

PENSION REGULATION AND SUPERVISION FOR DEVELOPING PENSION SYSTEMS



WORLD BANK GROUP

Pension Core Course 2015

Fiona Stewart

AGENDA

1. Structure of pension supervisory authorities
2. Steps to establishing a supervisory framework
3. Supervising investments
4. Measuring supervisory success

1. SUPERVISORY STRUCTURES

CLICKER QUESTION



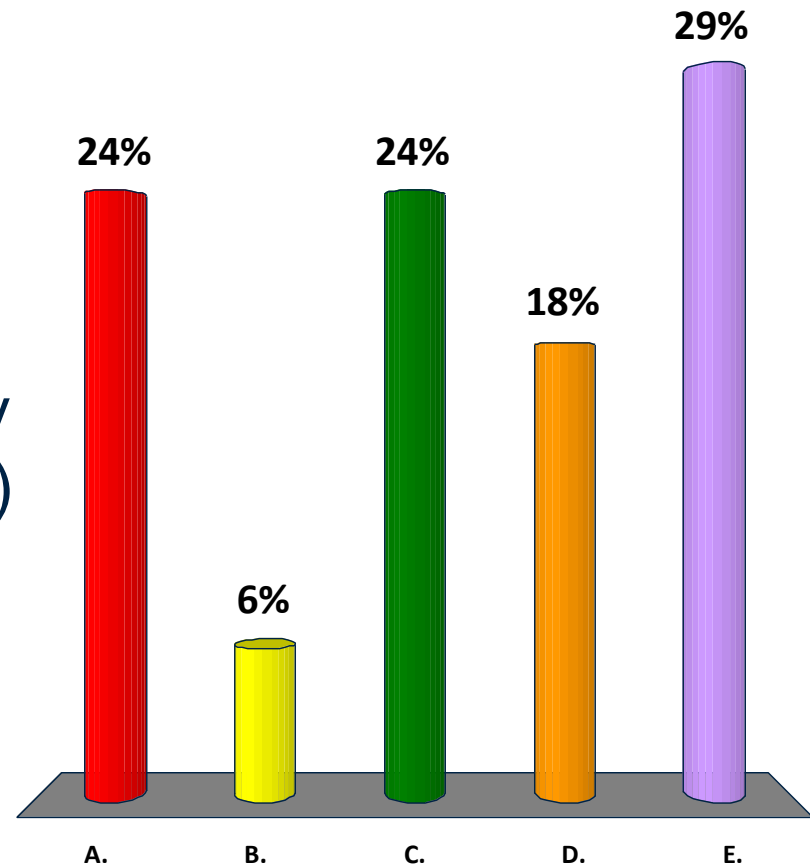
The pension supervisory authority in my country is:

Your answers:

- A. No supervisory authority
- B. Central Bank
- C. Integrated financial sector supervisory authority
- D. Semi-integrated authority (pensions and insurance)
- E. Independent pension supervisor

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TYPES OF SUPERVISORY STRUCTURE

Integrated Supervisory Authority

- Better for conglomerates
- Avoids regulatory arbitrage
- Economies scale
- Share information across financial sectors

Independent Pension Supervisory Authority

- Pensions sufficiently different
- Cross sector gains don't materialize
- Coordination between authorities can achieve same effect

Lessons Learnt

- Some structures more appropriate for certain circumstances (e.g. occupational pensions more suited to independent supervisory authority / developing economies may want to keep resources in integrated authority or central bank)
- Structure is not the most important thing - authorities which are focused, disciplined and communicate will deliver whatever the structure

TWIN PEAKS MODEL ATTRACTING ATTENTION POST GFC

		<i>Objective</i>	
		Twin Peaks (Only prudential supervision. Separation of consumer protection / conduct of business supervision)	Unified (Supervises both prudential soundness and consumer protection / conduct of business)
<i>Institutional</i>	Specialised Authority	Twin Peaks/ Specialist	Unified/ Specialist
<i>Functional</i>	Integrated Authority	Twin Peaks/ Integrated	Unified/ Integrated

STRUCTURES OF PENSION SUPERVISION

Specialized Pensions Supervisor	Semi-integrated Supervision	Integrated Supervision
	<i>At least pensions + insurance</i>	<i>Pensions, insurance, securities and possibly banks</i>
Chile	Belgium	Australia
Costa Rica	Finland	Austria
Hong Kong	France	Bulgaria
India	Jordan	Canada
Ireland	Luxembourg	Croatia
Italy	Portugal	Czech Republic
Japan	Spain	Denmark
Kenya	Turkey	Germany
Mexico	Zambia	Hungary
Nigeria		Iceland
United Kingdom		Israel
United States		Jamaica
		Kazakhstan
		Kosovo
		Korea
		Mauritius
		Namibia
		Netherlands
		Norway
		Pakistan
		Poland
		Slovak Republic
		South Africa
		Thailand
		Trinidad + Tobago

2. BUILDING A SUPERVISORY FRAMEWORK



CLICKER QUESTION

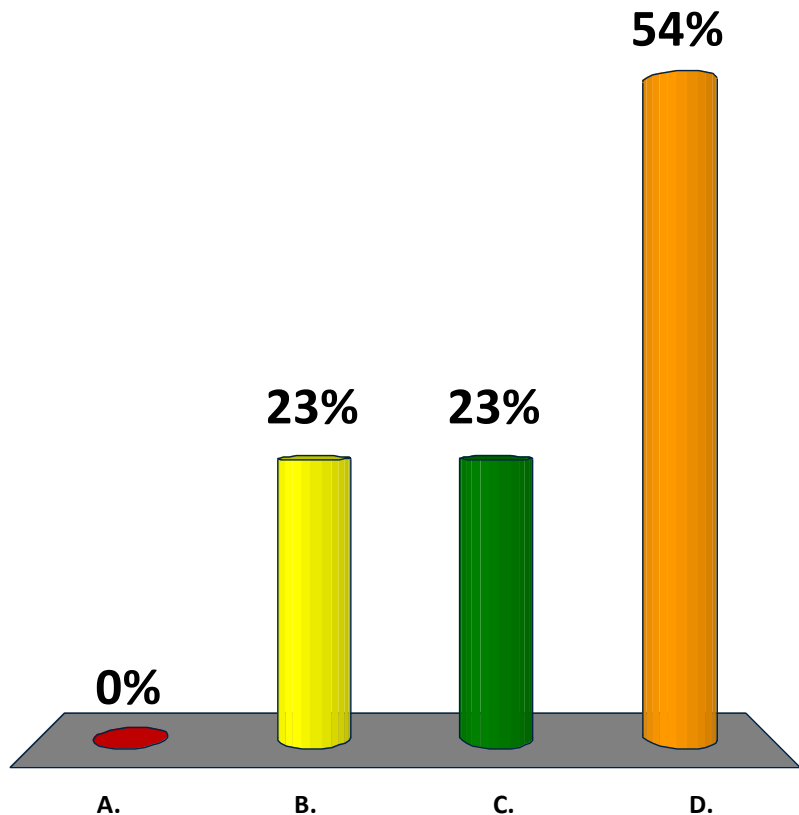
“The pension system in my country has:

Your answers:

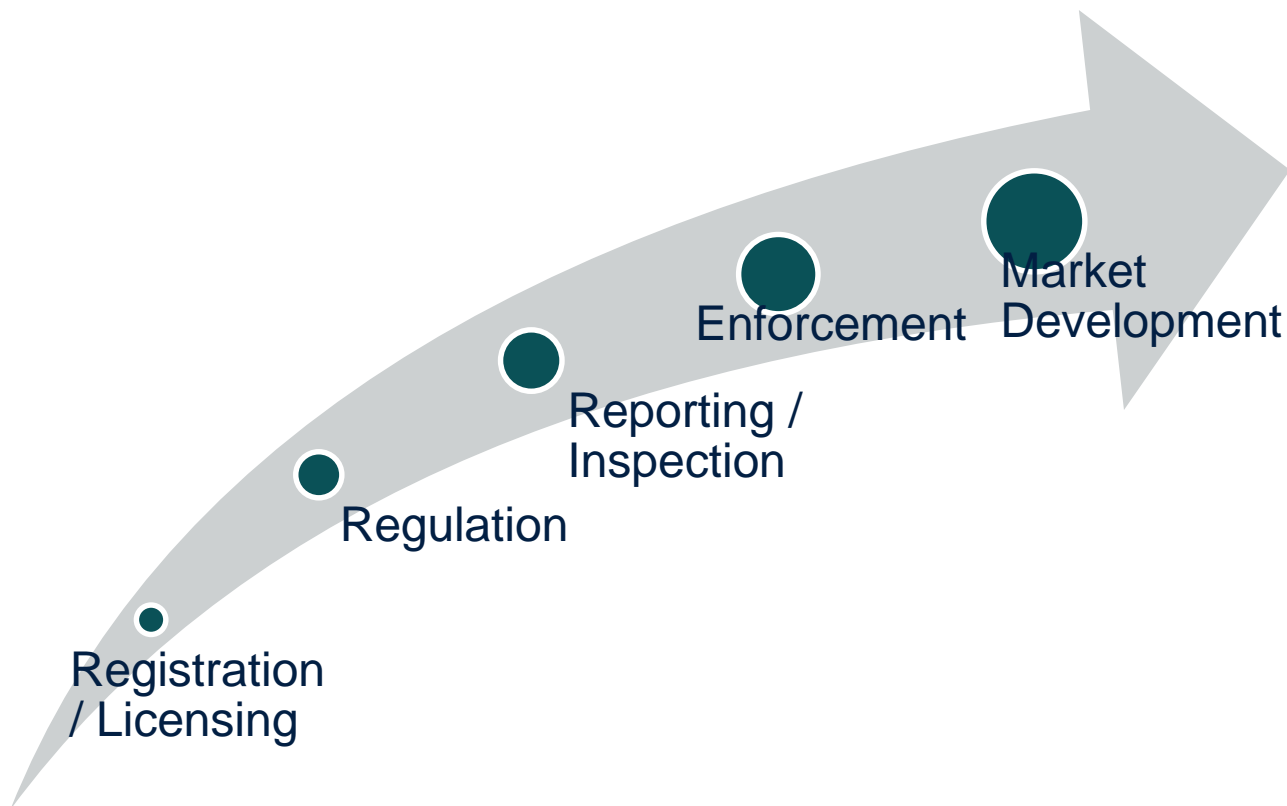
- A. No supervisory framework
- B. Pension law but no regulations
- C. Regulations in place but implementation limited
- D. Risk-base supervisory framework

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REGULATORY STEPS



REGULATORY STEPS

1. Registration of schemes
2. Establishment of reporting requirements
3. Establishment and verification of internal control systems
4. Establishment and oversight of requirements for periodic audit
5. Data management control requirements (and oversight),
6. Custodial requirements (and oversight)
7. Payment system requirements (and oversight)
8. Risk management systems.

REGISTRATION VS. LICENSING

- Registration 1st step establish size / scope of existing funds
 - Check via tax registration if are tax breaks (e.g. Lesotho/Guyana)
 - Check via corporate registrations / corporate organisations (e.g. Uganda)
 - Cross check with mandatory scheme /social security fund registrations (e.g. Kenya?)
 - Check via main providers (e.g. insurance companies Rwanda)
- Don't scare the horses – don't want to close down what already there
- Once universe known establish collaborative relationship - communicate what expected of them (funds and providers)/ what they should expect of the regulator
- Often find regulation is welcome (if not figure out why not – e.g. funding issues/ concerns about onerous administration or will be shut down/ don't see benefit)?
- Later move to full assessment and granting of full licenses – giving suitable time to comply

REGULATIONS

- Once pension law in place need supporting regulations:

- *Governance*
- *Investments*
- *Operating systems / risk management*
- *Disclosure / reporting*

Compliance also a collaborative process / Provide guidance as well a guidelines + consult with industry before regulations released

Kenya		Tanzania
1997 Retirement Benefits Act (amended 2006/ 2007)	Established RBA	2008 Social Security Regulatory Authority Act
2000 Retirement Benefits Regulation	Administration, membership, benefits, investment guidelines, minimum funding levels, winding up, managers and custodians, fees and disputes	2012 Social Security Laws (Amendments) Act
2005/2006/2007 Preservation Rules	Withdrawals	2012 Social Security Conduct of Actuarial Services Guidelines Social Security Data Management Guidelines
2007 Retirement Benefits (Administrators)	Rules for administrators and trustees	2013 Social Security Schemes Membership Registration Guidelines Social Security Schemes Totalization of Contributions Periods Guidelines Social Security Investment Guidelines
2013 National Social Security Act	Repealed and replaced previous act - provides a comprehensive social security for the members and their dependents for various contingencies.	2014 Social Security Schemes Annual Members Conference Guidelines, Social Security Schemes Security of Electronic Information Guideline Social Security Schemes Interoperability Guidelines Social Security Schemes Annual Reporting Guidelines

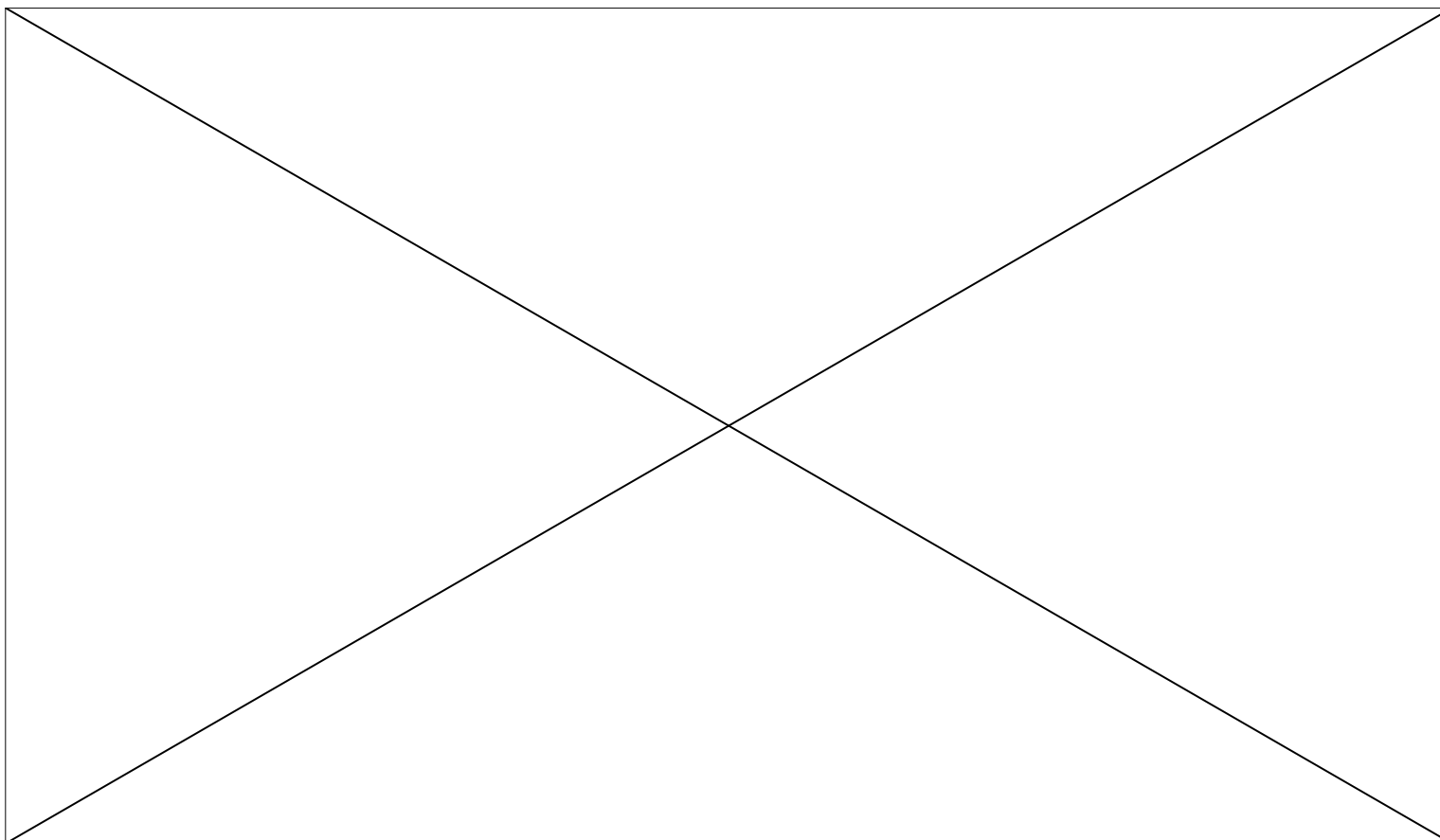
REPORTING

- Basic data need to do job – foundation on offsite
 - *IOPS WP #14 Efficient Information Collection*
- Also act as comparative source to improve / imposing standards on industry
- Role of supervisor in providing comparative data

	Performance	Cost	Service
Australia	1 5 7	√	
Bulgaria	1 2 (+volatility)	√	
Chile	1 3 5 (+volatility)	√	√
Cost Rica	1 +since inception (+volatility)	√	
Hong Kong		√ (synthetic indicator)	
Israel	1 + quarterly (Sharpe ratio)	√	
Italy	1 2 4 5 10	√ (synthetic indicator)	
Turkey	Daily (Sharpe ratio)	√	√
Spain	1 3 5 10 15	√	

REPORTING SUPERVISORY ASSESSMENT/ SCORES

Jurgen Boyd FSB South Africa



INSPECTIONS

- Organization – horizontal (portfolio)/ vertical (functional)/ matrix (hybrid) approach
- Central vs. individual supervisory input
- Chile – reactive (follow complaints) /separated out to different department

The screenshot displays the IOPS Risk-based pensions supervision Toolkit interface. The title is 'Consistency of Scores'. It compares two countries: Australia and the Netherlands. Australia's approach involves individual supervisors inputting scores for risk categories and mitigants, guided by benchmarks, and defending ratings at a review panel. The Netherlands' approach involves centrally produced templates for different fund types, with individual supervisors able to override scores but providing explanations, and FIRM Expert team inputting default values.

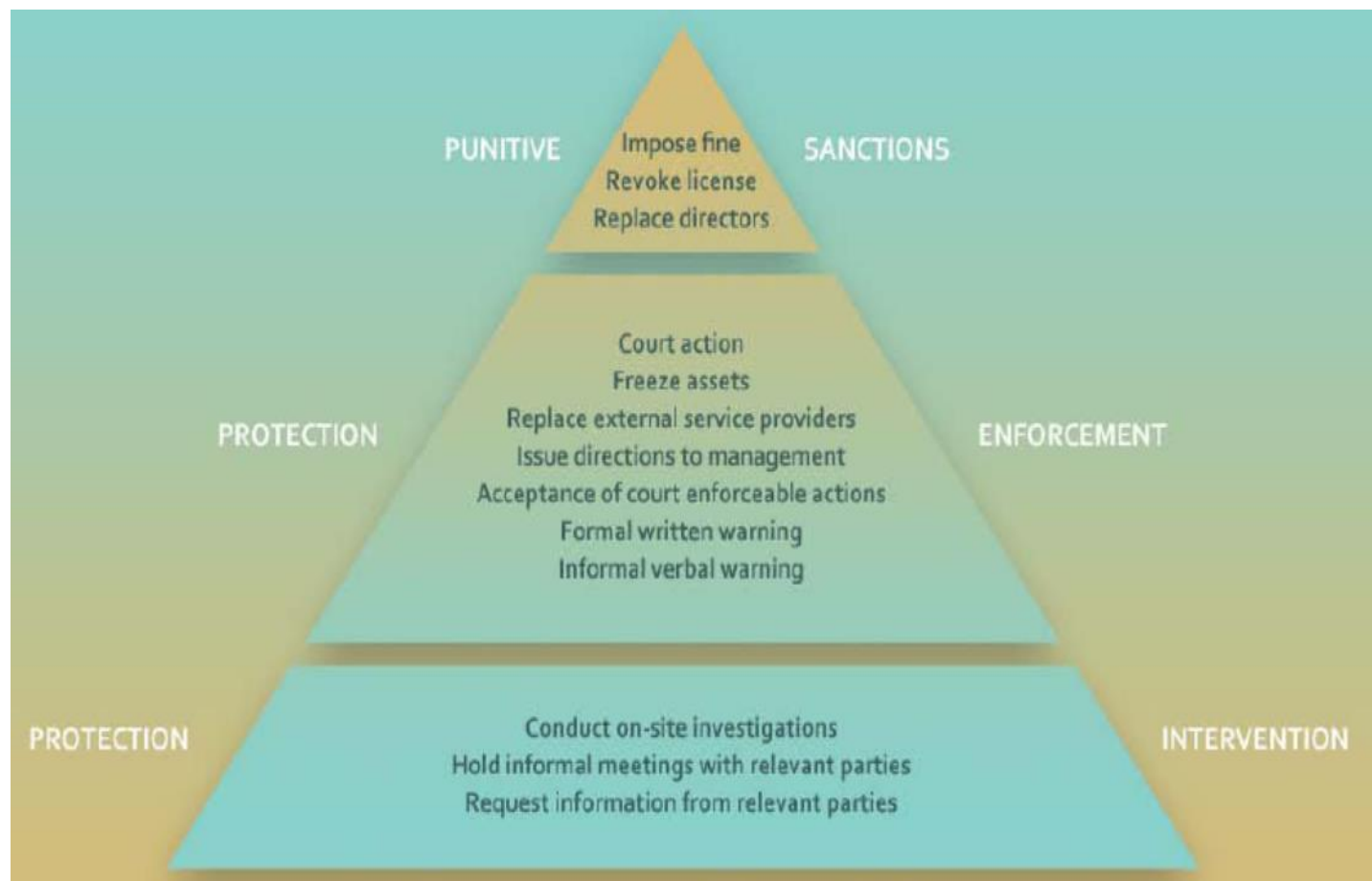
IOPS Risk-based pensions supervision

>> Toolkit

Consistency of Scores

	
Australia	Netherlands
<ul style="list-style-type: none">• Individual supervisor inputs scores for risk categories + mitigants and decides on weightings• Guided by benchmarks / reference points• Supervisors may have to defend their ratings at a review panel	<ul style="list-style-type: none">• Templates produced for different types of fund with scores for risk categories / mitigants/ weightings input centrally• Individual supervisor can override these scores but must provide an explanation• FIRM Expert team input default values

ENFORCEMENT PYRAMID



Oversight of Public/ Social Security Funds

Challenges

- Political Boards
- Political involvement in investments
- Size of assets vs. economy/ markets
- Interaction between supervisor and ministry

Solutions

- **Ensure have legislative /regulatory power**
 - Have to report to supervisor
 - Have right to audit the fund
 - Can ask for information/ inspect
 - Can publish reports
 - Should follow investment guidelines
- **Find a champion to support Regulator**
- **Get own governance right so have credibility and independence**
- **Reduce dominance of assets**
 - Enforce diversification requirements
 - Some overseas
 - Some outsourcing / competition
- **Report**
 - Publish findings (stop rumors)
 - State publicly if not able to enforce supervisory duties
- **Sanction**
 - Be prepared to fine fund if rules broken (power back to regulator) / explain why done so

INDUSTRY DEVELOPMENT ROLE?

Can be tricky – balance development role vs. oversight role/ can conflict?

1. Structure of industry? (# license/ licensing trustees/ encourage merger into larger pooled funds)?
2. Development of coverage
 - India
 - Kenya
3. Development of instruments
 - Costa Rica (capital markets and pension regulators working together)

CLICKER QUESTION



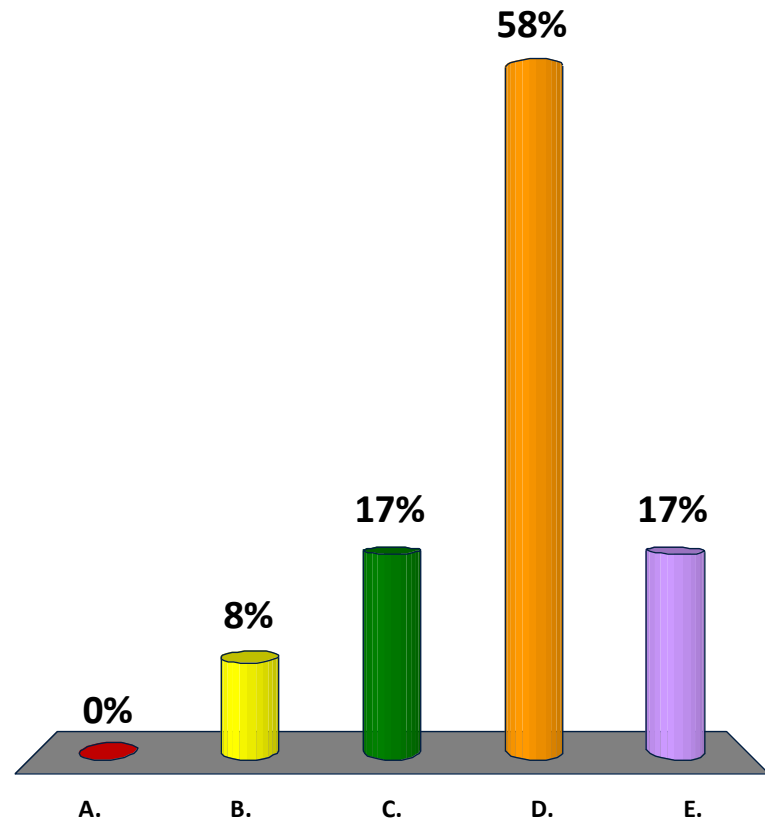
The major challenges with pension supervision in my country relate to:

Your answers: - Discuss with your neighbours

- A. Lack of regulatory structure
- B. Lack of guidance/ clarity from supervisory authority
- C. One large player distorting the market
- D. Political 'interference'
- E. Lack of enforcement capability

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3. SUPERVISING INVESTMENTS

SUPERVISING INVESTMENTS

- **Pass regulations**
 - Uganda
 - Rwanda
- **Start check funds in line**
 - Tanzania – BoT instruction to funds to reduce exposure to government loans and no new ones to be extended until 10% limit reached (+ pressure on government to repay overdue interest)
 - Kenya – RBA gradually enforced real estate limits
- **Change regulations as markets change**
 - LAC - Multifonds
 - EAC – harmonization/ regional investment considered within domestic limits
 - Chile - international diversification
 - Mexico - new instruments

SUPERVISING INVESTMENTS

- **Transparency and Education**
- **Risk Management Systems**
- **Quantitative Investment Limits**
- **Product Design (life-cycle funds)**
- **Guarantees**
- **VaR**
- **Replacement Target Rates**

Country	Transparency	Good Practice	Quantitative Limits	Product Design	Guaranteed Returns	Control Risk Levels
Mandatory						
Chile	X	X	X	X	X	
Mexico	X	X	X	X	X	X
E. Europe	X		X	Common		
Switzerland			X		X	
Australia	X	X				
Nigeria	X	X	X			
Voluntary						
USA		X		X		
Denmark			X			X
Ireland	X		PRSA			
Israel			X			
Kenya		X	X			
S.Africa		X	X			
Italy	X	X	X	X	X	
UK	X	X				

Source: (IOPS 2010), Working Paper No. 12 'Managing and Supervising Risk in DC Pension Funds'

Transparency and Education

- Information disclosure requirements
 - OECD guidelines
 - IAIS stress *how* as well as what disclosed important
 - Some countries prescribe precise format of documents (Chile, Italy, Mexico, Slovakia)
 - Others how information should be disclosed (e.g. net of charges/ frequency of reporting / risk or volatility as well as returns)
 - Some authorities approve key documents prior to publication (Bulgaria, Hong Kong, Slovakia)
 - Some check for compliance after (e.g. Turkey)
- Supervisors themselves can provide comparative information (e.g. Chile, Hong Kong)
- Others play a role in educating members (e.g. Ireland)

Investment Control and Risk Management Systems

- Risk-management systems
 - Some supervisory authorities lay out detailed requirements (e.g. Mexico)
 - Others more general guidance (e.g. UK, Australia)
 - OECD guidance
 - Management Oversight & Culture
 - Strategy & Risk Assessment
 - Control Systems
 - Information, Reporting & Communication
- Statement of Investment Principles is a key part of risk-management

Quantitative Investment Limits

- OECD Guidelines on Asset Management
 - Prudent person should apply
 - No floors
 - Can use caps

to the extent that they are consistent with and promote the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested. Portfolio limits that inhibit adequate diversification or impede the use of asset-liability matching or other widely-accepted risk management techniques and methodologies should be avoided

- No self-investment / sponsor limited
- Diversification requirements
- Allow investment abroad

Quantitative Investment Limits – General Practice

Limits	Examples
No investment limits	Many OECD – e.g. Australia, Belgium, Canada, Germany (pensionsfonds), Israel, Iceland, Japan (ex real estate) , Netherlands, NZ, UK, USA
Equity limits	Generally 50-75% - e.g. Czech Republic, Denmark, Finland, Greece, Switzerland, Romania, South Africa – Norway 35% Nigeria 25%
Non-listed	Generally 5-15%
Corporate bonds	Generally 50-70% - e.g. Denmark, Greece, Iceland, Switzerland – Nigeria 35%
Self-investment	Generally 5-10%
Single issue	Generally 5-10%
Foreign investments	
Prohibited	Nigeria (DC) Brazil
2-3%	
15%-30%	Austria, Kenya, Korea, Mexico, Poland (EPF – 5% OPF), Russia (mandatory), South Africa, Ukraine
40%-80%	Chile, Costa Rica, Macedonia, Colombia (by type fund)
Regional listings	OECD- e.g. Czech, Iceland / Greece – EU, EEA / Kenya – Kenya, Tanzania, Uganda A-rated country - Israel

Quantitative Limits on Alternative Investments

Country	Total	Hedge funds	Private Equity	Infrastructure	Real estate	Currency	Commodities	Structured Products	Others
Australia	No limits ¹⁸								
Belgium	No limits								
Canada					25%				
Chile ¹⁹									
Columbia			40%						
Costa Rica			10%					5%	
Czech Republic ²⁰		5%	5%	5%		5%	5%	70%	70%
Germany Pensionskassen		5%	15%		25% REITS	30%	5%		
Hong Kong						30% ²¹			10% REITS
Israel	No limits								
Mexico			10%	10%		30%		10%	
Netherlands	No limits								
Norway	7%								
Poland		10%	10%	10%	10%	10%	10%	10%	10%
Portugal	10%								
Romania ²²			2%				3%		
Slovak Republic (voluntary funds)					30%				
South Africa ²³		10%	10%		25%				
Swaziland	15%				25%		10%	Look-through principle applies	
Switzerland ²⁴	15%					30%		10%	
Turkey	No limits								15% warrants 20% venture capital
UK	No limits								

Product Design – Lifecycle Funds

- Quantitative limits crude control mechanism
- Lifecycle or multi-fund model applies asset class limits according to age
- In practice – take very different forms in different countries (i.e. level of risky assets, age at which apply)

	Option 1	Option 2	Option 3	Option 4	Option 5
Chile ²	40%-80%	25%-60%	15%-40%	5%-20%	0-5%
Mexico	30%	25%	20%	15%	0%
Hungary	100%	40%		10%	
Slovak republic	80%	50%		0%	
Estonia	50%	25%		0%	

Guarantees

- Absolute (e.g. Belgium, Romania - mandatory, Czech Republic, Slovakia, Switzerland, Germany - Reister)
 - Fixed/ minimum nominal/ real time period
 - Can be expensive – who pays?
 - Basic capital only guarantee over 40 years few bp

	Capital guarantee	2% guarantee	Inflation-indexed capital guarantee	Ongoing capital guarantee	4% guarantee with annual fees	Floating guarantee	4% guarantee with ongoing haircut	4% guarantee with final haircut
% of net asset value	0.06%	0.22%	0.24%	0.39%	0.89%	1.22%	-	-
% of contributions	1.24%	4.94%	5.58%	18.36%	18.71%	26.09%	-	-
% of surplus	-	-	-	-	-	-	1.60%	-
% of final surplus	-	-	-	-	-	-	-	24.06%

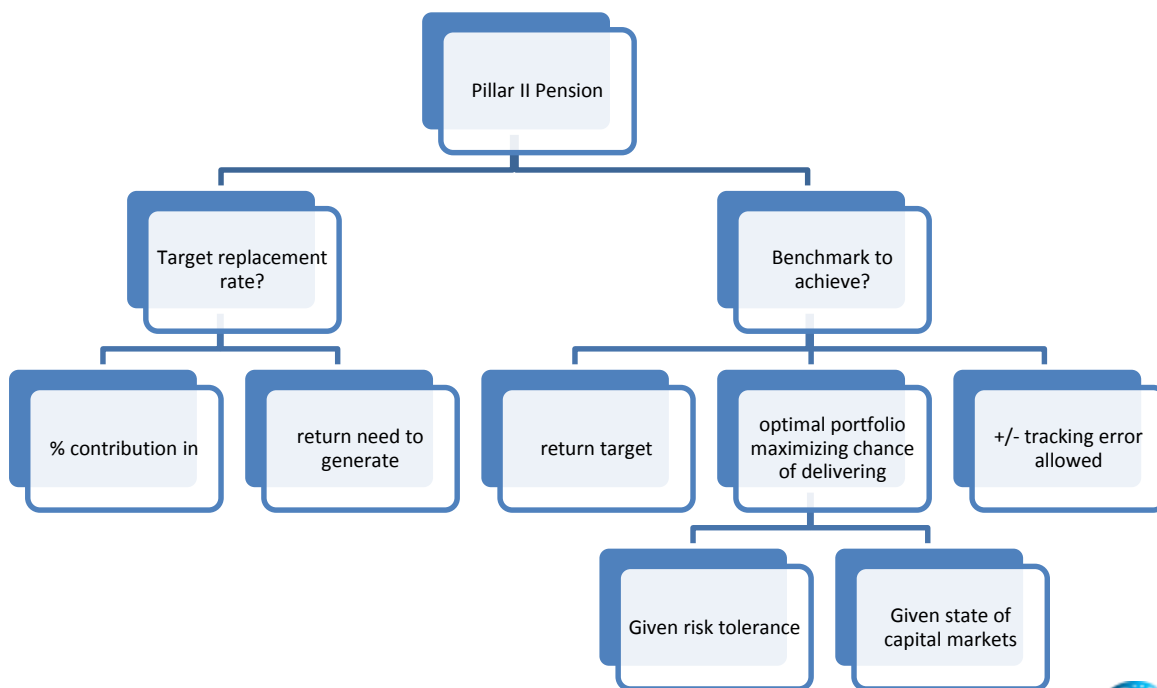
- Relative to industry (e.g. Chile, Poland)
 - Not offer genuine protection to members
 - Creates mis-incentives/ herding amongst managers

Value at Risk

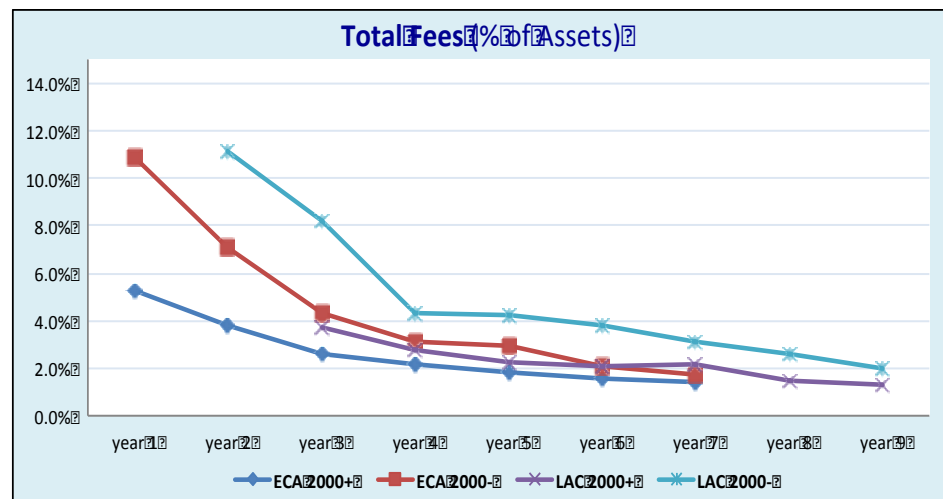
- Alternative control risk exposure
- Mexico VaR
- Maximum loss in a portfolio with a given probability or confidence interval (typically 5%) and over a given planning horizon
- Gives common, easy to understand measure
- But
 - Short time horizon inappropriate for pensions
 - Doesn't consider extent of risk
 - Can require pro-cyclical reactions

Target Outcomes

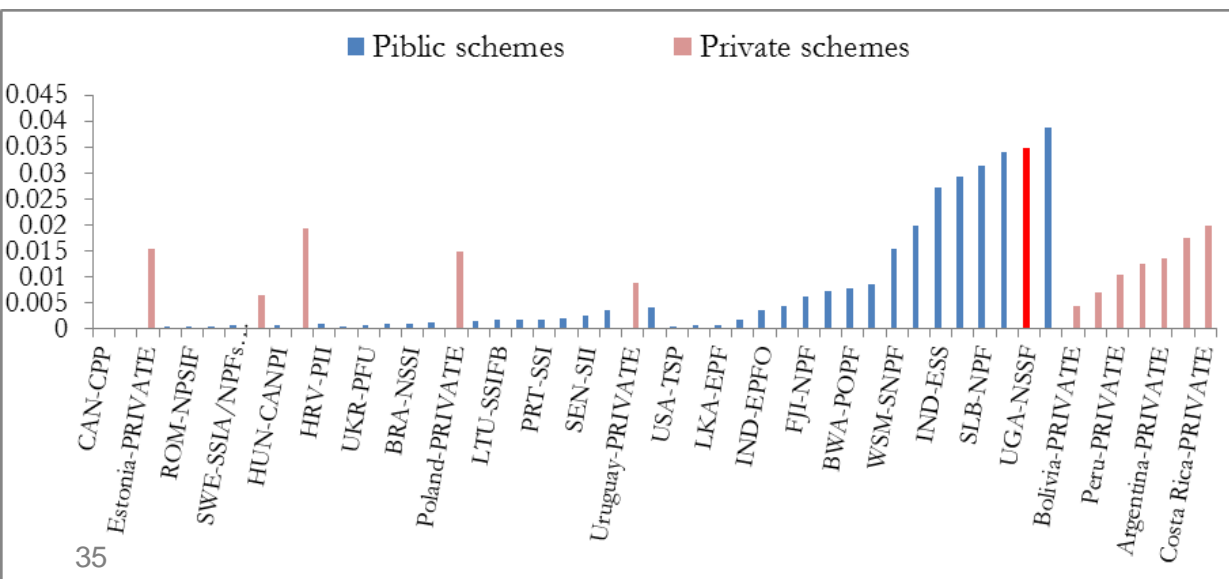
- Other control mechanisms focus on short-term volatility
- Real risk to members of pension fund is not receiving adequate retirement income
- Should base control of investment risk on such explicit, long-term target



Supervising Costs



Source: Pension Fund Regulators + WB staff calculations



Source: Sluchynsky, 2014

Cost Control Measures

Country	Fee Caps	Change Fees	Transparency	Others
Chile		√	√	Auction
Costa Rica	√	√	√	Fund mergers
Hong Kong			√	Competition + disclosure/ fund mergers/ member education/ admin improvements
Hungary	√			
Israel				Competition
Macedonia	√			
Mexico	√	√	√	Fund mergers
Peru		√		Auction
Poland	√			
Romania	√			Education members/ fund mergers
Turkey	√	√		

4. MEASURING SUPERVISORY SUCCESS

Measuring Supervisory Success

Measures of Pension System

Coverage

Sustainability

Adequacy

Efficiency

Security

	Supervisory Measures
Activity	<ul style="list-style-type: none">• # investigations• # complaints handled• # licenses registered
Efficiency	<ul style="list-style-type: none">• Costs vs. # investigations• Staff vs. # entities covered
Service Quality	<ul style="list-style-type: none">• Time to respond to complains• Time to process applications etc.
Effectiveness	<ul style="list-style-type: none">• Funding ratio• Money \$ value funds protected/ lost• No. entities moving from higher to lower risk categories
Surveys	<ul style="list-style-type: none">• Industry feedback• Industry surveys (improvement in governance etc.)

IOPS PRINCIPLES PRIVATE PENSION SUPERVISION

Principle 1: Objective National Laws should assign clear and explicit objectives to pension supervisory authorities

Principle 2: Independence Pension supervisory authorities should have operational independence

Principle 3: Adequate Resources Pension supervisory authorities require adequate financial, human and other resources

Principle 4: Adequate Powers Pension Supervisory authorities should be endowed with the necessary investigatory and enforcement power to fulfil functions and achieve their objectives

Principle 5: Risk Orientation Pension supervision should seek to mitigate the greatest potential risks to the pension system

IOPS PRINCIPLES PRIVATE PENSION SUPERVISION

Principle 6: Proportionality + Consistency Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent

Principle 7: Consultation + Cooperation Pension supervisory authorities should consult with the bodies they are overseeing and cooperate with other supervisory authorities

Principle 8: Confidentiality Pension supervisory authorities should treat confidential information appropriately

Principle 9: Transparency Pension supervisory authorities should conduct their operations in a transparent manner

Principle 10: Governance The supervisory authority should adhere to its own governance code and should be accountable

IOPS PRINCIPLES ASSESSMENT METHODOLOGY

Provides a structured framework for assessing the extent to which a pension supervisory authority complies with the spirit and the letter of the Principles

Can be used for external or self-assessment

Also indicates types of evidence that may help to answer questions

Compliance rated as:

- *Full implemented* – IOPS Principle is implemented in all material respects
- *Broadly implemented*- IOPS Principle is implemented in all but one or two material respects and the exceptions do not detract from the overall opinion. It should be possible to say something positive about compliance in answer to nearly every question
- *Partially implemented* – while a negative answer is given to some questions, the response to the majority of questions is consistent with compliance
- *Not implemented* - there are major shortcomings against the Principle

PRINCIPLE 9 – TRANSPARENCY ASSESSMENT QUESTION

- Does the supervisory authority publish its rules and procedures?
- Is the supervisory authority subject to appropriate audit and reporting requirements (that do not compromise its independence)?
- Does the supervisory authority publish an Annual Report explaining how it has (or has not) met its objectives?
- Does the supervisory authority explain to individual supervised entities why it has taken particular action?

CLICKER QUESTION

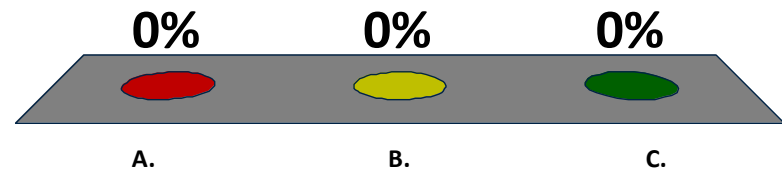


How would you rank your supervisory authority?

	Well Implemented	Medium Implemented	Poorly Implemented
1. Objectives			
2. Independence			
3. Adequate resources			
4. Powers			
5. Risk-based supervision			
6. Proportionality + Consistency			
7. Communication			
8. Confidentiality			
9. Transparency			
10. Governance			

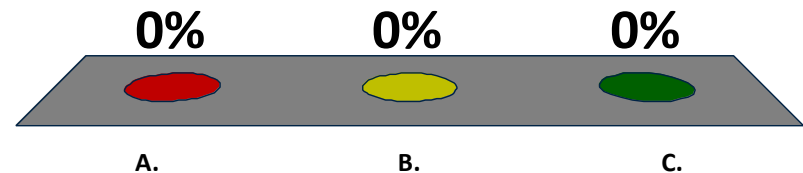
How would you rank your supervisory authority? OBJECTIVES

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



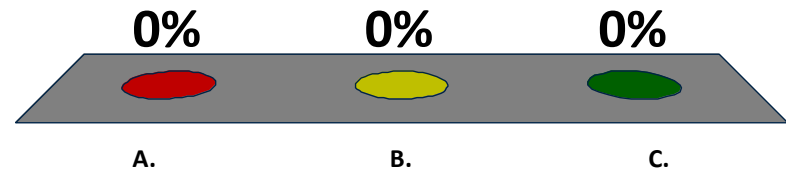
How would you rank your supervisory authority? INDEPENDENCE

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



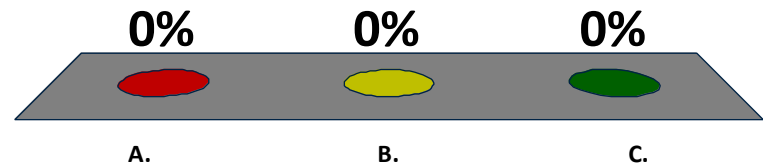
How would you rank your supervisory authority? ADEQUATE RESOURCES

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



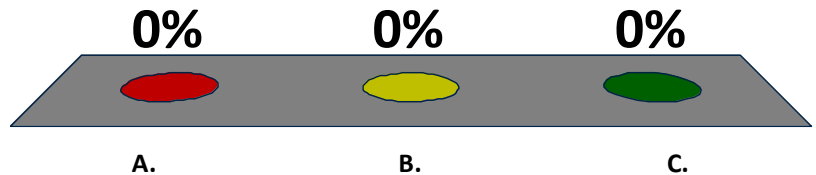
How would you rank your supervisory authority? RISK-BASED SUPERVISION

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



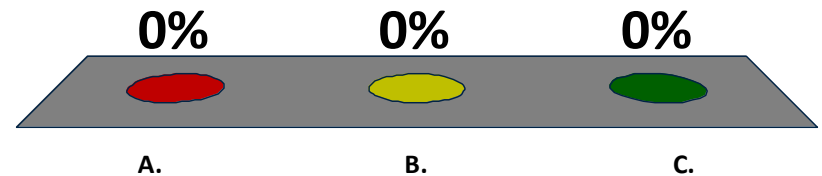
How would you rank your supervisory authority? POWERS

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



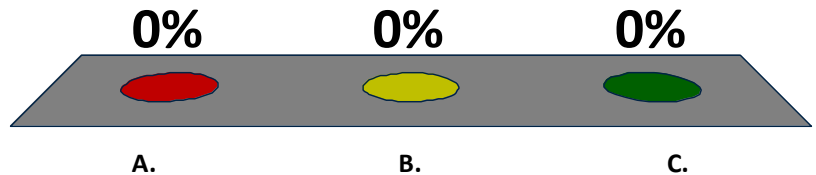
How would you rank your supervisory authority? PROPORTIONALITY + CONSISTENCY

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



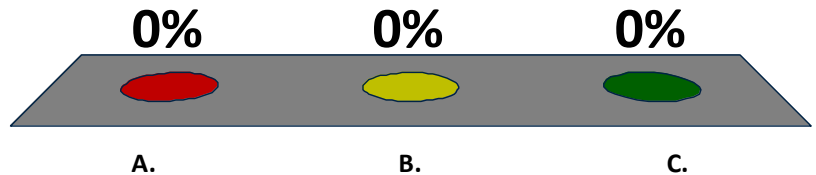
How would you rank your supervisory authority? COMMUNICATION

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



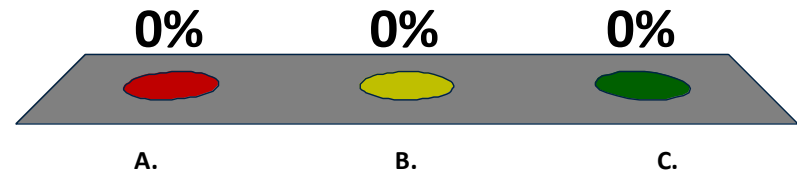
How would you rank your supervisory authority? CONFIDENTIALITY

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



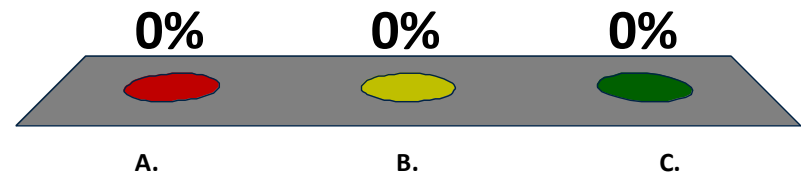
How would you rank your supervisory authority? TRANSPARENCY

- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



How would you rank your supervisory authority? GOVERNANCE

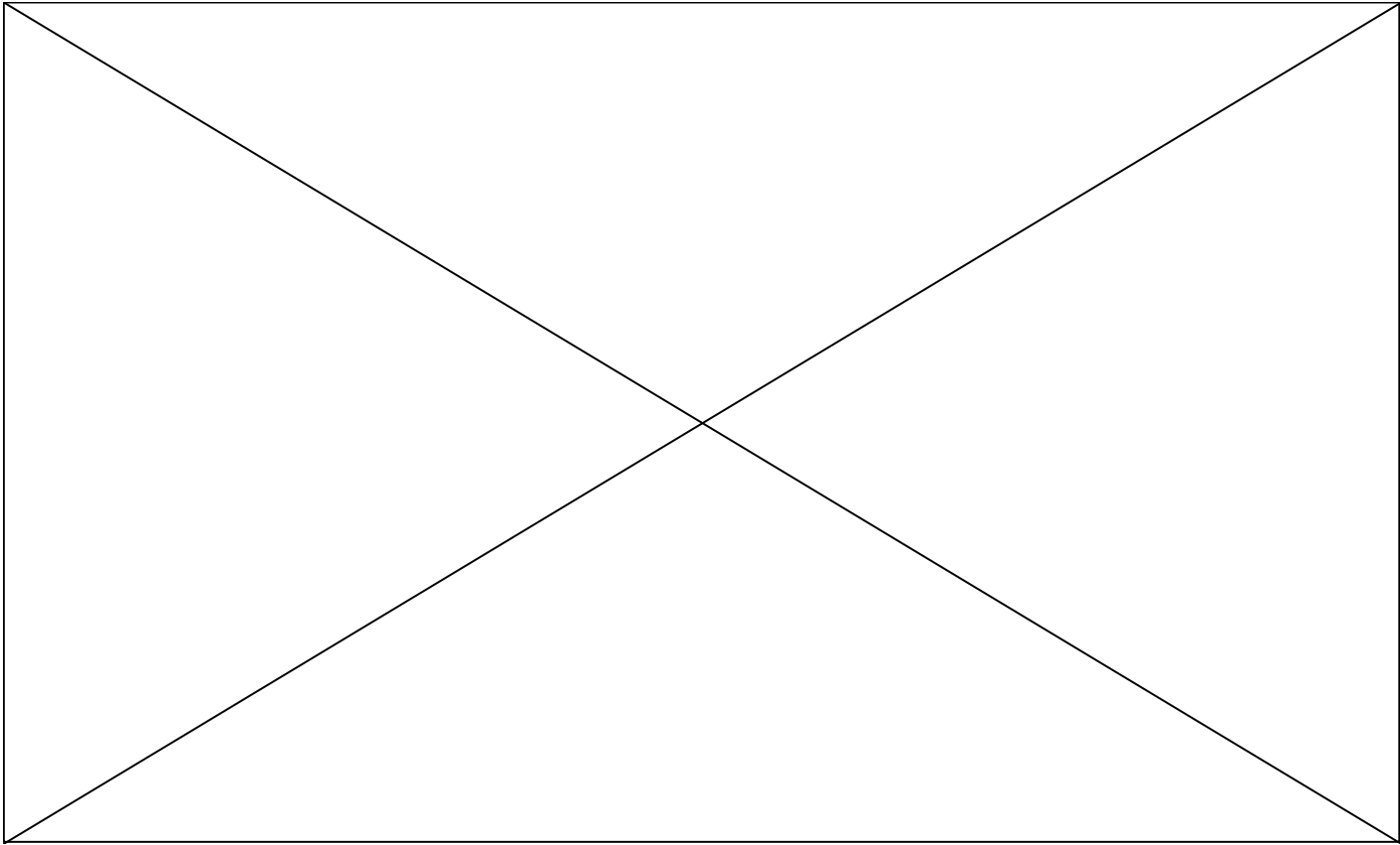
- A. Well Implemented**
- B. Medium Implemented**
- C. Poorly Implemented**



IOPS SELF-ASSESSMENT RESULTS

Well Implemented	Medium Implemented	Poorly Implemented
1. Objectives	10. Governance	5. Risk-based supervision
4. Powers	9. Transparency	6. Proportionality + Consistency
7. Communication	2. Independence	3. Adequate resources
8. Confidentiality		

NIGERIA –SELF ASSESSMENT VS. IOPS PRINCIPLES



SEVEN DEADLY SINS OF SUPERVISION

1. **Structure** – lack of independence /opaque appointments/ poor governance/ lack power
2. **Staff** - insufficient numbers/ poorly paid/ poorly trained/ little guidance material
3. **Style** - Risk vs. Rules based
4. **Statistics** – offsite reviews?/ separate unit?/ how much information?/ what to analyse (x summarize)/ trends/ finding relevant peer group/ means what?
5. **Scope** – what determines inspection cycle?/ full or partial inspections?/ who sets the scope/ what is it based on (offsite analysis/ previous review/ industry gossip/ media)?
6. **Significance** – report significant matters – not a list of minor transgressions/ require reports to be discussed at Board level/ require a response and plan of action
7. **Staying the distance** – if it is significant enough to report, it is worth pursuing/ allow reasonable time for response/ written response from the Board not the management/ if action plans have time lines in them, follow up on the date the activity is meant to be completed / arrange for follow inspection not wait till the next routine inspection