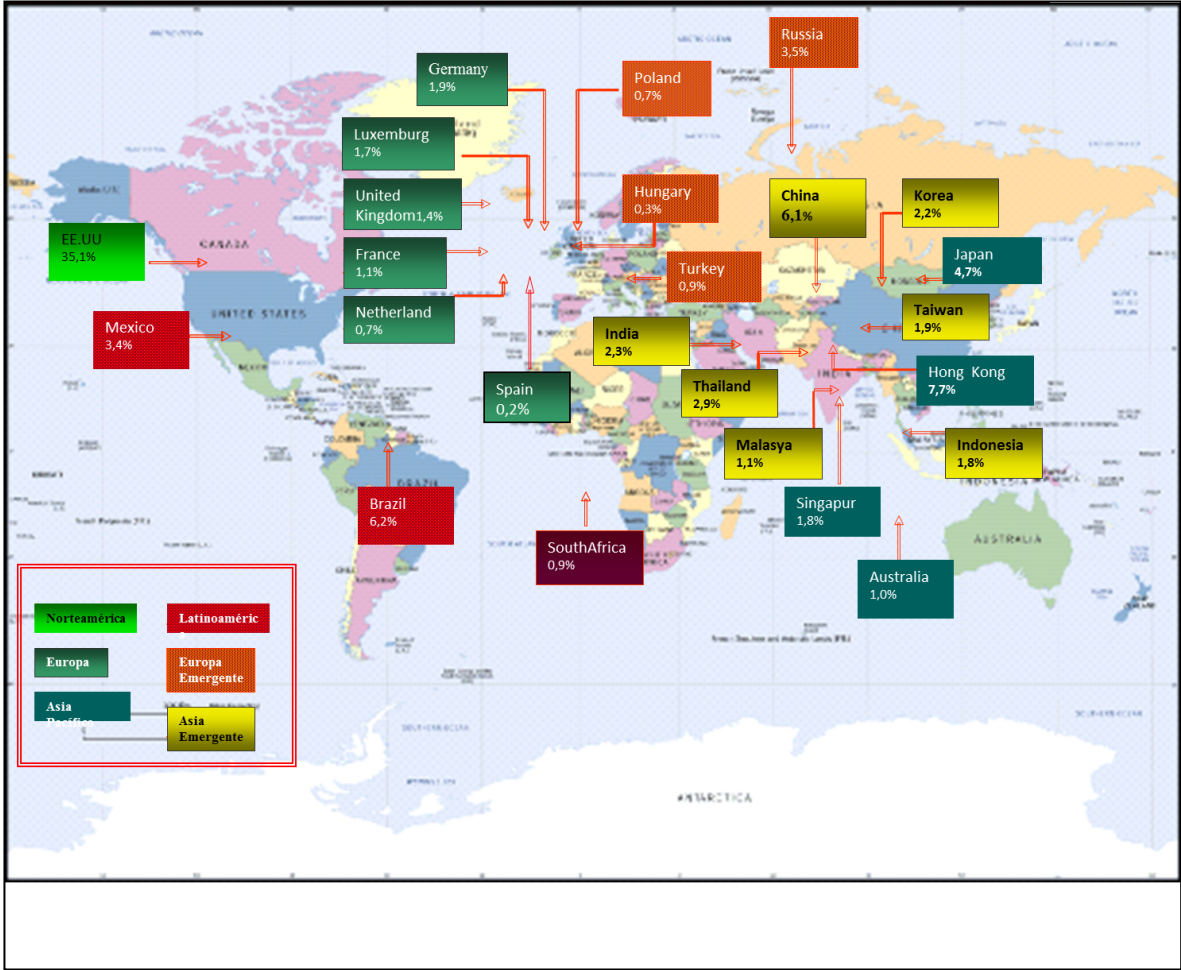
## Aggregate Portfolio of the Pension Funds (Dec 2013)



- National equity is mainly composed by shares (82%), with a lower participation of investment funds and others.
- National fixed income includes mainly instruments of financial intermediation (14%), treasury bonds (47%), bank bonds (22%) and corporative fixed income (17%).

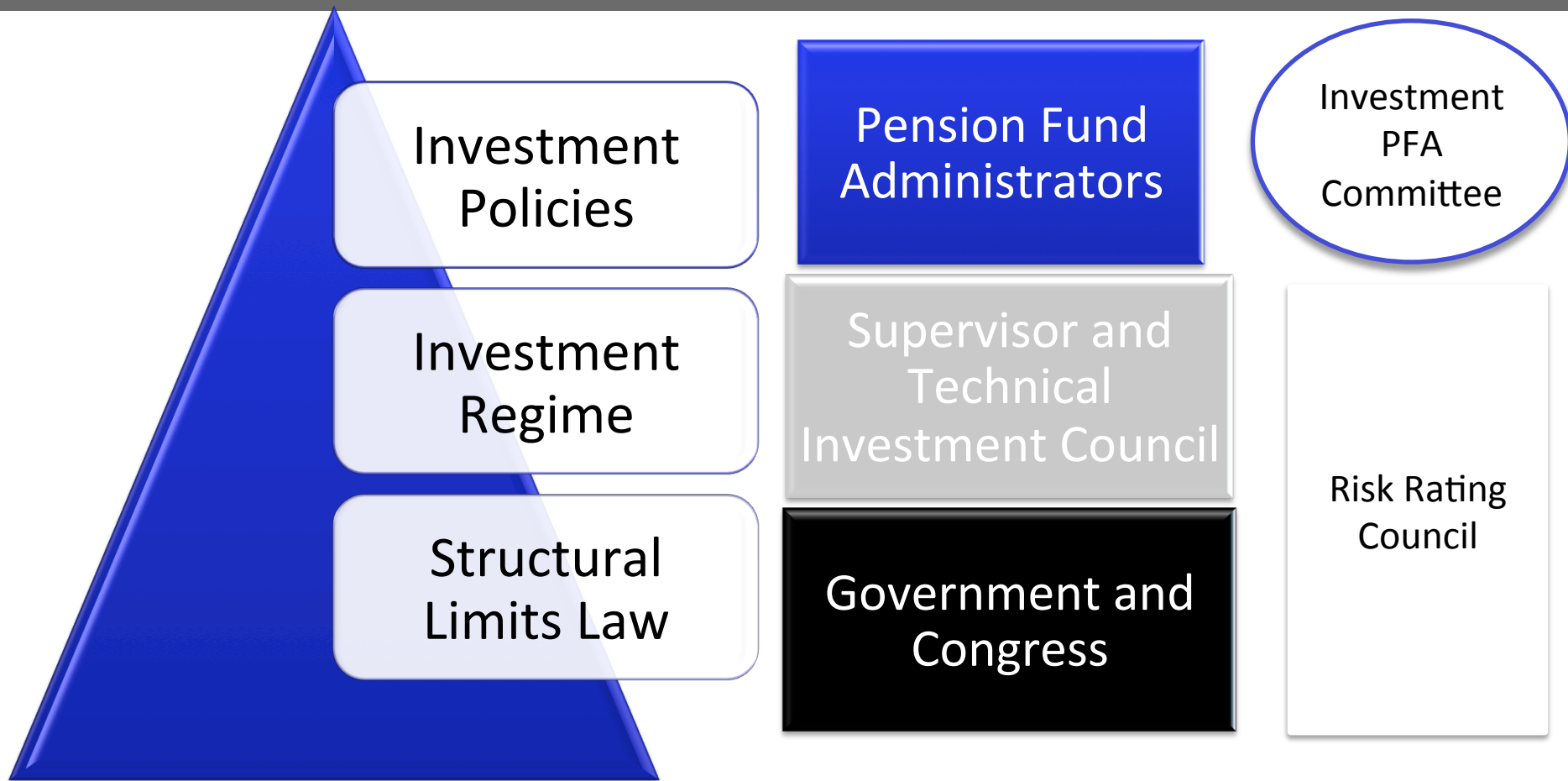
# Diversification of Foreign Investment

## Foreign Investment MMUS\$ 69,054 (December 2013)



- Structure of Investment Regulation
- Financial instruments and adequate vehicles to use
- Foreign currency risk management

# Investment Regulation: Chilean case





# Financial Instruments and Vehicles

“The Administrators must do everything necessary in order to obtain adequate returns and security in the investment of administrated funds...” (Article 147, subsection first and second)

Return

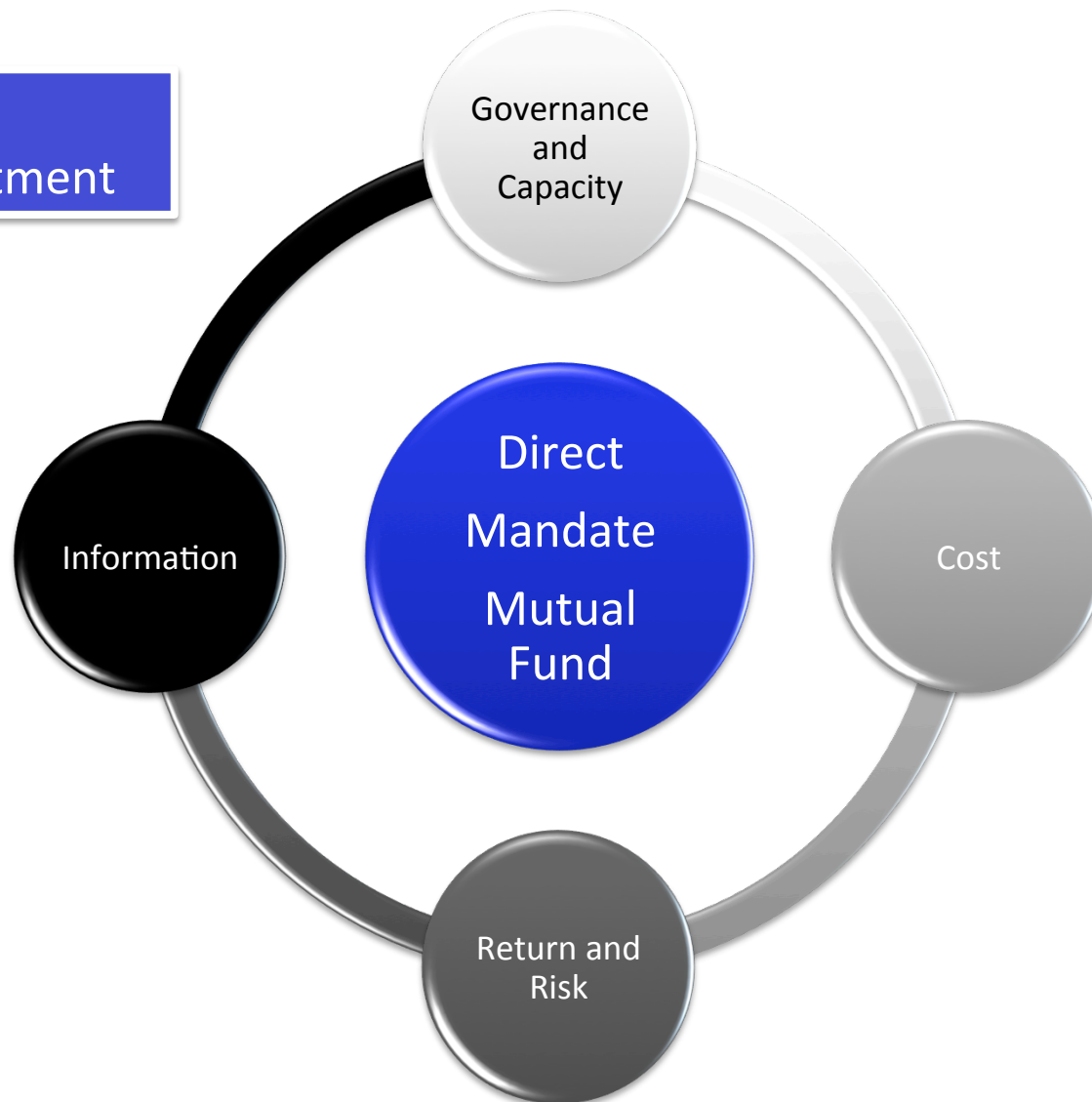
Risk

Cost

Indirect or Direct Investment

# Financial Instruments and Vehicles

Indirect  
Foreign investment



- Variations in the exchange rate may impact returns and volatility of pension funds
- Currency hedging strategies help mitigate the risk of pension funds
- Hedging should consider:
  - Protect the value of the funds in the relevant currency for the payment of pensions (*pesos*).
  - Be flexible enough to allow PFAs to manage risk according to the scenario they face.
  - Capture the differences in the nature of the types of foreign instruments or investment vehicles.

# Currency Hedging



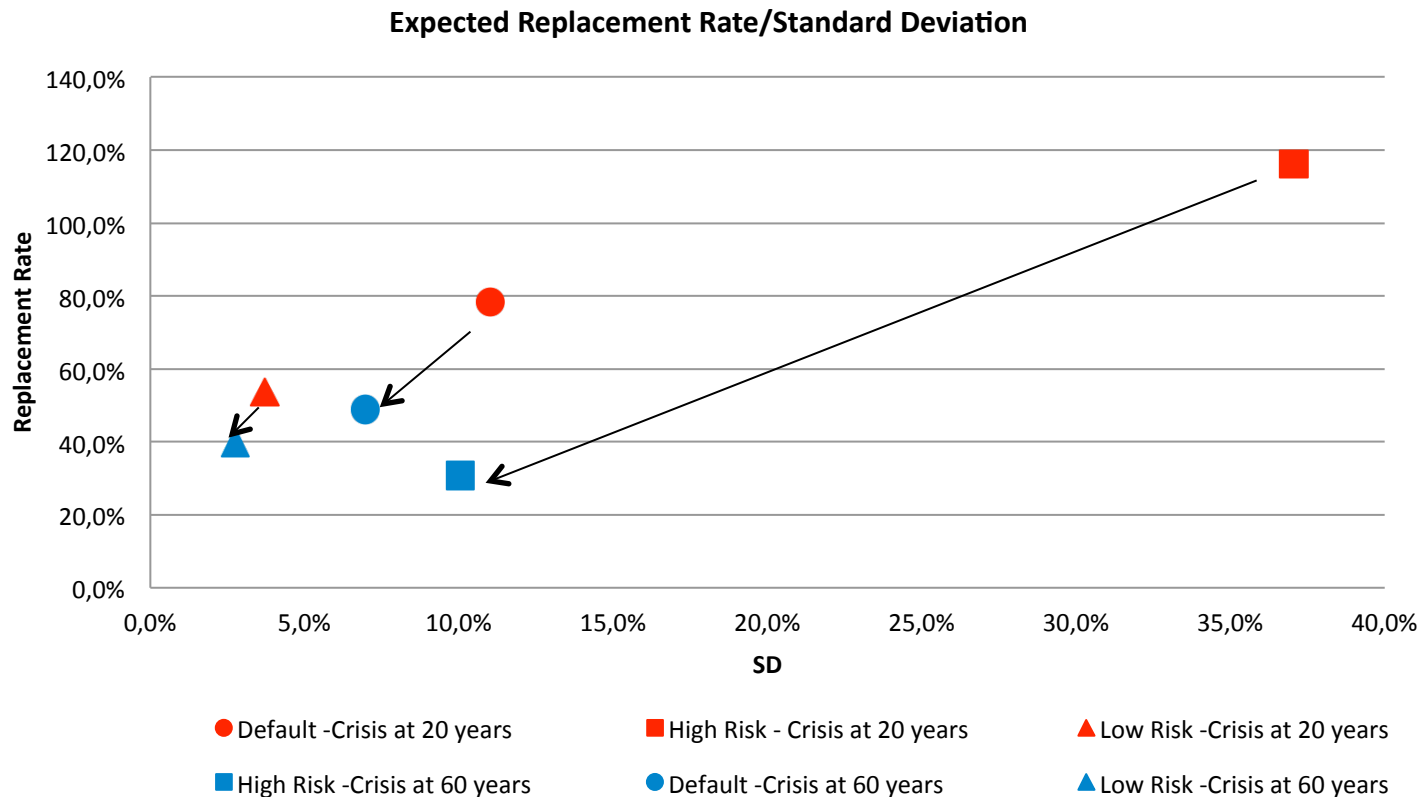
<b>Type of instrument</b>	<b>Minimum Coverage</b>	<b>Maximum Coverage</b>
Foreign Fixed Income with Investment grade	50%	100%
Foreign Fixed Income with low Investment grade	0%	70%
Foreign equity	0%	50%

# Investment Regulation: Challenges



- Assess the adequacy of the current derivatives limits framework for investment derivatives
- Assess the regulation related to “alternative assets”, mainly private equity.
- Assess risk rating restrictions for foreign investment
- Elaborate mechanism to allow reevaluation of the investment regime when there are changes in the behavior of instruments and their correlations with the Chilean peso.
- Define the convenience of discrimination with respect to the currency of the investment (between strong and weak currencies, for instance)

# Investment Regulation: Challenges



Source: Berstein, Fuentes and Villatoro, Journal of Pension and Finance (2013)

¿How much risk can the individual assume?

Financial advisory role

Investment regulation: goal of final pension level and risk: Reference portfolio

# Conclusions



- The regulatory framework of national and foreign investments must guarantee that PFAs have incentives to seek instruments or financial vehicles with a good mix of cost, risk and return
- The important trade-off between regulation and efficiency of investments should be balanced taking into account the objectives of the invested funds (in this case, the final value of the pension) associated with a tolerable level of risk.
- In this sense, the more alternatives of investment that emerge allowing foreign investment increase the chances of achieving these objectives, but impose new challenges in terms of regulation and supervision

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