Regulation and Supervision of Pension Funds

Richard Hinz
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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 System 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 Annuinations, 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

- Intensity of Supervision
  - Licensing
  - Monitoring
  - Communication
  - Analysis
  - Intervention
  - Correction

- Economic Development
  - Depth of Financial Markets
  - Rule of Law
  - Governance
  - Number of Pension Funds

- Stage of Development
  - High
  - Low

- Civil Law Tradition
- Common Law Tradition
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 the 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
  – Overly 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
- Conditions 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