

Regulation and Supervision of Pension Funds

Richard Hinz

March 10, 2014

Distinction Between Regulation & Supervision

- Regulation:
 - Legal Foundations and System of Rules and Regulations Governing the Structure and Operation of Pension Funds
 - Establish form of system and “empower” various parties to perform functions or protect interests
- Supervision:
 - Oversight and Enforcement of Compliance With The Rules
 - Collection of information and monitoring of system to support review and analysis

Why Pension Funds are Different Than Other Savings?

- Vulnerability To Old Age Poverty Leads to Less Risk Tolerance
- Potentially a High Proportion of Average Members Wealth
- Less Sophisticated Clientele – More Likely Low Income and Less Educated if Sytem is Mandatory
- Limited Choice By Consumer Due to Mandates and Constrained Products

Attributes of Private Pensions

- Specialized Financial Intermediary
 - Long Time Horizon
 - Low Liquidity Needs
 - Heterogeneous Risk Tolerance
- Often Multiple Levels of Intermediation When Employers or Worker Associations are Involved
- Use of Commercial Service Providers Creates Complex Incentive Problems
- Possible High Fiscal Exposure Through Tax Treatment and Guarantees

Theoretical Basis for The Need for Regulation and Supervision

- Address Market Imperfections and Failures
- Compensate for Asymmetric Information
- Control Potential Moral Hazard
- Overcome Consumer Myopia
- Stimulate Competition and Efficiency

Types of Risks to Be Addressed

- Systemic – Vulnerability to Macro Conditions
- Portfolio – Quality of Investments
- Agency – Incentives of Individuals and Institutions
- Principal – Member's Knowledge and Experience

Main Aspects of Regulation Common to All Systems

- I. Rules Defining the Structure and Organization of Funds
- II. Requirements for the Operation of Funds
- III. Authority for Supervision, Sanctions & Remedial Action

I. Structure of Pension Funds

- Licensing of Fund Operators
- Governance of Funds
- Capital and Reserves
- Segregation of Assets
- Custody of Assets

II. Operation of Pension Funds

- Investment Guidelines
- External Audit Requirement
- Reporting and Disclosure
- Limits on Fees and Expenses
- Guarantees

III. Supervision, Sanctions and Remedial Action

- Government Agency with Oversight and Regulatory Authority
- Legal Venue and Guidelines for Application of Sanctions – Punitive and Remedial
- Rights of Members and Venue for Resolution of Disputes

Some Dimensions of Variation

Defined Benefit



Defined Contribution

Employer Sponsored



Personal Account

Trust Funded



Financial Institution

Single Employer



Multi-Employer

Constrained Choice



Individual Choice

Two Stylized Models

Many Systems Incorporate Elements of Both

- **Latin American/Central European** -
Mandatory Personal Accounts
 - Special Purpose Investment Companies
 - Primary Intermediation
 - Open Funds
- **Anglo American** -
Voluntary Employment Based DB and DC
 - Employer Managed Trusts
 - Secondary Intermediation
 - Closed funds

Latin American/ Central European

- **Structure**
 - Pension Funds Are Profit Making Commercial Entities
 - Stockholders and Officers Establish Authority
- **Rules for Operations**
 - Directive Outcome Oriented Rules
 - Define Specific Limits and Practices
- **Supervision**
 - Directive and Proactive
 - Daily Reporting, Pre-emptive Authority

Anglo-American

- **Structure**
 - Trust based, Not-for Profit Entities
 - Governance on Behalf of Members,
 - Agents Rather Than Principals
- **Rules for Operations**
 - Process Based – Prudent Man Rules, Control of Transactions
 - Agency/Relationship Oriented - Conflict of Interest Prohibitions
- **Supervision**
 - Exception Basis , Re-active
 - Remedial and Punitive

Regulatory Structure of Latin American Systems

- Specific Entry Requirements w/ Capital and Reserve Requirements
- Small Number of Entities Permitted
- Quantitative Investment Standards
- Extensive Interaction and Monitoring
- Preventive Sanctions

Rationale for Latin American/Central European Approach

- Low Risk Tolerance of Worker
 - Mandatory Pension Major Source of Security
 - Less Sophisticated, Experienced Population
- More Volatile Environment
 - Higher Exposure to Macro Instability
 - Less Developed Primary Financial Regulation
- Lower Opportunity Costs
 - Less Diverse Financial Products
 - Less Competitive Markets
- Higher Fiscal Exposure Through Politically Necessary Guarantees

Regulatory Structure Of Anglo-American Systems

- Minimal or No Entry Requirements - Registration
- Large Number of Funds
- “Prudent Expert” Investment Standards
- Reliance on Disclosure to members
- High Reliance on Other Financial Services and Regulation of Professions
- Exception Based Interventions
- Remedial/Corrective Sanctions

Rationale For Anglo-American Approach

- Higher Risk Tolerance
 - Primarily Voluntary Occupational Funds
 - Supplement Universal Public Pension Programs – More concentration in higher income groups
- Highly Developed Primary Financial Services Regulation
- Extensive System of Civil Law and Liability – Private Rights of Action
- Potential High Opportunity Losses from Restrictive Regulation
- Typically Limited Public Guarantees

Comparison

- Security – Efficiency Tradeoffs
- Stage of Development – Movement To Convergence Over Long Run
- Practicality: Small vs Large Number of Funds
- Different Reliance on Market Forces and Competition

Notable Developments and Trends

- Licensing, Training and “Fit and Proper” Requirements for Trustees
- Introduction of Solvency Standards Linked to Market Derived Criteria – VAR and Asset Liability Matching Models
- Required risk management architecture, procedures or governance oversight groups
- Harmonization with other Financial Regulations

Trends (cont)

- Movement to Multiple Portfolios and Age Based Portfolio Choices
- Introduction of Automatic Enrollment and Default Portfolios
- Increased Limitation of Permissible Fees and Expenses
- Greater Reliance on Market Disclosure
- Minimum Annuitizations, Programmed Withdrawals and Phased Retirement

Supervision of Pensions

Basic Elements of Supervision

- **Control of Entry - Licensing**
 - Pension Companies
 - Fund Managers and Trustees
 - Custodians, Actuaries and other Service Providers
- **Monitoring**
 - Financial Reporting and Auditing
 - Actuarial Reviews
 - On-Site Reviews and Investigations
 - Receiving Complaints & “Whistleblowers”

Elements of Supervision (Cont)

- **Measurement**
 - Comparison to Normative Standards
 - Risk Scoring and Evaluation
- **Communication**
 - Disclosure
 - Outreach and Education
 - Training

Elements of Supervision (Cont)

- **Intervention**
 - Notification of Violations
 - Directive Actions
 - Negotiated Resolutions
- **Correction**
 - Punitive
 - Remedial
 - Compensatory

Determinants of Supervision

- Many different approaches to supervision have been implemented
- Will vary by intensity of oversight and pro-active vs re-active style of operation
- Differences arise from many factors. Some of the more important include:
 - Design of Pension System
 - Number of funds
 - Level of financial market development
 - Legal tradition and rule of law

Mandatory Systems Require More Intensive Supervision

- Less Sophisticated Members
- Greater Reliance on Pension for Subsistence
- Fewer Choices – Less Market Discipline
- Voluntary Systems Can Afford Fewer Costs and Require More Flexibility
 - Employer Will Not Enter System If Risks Are Perceived As High
 - Limits of Compensating Differentials – Cost of Monitoring and Intervention Will Not be Absorbed by Members

More Developed Economies and Large Number of Funds Reduces Intensity

- More Sources of Information with Greater Reliability Supports Reactive Approach
- Greater Diversity of Fund Design Limits Potential Intensity of Oversight
- More Flexible and Process Oriented Rules Not Conducive to Directive/Pro-Active Methods
- Greater Reliance on Communication and Competition Improves Efficiency
- Typically higher levels of “Financial Capability”

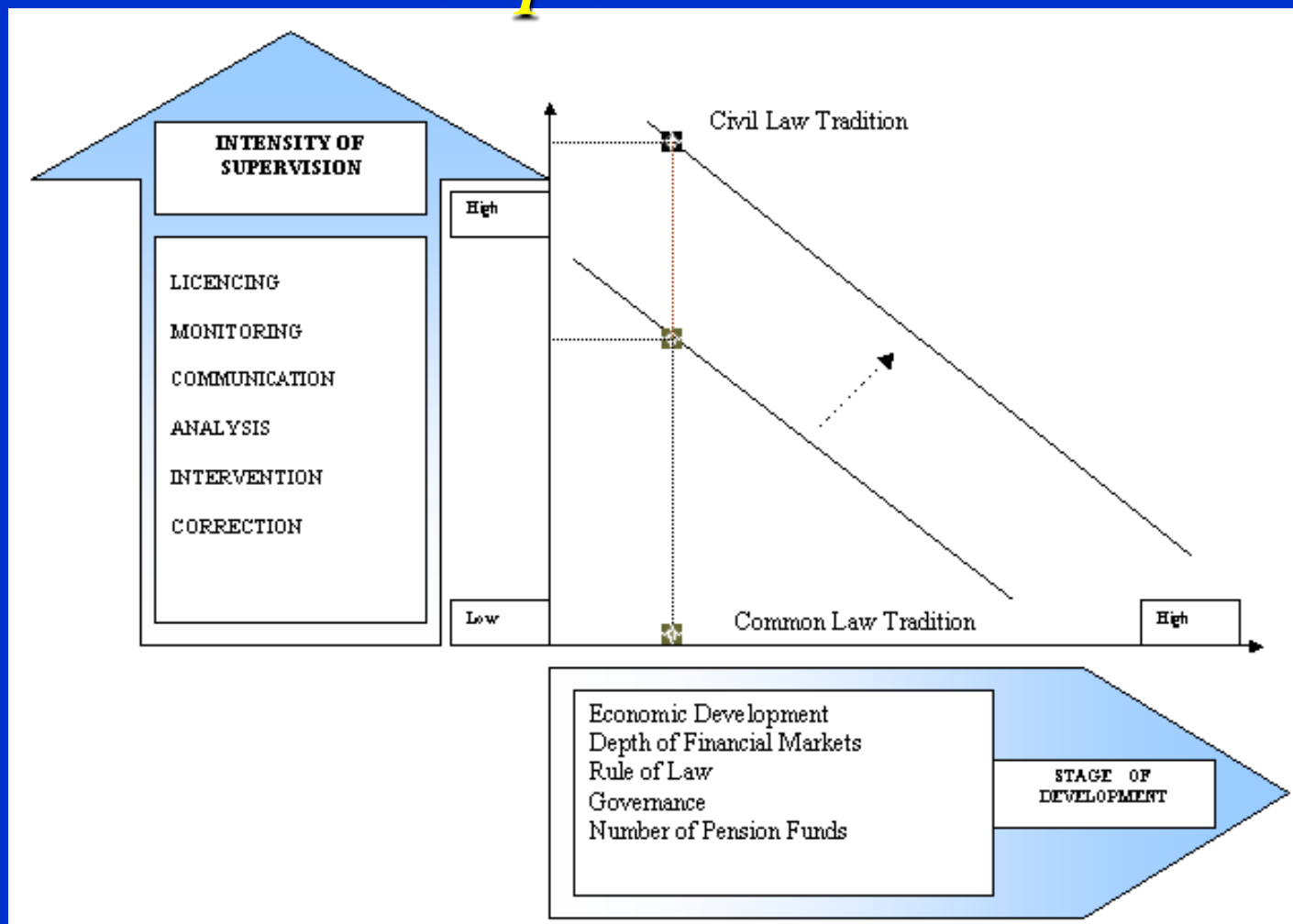
Financial Market Development Facilitates Less Intensive Oversight

- More Products Enhance Competition
- Institutional Development Creates Private Third Party Oversight
 - Financial Accounting Rules
 - Auditors
- Development and Supervision of Financial Professionals Limits Need for Specialized Pension Supervision
- Primary Market Regulation Supports Less Intensive Oversight

Enhanced “Rule of Law” Lowers Required Intensity of Supervision

- Greater Capacity for Individual Rights of Action Limits Need For Supervision
- Capacity to Achieve *ex post* Remedial Sanctions Diminishes Requirement for Pro-Active Methods
- Greater Reliance on Negotiated Process and Litigation

Some Basic Relationships For Supervision



General Observations on Supervision

- Effective Monitoring and Control are Essential – Wide Range of Feasible Approaches to Measurement and Interventions
- Some Common Elements and Consistent Patterns of Supervision in Relation to Design and Development
- Practices Are Significantly Derived From Matching Context With Methods

Risk Based Supervision

- Recent Innovation – Rapidly Advancing in a Range of Settings
- Strongly Influenced by Trends in Bank and Insurance Regulation and Development of Integrated Supervisory Authorities
- Early Adopters (WB Paper): Netherlands, Mexico, Australia, Denmark, Canada
- Others (IOPS Paper): UK, Germany, South Africa, Croatia, Kenya

Initial Assessment of Risk Based Methods

- **Offer Promise of :**
 - Efficiency Gains in Investment of Funds Assets
 - Lower Interventions and Supervisory Costs
 - Flexibility to address differing needs within same supervisory system
 - Alignment of Pension with other Financial Supervision – Integration of Authority
 - Political economy of relaxing restrictions
- **Challenges:**
 - Aligning risk standards with retirement income
 - Potential pro-cyclical nature of systems
 - Accommodating diversity of members risk preferences
 - Adequacy of solvency standards
 - Political economy of acceptable risk levels

Concluding Thoughts

- No Right or Wrong System - Like Good Architecture - Form Follows Function
- Objective and Tradeoffs Define Systems - Every Approach is Inevitably a Compromise
- Optimize Through Evaluating Objectives, Structure and Priorities
- Assume Regulated Will Always Be Well Paid, Creative and Motivated To Find A Way To Get To The Money

Annex

Basic Elements of Pension Regulatory Law

Three Levels

- Statutory (Legislative)
 - Establishes Basic Framework and Rules of System
 - Creates Source of Regulator/Supervisors Authority
- Interpretive (Regulatory)
 - Extends statutory provisions to make system operational
 - Capacity to adjust to changing conditions, new products & practices
 - Oriented to Standards and Procedures
- Implementation (Judicial)
 - Application to specific facts and circumstances

Considerations in Allocation Among Levels

- Civil vs Common Law Environment
- Underlying System Design (Trust vs Pension Companies)
- Strength of Mobilization of Interest Groups & Expectation of Opposition
- Time for Development
- Independence and Technical Capacity Regulator
- Quality and Independence of Judiciary

Main Elements That Need To Be Addressed in Some Form

- Legal Status and Governance of Funds
- Definition and Holding of Assets
- Licensing and Entry Requirements
- Structure and Scope of Regulatory/Supervisory Authority
- Rule Making/Interpretive Procedures
- Funding Source for Regulator/Supervisor
- Relationship of Pension Law to Other Laws Controlling Financial Services

Main Elements (Cont)

- Individual Rights and Dispute Adjudication
- Withdrawal Requirements and Access to Funds
- Liability Structure and Delegations
- Tax Treatment of Pensions
- Reporting, Data and Records
- Conflict of Interest Prohibitions
- Fees and Expenses
- Investment Requirements or Prohibitions
- Penalty and Enforcement Structure

Legal Form of Pension Funds

- Holding/Organizational Entity or Consolidated Financial Services
- Governance Structure and Standards
- Deference to Other Licensing Authorities
- Limitations of Who May Sponsor or Create
- Restriction on use of Term Pension Fund and Marketing Limitations

License and Entry Requirements

- Authority for Fit and Proper Tests and Categorical Exclusions
- Capital or Indemnification Requirements
- Fees and Duration of License
- In Regulations:
 - Procedures for Application and Establishment of Standards

Definition and Holding of Assets

- Establish level to be subject to rules – Degree of “look through” to underlying assets
- Holding of title - Common structure requires use of third party custodian
- Statute should establish principle and define entities that qualify to act in this capacity
- Should consider principle of independent judgment of appropriate instructions in law (Maxwell case)
- Regulations can define procedures

Liability and Delegations

- Establish Structure for Responsibility and Liability (Named Parties)
- Determine Whether Delegations and Shield will be Permissible – All actions require responsible party
- Co Liability and Knowing Involvement Standards
- In Regulations:
 - Standards for proper delegations, reach of liability to involved parties (deemed responsibility)

Procedures for Rulemaking

- Need to establish some parameters in advance
- Reference to existing administrative procedures can work if effective framework exists
- Explicit framework for industry and public comment desirable – limitations on consultations outside of established framework
- Cost benefit or economic impact requirements?

Tax Treatment

- Conforming Amendments to Tax Law to Ensure Consistency
- Create Specific Principles and Standards for Access to Preferential Treatment
- Often used to achieve distributional outcomes
- May include credits or start up contribution for low income workers or informal sector

Reporting, Data and Records

- Need to Provide Authority and Distinguish Three Elements:
 - Information to be Reported Periodically
 - Requirement to Retain and Produce Records
 - Reporting to Individuals Especially Rights and benefits Earned
- Requirement for Third Party Verification of Financial Information
- By Regulation:
 - Specific contents and forms for reports, specifics on record retentions
 - Measurement Standards and Qualifications for Audit

Conflict of Interest Restrictions

- General principle of exclusion of all transactions and fees with related parties
- Prohibit capacity to control own fees (self dealing)
- Define categories of related parties – Limits of reach
- In regulations:
 - Specific applications and exceptions

Individual Rights

- Define scope and limits of private rights of action against funds
- Prohibition of retaliation for reporting problems or violations
- Appropriate venue and causes of action
- Access to information from funds
- Creation of Ombudsman or other authority outside of regulator

Penalties and Enforcement

- Establish principles of Scope of Penalties in Statute
 - Punitive, Remedial, Compensatory
 - Civil money penalties
 - Exclusion from Pension Business
 - Application of Criminal Penalties
- Basic Outline of Procedures and Limits in law, Process of imposition and standards by regulations

Investment Restrictions

- Main principles in law – Interpretation by both regulations and precedent
- Two Basic Approaches
 - Quantitative Restrictions (results)
 - Prudent Person (decision process)
- Recent Trend to “Prudent Person Plus”
 - Specific asset allocation limits by products
 - Overlay of due diligence and expertise in process

Common Elements in Quantitative Limits

- Limits on specific asset classes
- Required diversification – limit on proportion of any single issue and share of portfolio
- Currency matching
- Required minimums and Maximums by asset class
- Consider defining concepts/categories in law
- Limits on Foreign Assets

Withdrawal Requirements

- Largely a subset of Tax Law
- Need to establish principles of access before retirement age and form of payouts
- Conditionf for loans, excise tax or penalties for early withdrawals
- Specifics by regulation (possibly tax law)
- Prohibitions against assignment as collateral, access by creditors or payment for civil judgements