Pension Regulation and Supervision

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World Bank

Pensions Core Course

Pension Regulation

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 From Other Savings?

- Vulnerability To Old Age Poverty Leads to Less Risk Tolerance
- Potentially a High Proportion of Average Member's 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 of 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

- Rules Defining the Structure and Organization of Funds
- Requirements for the Operation of Funds
- 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

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 – Investment Advice and commissions emerging as key issues
- 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 Annutizations, Programmed Withdrawals and Phased Retirement

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

Main Elements (continued)

Relationship of Pension Law to Other Laws Controlling Financial Services

Individual Rights and Dispute Adjudication

Withdrawal Requirements and Access to Funds

Liability Structure and Delegations

Tax Treatment of Pensions

Main Elements (continued)

- Reporting, Data and Records
- Conflict of Interest Prohibitions
- Fees and Expenses
- Investment Requirements or Prohibitions
- Penalty and Enforcement Structure

CONCLUDING THOUGHTS

- No Right or Wrong System - Like Good Architecture - Form Follows Function
- Context is Key Determinant
- 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

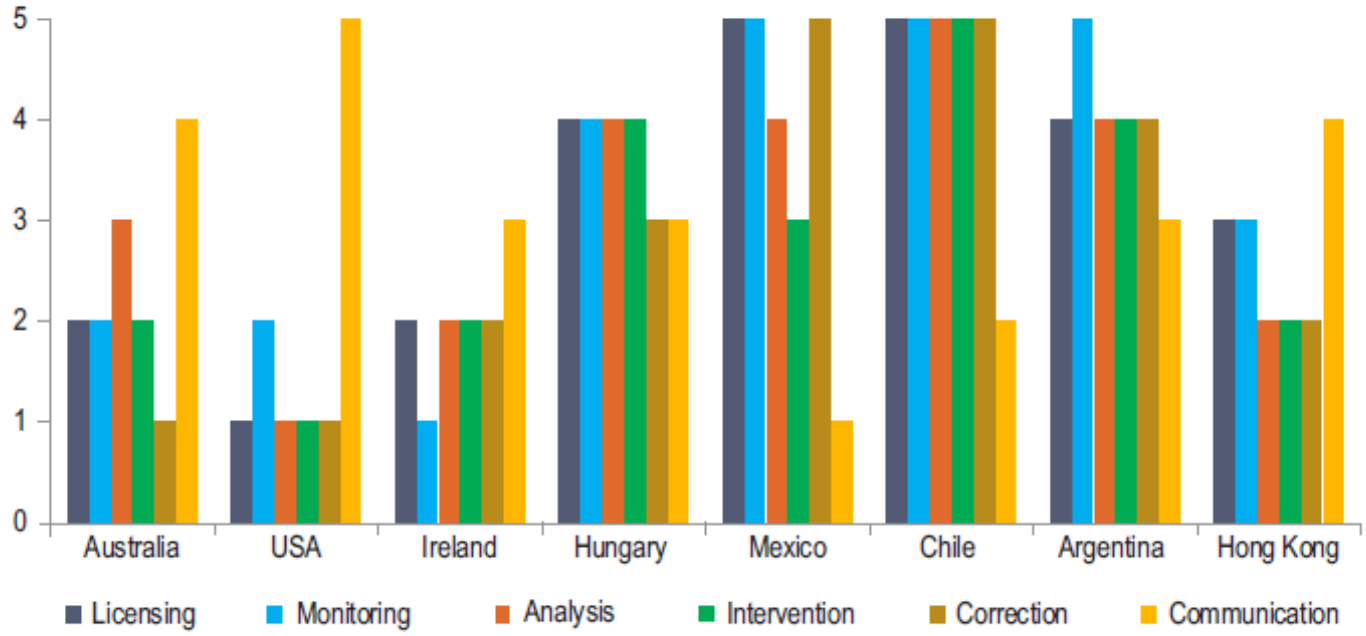
Pension supervision

AGENDA

- Approaches to Supervision
- Risk-based Supervision and what it means for Pensions
- New Supervisory Risk: Climate
- New Supervisory Risk: Cyber

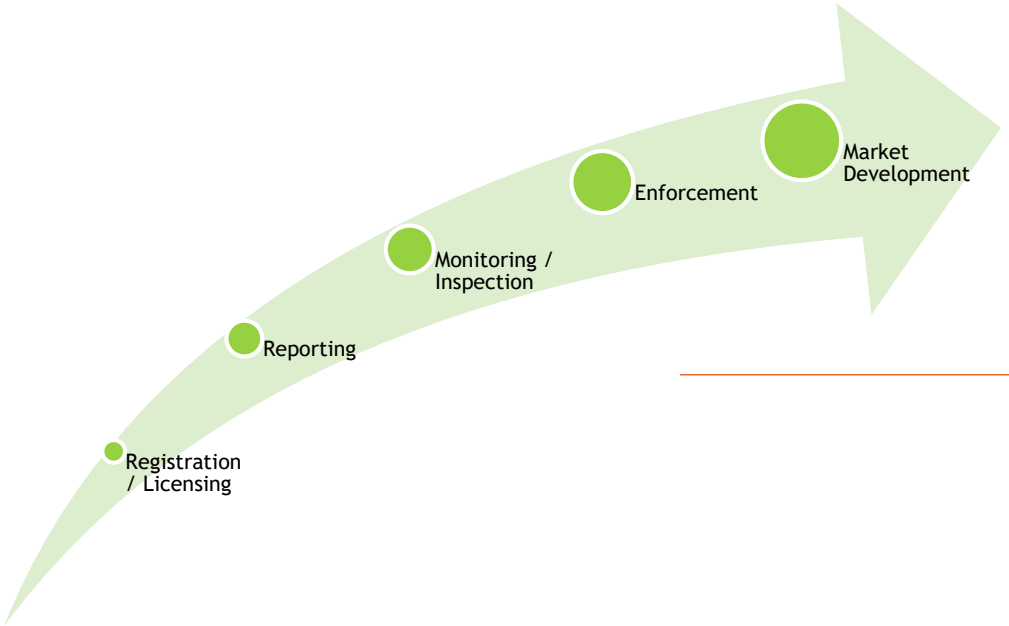
Basics of Supervision

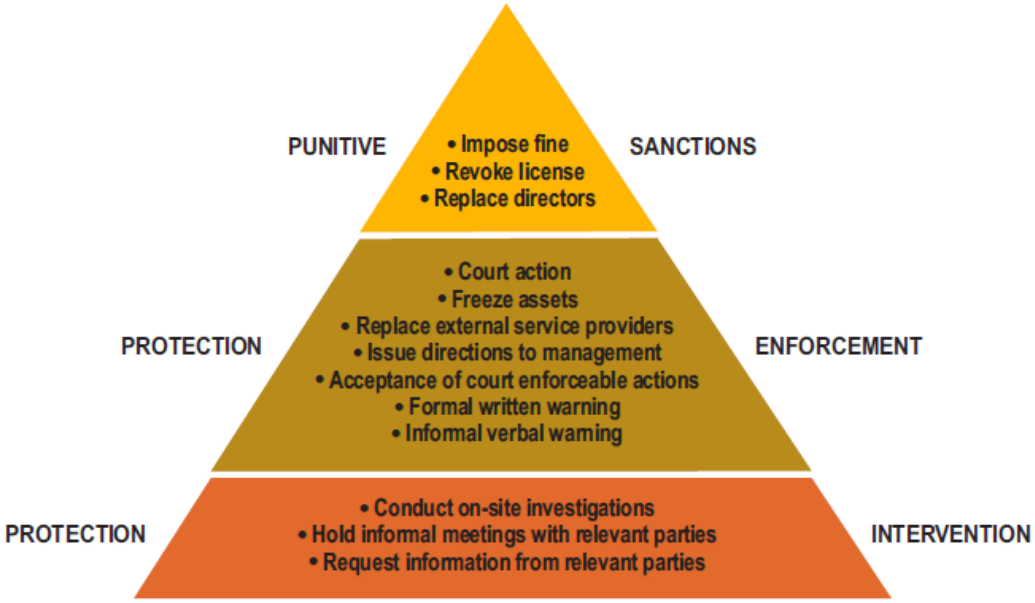
Control of Licensing	Pension Companies –Fund Managers and Trustees –Custodians, Actuaries and other Service -Providers
Monitoring	–Financial Reporting and Auditing –Actuarial Reviews –On-Site Reviews and Investigations –Receiving Complaints & “Whistleblowers
Measurement	–Comparison to Normative Standards –Risk Scoring and Evaluation
Communication	Disclosure –Outreach and Education –Training
Intervention	–Notification of Violations –Directive Actions –Negotiated Resolutions
Correction	- Punitive –Remedial –Compensatory



Supervisory Approaches

SUPERVISORY STEPS





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**

IOPS Working Papers No. 1+16

What is Risk-based Supervision?

- **A structured approach focusing identifying potential risks faced by pension funds and assessing the financial and operational factors in place mitigate those risks. This process then allows the supervisory authority to direct its resources towards the issues and institutions which pose the greatest threat.**

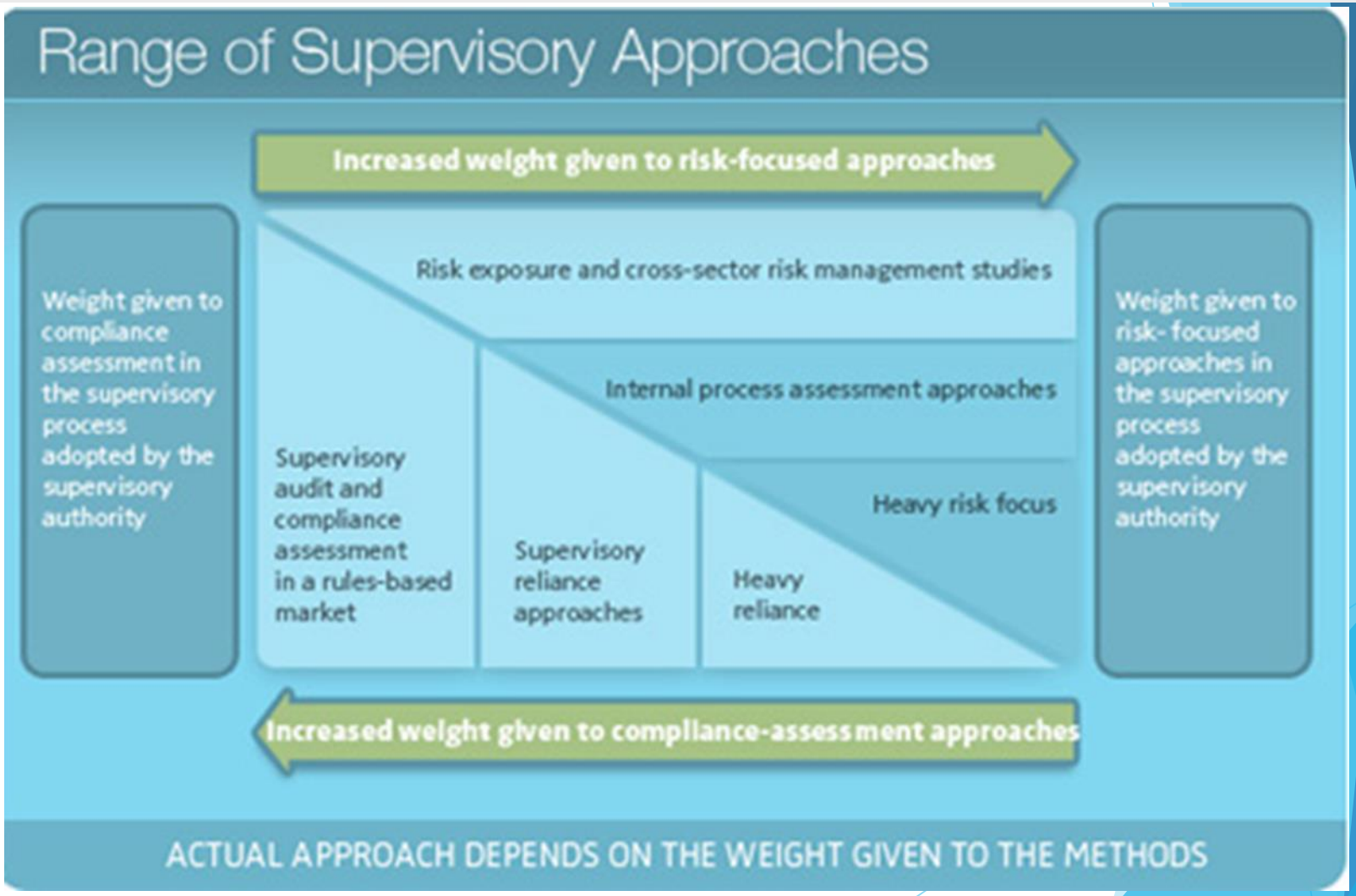
- ***Can be applied in many different ways***
  - quantitative measures of risk vs. qualitative judgement of risk management
  - risk-scores for each entity vs. analysis of risks systemic to pension system
  - identify weak areas within a supervised entity vs. which institutions amongst thousands may pose the greatest threat

- ***Elements common to all RBS systems***
  - Determine objectives of supervisory authority + greatest risks to these
  - Assess hazard or adverse events + likelihood of these occurring
  - Assign scores and / or ranks to firms or activities based on assessments
  - Link supervisory response to the risk scores assigned

Risk-based Vs. Compliance-based Approach

Compliance-based	Risk-based
• Focus on compliance e.g. with tax and labour laws and (often) quantitative investment rules • All funds get same degree of attention	• Identifies potential risks • Assesses mitigating factors • Seeks proper management of risks • Allows scarce resources to be targeted at funds most at risk
• Detailed, often rigid, rules that are difficult to change to meet urgent regulatory needs	• Forward looking and principles-based regulation • Flexible
• Institutions focus is on compliance with rules, not risk management	• Incentives for institutions to strengthen risk management practices
• Point in time focus • Overlooks major risk areas • No early warning system	• Supervisors use judgement to assess risk and quality of management
• Duplicates work of auditors	• Compliance checks done by audit etc. – removes duplication
• Difficult to get meaningful comparisons	• Supervisor can benchmark institutions and assess overall industry
• Penalises past breaches of rules	• Attention directed to emerging problems

Can combine the two approaches



Why Adopt Risk-based Supervision?

- To improve supervisory effectiveness and efficiency
- To address internal organisational concerns
- To adapt to changes in the overseen industry
- To gain legitimacy following supervisory failure
- To meet requirements imposed by legislation
- To adapt to the changing nature of financial risks themselves, as these become more complex and - with the growth of DC pension systems - are increasingly transferred to individuals

Challenges to Introducing Risk-based Supervision

- Combining simplicity with complexity
- Knowledge and data
- Ensuring that assessments of firms are forward looking
- Going beyond the individual firm in assessing risk
- Structure and operation of internal risk governance processes
- Changing the culture to embed the risk based approach across the whole organization
- Managing blame
- Making resources follow risks

Risk-based Supervision DB vs. DC

RBS DB

- Focus on sponsor
- Solvency + funding issues key
- Use of quantitative measurement tools

RBS DC

- Focus on Individual Members
- Focus on Risk-management systems
- Qualitative measurement more appropriate

Is it right for everyone?

Yes if…	lots of funds
	DB / guarantees (based on solvency measures)
	lots of supervisory resources
	integrated authority (apply same model across all sectors)
Not necessarily if….	only few funds
	DC (quantitative not appropriate long term investments/ qualitative too subjective)
	developing pension market and supervisory authority (not got resources/ expertise - regulation based more secure / restrictions not such an issue)
	specialist authority (?)

New Areas of Supervisory Risk

CLIMATE / ESG

CYBER / FINTECH

ESG / Climate

- How it impacts financial sector

Climate risks
- Physical
  - Climate disasters
  - Gradual warming
- Transition

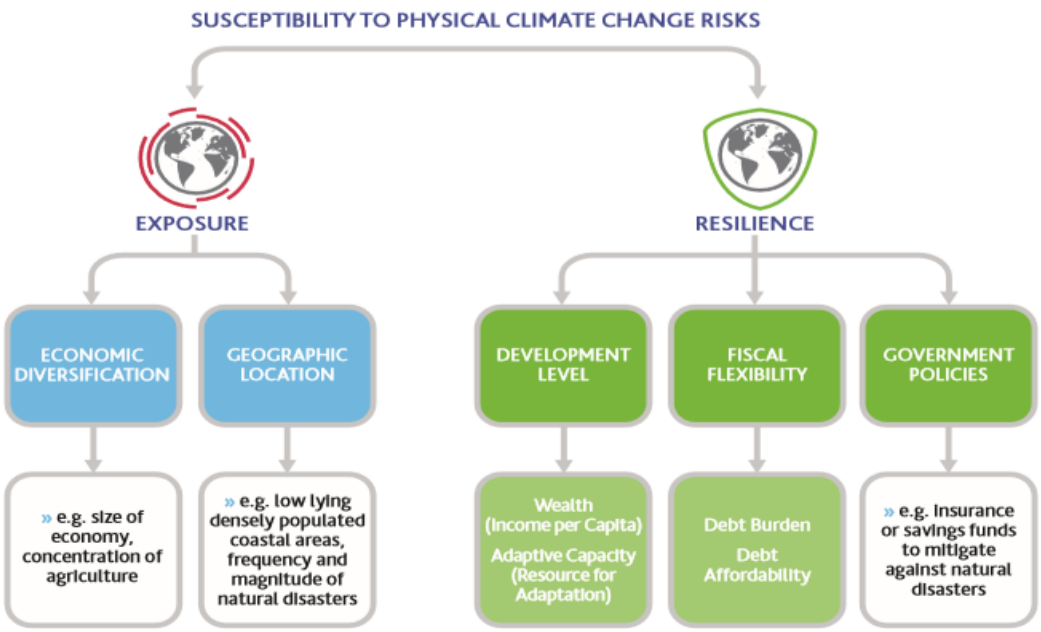
Financial risks
- Credit
- Market
- Operational
- Underwriting

Financial and physical assets valuations
- Less productive, damaged or stranded
- Risk premia

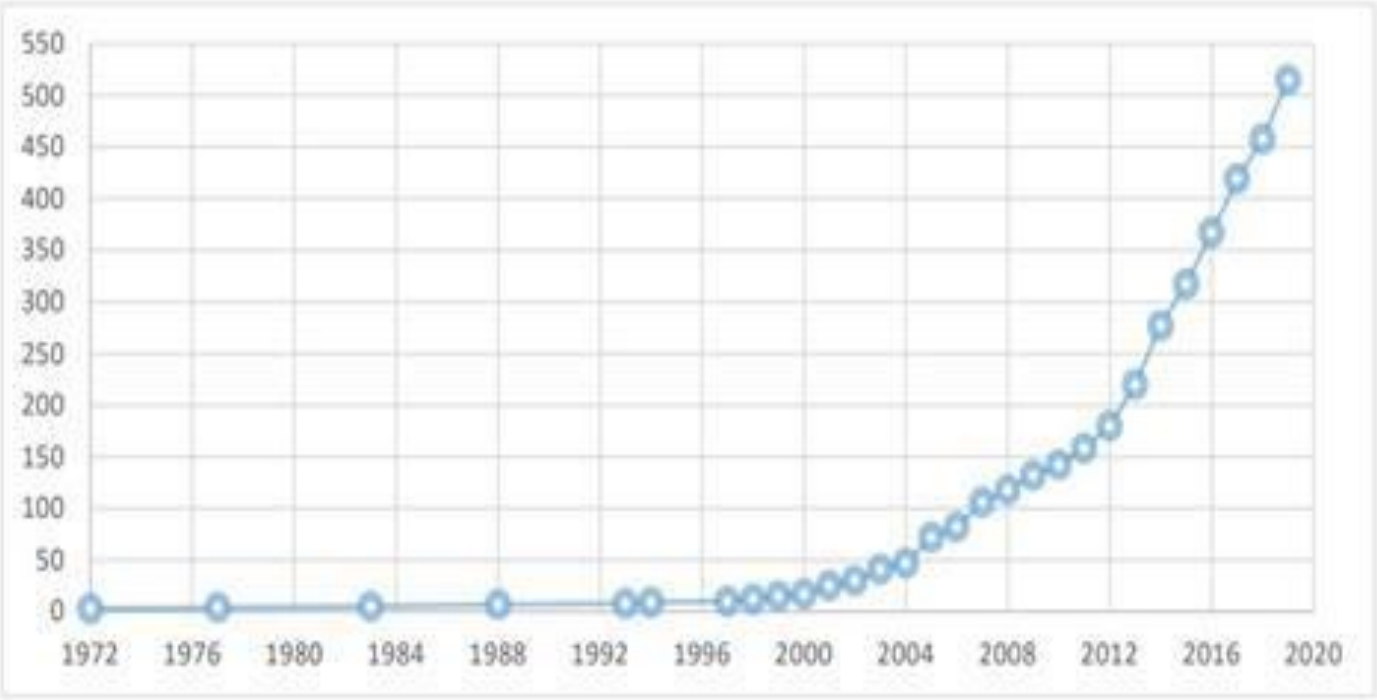
Financial sector balance sheet strength
- Institutional investors
- Banks
- Insurers

Financial sector ability to reduce climate risks
- Shift to low-carbon, climate resilient investments
- Disaster risk management

Macro-financial risks
- Financial stress and feedback loops
- Growth outlook and investor confidence



The Regulatory Response thus far -

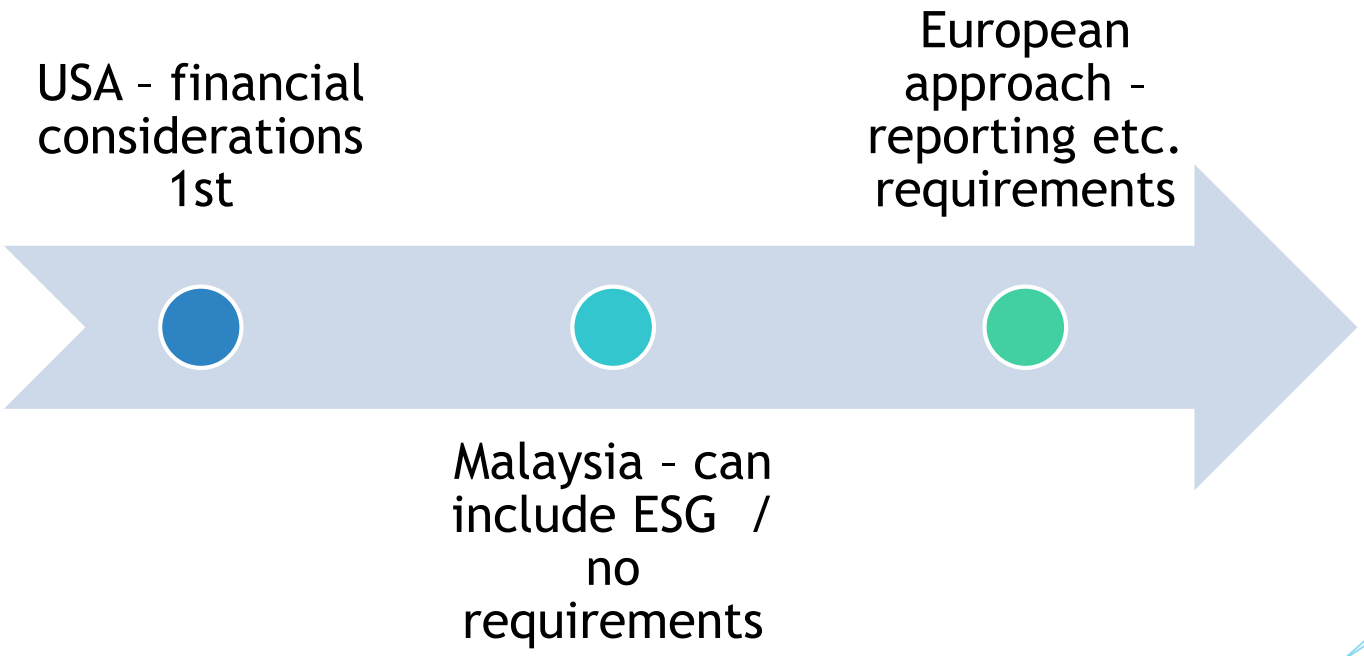


Cumulative number of policy interventions per year (source: PRI responsible investment regulation database, https://www.unpri.org/sustainable-markets/regulation-map).

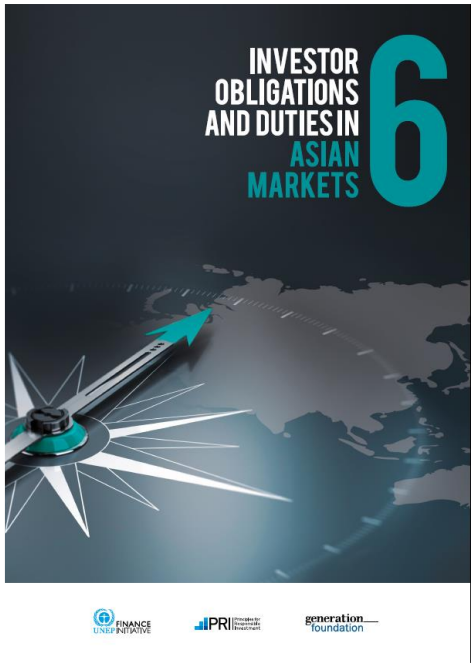
These policy instruments can be divided into three broad categories:

- Pension fund regulations, in particular disclosure requirements, and regulations encouraging pension funds to adopt responsible investment practices.
- Stewardship codes.
- Corporate disclosures. These include requirements to discuss ESG issues in annual reports and accounts, and requirements to provide disclosures on specific ESG issues.

Spectrum of Regulatory Approaches



Does Regulation Drive Practice? Or is it More Complicated?



MALAYSIA

EXPLORE NATIONAL REGULATORY CLARIFICATION

The Malaysian government could investigate clarifying each of the Employees Provident Fund Act 1991, the Retirement fund Act 2007, the Financial Services Act 2013, the Islamic Financial Service Act 2013 and the Capital Markets and Services Act 2007 to have all pension funds and investment managers take account of ESG issues, encourage high standards in investee companies and report on how they are doing so.

ENSURE THE EFFECTIVE IMPLEMENTATION OF THE MALAYSIAN CODE FOR INSTITUTIONAL INVESTORS

The Securities Commission of Malaysia could work with the investment industry to ensure the effective implementation of the Malaysian Code for Institutional Investors.

ENHANCE CORPORATE DISCLOSURE

Bursa Malaysia and the Securities Commission of Malaysia could analyse and report on the disclosures being provided by listed companies and could work together to improve the quality of these disclosures.

SUPPORT RESEARCH

The Securities Commission of Malaysia, Bursa Malaysia and the investment industry could work together to support high-quality academic research into ESG issues.

- UN PRI Asia Study: Public funds have a key role in driving market adoption/uptake of sustainable investment

Cyber / Fintech

SUBSTANTIAL NEW OPPORTUNITIES

SIGNIFICANT RISKS

Cyber/Fintech Opportunities

Industry – Growth & Efficiency

- New Channels to reach wider range of Individuals
- New Business Models, ‘smart’ contracts, products and services
- Optimization of operational processes and cost reduction

Customers – Increased Trust and more personalized services

- Increased trust and confidence
- More personalized products and services
- Easier access to information, facilitating decision making, better services at lower price

Authorities – More Efficient and Transparent public service

- Data collection, registration and analysis
- Automating reporting and compliance

Source: International Organization of Pension Supervisors (IOPS) Presentation to Africa Pension Supervisors Forum, September 2019

Cyber/Fintech Risks

Industry

- Concentration Risks, Increased Competition Pressure
- Operational Risks (Cyber, IT Security)
- Lack of Digital Competencies

Consumers

- Informational asymmetry between providers and consumers
- Complex products, data protection issues
- Fraudulent activities, online consent issues, complaints resolution

Authorities

- Consumer Protection Issues
- Challenge to Understand and Adequately react to changes
- Lack of Digital Competencies

Source: International Organization of Pension Supervisors (IOPS) Presentation to Africa Pension Supervisors Forum, September 2019

Supervisory responses to Cyber / Fintech

Reflect/implement "right-sized" regulations

Development of supervisory skills and resources

- Dedicated units/divisions?
- Training

Support Financial Innovation

- Stay close to industry
- Provide guidance
- Be a part of exploration process (innovation hubs, etc)

Closely monitor and address any potential risks

Publicity & Launching of Organized Awareness Campaigns

Maintaining Close Cooperation

- With Industry
- With other Supervisors Globally

Source: International Organization of Pension Supervisors (IOPS) Presentation to Africa Pension Supervisors Forum, September 2019

Focus Area – Technology Opportunity for Supervisors

- "Suptech" used by some supervisors for:
  - Data Collection (reporting, data management)
  - Data Analysis (market surveillance, misconduct analysis, micro and macro prudential supervision)
- Examples
  - Mexico – Technology platform used to supervise AFOREs
  - Others – Hong Kong, Liechtenstein
- Challenges
  - Technical, Data Quality, Operational
  - Legal, Reputational, Capability & Human Resources
  - Cost of these solutions

Source: International Organization of Pension Supervisors (IOPS) Presentation to Africa Pension Supervisors Forum, September 2019

Group Discussion

- What is your regulator doing as regards this climate risk? Where do they sit on the spectrum? Any impact on market behaviour?
  - 10 minutes group discussion
  - 5 minutes report out

- What has been the experience of your country in dealing with both the opportunity and risk presented by Cyber / Fintech? Are the risks really new risks?
  - 10 minutes group discussion
  - 5 minutes report out