Pension Regulation and Supervision
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Richard Hinz, Fiona Stewart
World Bank

Pensions Core Course
Pension Regulation
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
Pension Funds Are Profit Making Commercial Entities
Stockholders and Officers Establish Authority

Directive Outcome Oriented Rules
Define Specific Limits and Practices

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 Annuitzations, 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

<table>
<thead>
<tr>
<th>Control of Licensing</th>
<th>Pension Companies</th>
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<tbody>
<tr>
<td></td>
<td>– Fund Managers and Trustees</td>
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<tr>
<td></td>
<td>– Custodians, Actuaries and other Service Providers</td>
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<tr>
<td>Monitoring</td>
<td>– Financial Reporting and Auditing</td>
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<td></td>
<td>– Actuarial Reviews</td>
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<td></td>
<td>– On-Site Reviews and Investigations</td>
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<td></td>
<td>– Receiving Complaints &amp; “Whistleblowers</td>
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<tr>
<td>Measurement</td>
<td>– Comparison to Normative Standards</td>
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<td></td>
<td>– Risk Scoring and Evaluation</td>
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<tr>
<td>Communication</td>
<td>Disclosure</td>
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<td></td>
<td>– Outreach and Education</td>
</tr>
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<td></td>
<td>– Training</td>
</tr>
<tr>
<td>Intervention</td>
<td>– Notification of Violations</td>
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<td></td>
<td>– Directive Actions</td>
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<td></td>
<td>– Negotiated Resolutions</td>
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<tr>
<td>Correction</td>
<td>- Punitive</td>
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<td></td>
<td>– Remedial</td>
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<td>– Compensatory</td>
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Supervisory Approaches
SUPERVISORY STEPS

- Registration / Licensing
- Monitoring / Inspection
- Enforcement
- Market Development

- Punitive
  - Impose fine
  - Revoke license
  - Replace directors

- Sanctions
  - Court action
  - Freeze assets
  - Replace external service providers
  - Issue directions to management
  - Acceptance of court enforceable actions
  - Formal written warning
  - Informal verbal warning

- Enforcement
  - Conduct on-site investigations
  - Hold informal meetings with relevant parties
  - Request information from relevant parties

- Intervention
  - Protection
  - Protection
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
What is Risk-based Supervision?

- A structured approach focusing on identifying potential risks faced by pension funds and assessing the financial and operational factors in place to 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

<table>
<thead>
<tr>
<th>Compliance-based</th>
<th>Risk-based</th>
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</thead>
<tbody>
<tr>
<td>• Focus on compliance e.g. with tax and labour laws and (often) quantitative investment rules</td>
<td>• Identifies potential risks</td>
</tr>
<tr>
<td>• All funds get same degree of attention</td>
<td>• Assesses mitigating factors</td>
</tr>
<tr>
<td>• Detailed, often rigid, rules that are difficult to change to meet urgent regulatory needs</td>
<td>• Seeks proper management of risks</td>
</tr>
<tr>
<td>• Institutions focus is on compliance with rules, not risk management</td>
<td>• Allows scarce resources to be targeted at funds most at risk</td>
</tr>
<tr>
<td>• Point in time focus</td>
<td>• Forward looking and principles-based regulation</td>
</tr>
<tr>
<td>• Overlooks major risk areas</td>
<td>• Flexible</td>
</tr>
<tr>
<td>• No early warning system</td>
<td>• Incentives for institutions to strengthen risk management practices</td>
</tr>
<tr>
<td>• Duplicates work of auditors</td>
<td>• Supervisors use judgement to assess risk and quality of management</td>
</tr>
<tr>
<td>• Difficult to get meaningful comparisons</td>
<td>• Compliance checks done by audit etc. – removes duplication</td>
</tr>
<tr>
<td>• Penalises past breaches of rules</td>
<td>• Supervisor can benchmark institutions and assess overall industry</td>
</tr>
<tr>
<td></td>
<td>• Attention directed to emerging problems</td>
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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
<table>
<thead>
<tr>
<th>Yes if...</th>
<th>lots of funds</th>
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<tbody>
<tr>
<td></td>
<td>DB / guarantees (based on solvency measures)</td>
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<tr>
<td></td>
<td>lots of supervisory resources</td>
</tr>
<tr>
<td></td>
<td>integrated authority (apply same model across all sectors)</td>
</tr>
<tr>
<td>Not necessarily if...</td>
<td>only few funds</td>
</tr>
<tr>
<td></td>
<td>DC (quantitative not appropriate long term investments/ qualitative too subjective)</td>
</tr>
<tr>
<td></td>
<td>developing pension market and supervisory authority (not got resources/ expertise - regulation based more secure / restrictions not such an issue)</td>
</tr>
<tr>
<td></td>
<td>specialist authority (?)</td>
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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

**SUSCEPTIBILITY TO PHYSICAL CLIMATE CHANGE RISKS**

- **EXPOSURE**
  - Economic diversification
  - Geographic location
  - E.g. size of economy, concentration of agriculture
  - E.g. low-lying densely populated coastal areas, frequency and magnitude of natural disasters

- **RESILIENCE**
  - Development level
  - Fiscal flexibility
  - Government policies
  - Wealth (income per capita)
  - Adaptive capacity (resource for adaptation)
  - Debt burden
  - Debt affordability
  - E.g. Insurance or savings funds to mitigate against natural disasters
The Regulatory Response thus far -

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

USA - financial considerations 1st

Malaysia - can include ESG / no requirements

European approach - reporting etc. requirements
Does Regulation Drive Practice? Or is it More Complicated?

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

<table>
<thead>
<tr>
<th>Reflect/implement “right-sized” regulations</th>
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<tbody>
<tr>
<td>Development of supervisory skills and resources</td>
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<tr>
<td>• Dedicated units/divisions?</td>
</tr>
<tr>
<td>• Training</td>
</tr>
<tr>
<td>Support Financial Innovation</td>
</tr>
<tr>
<td>• Stay close to industry</td>
</tr>
<tr>
<td>• Provide guidance</td>
</tr>
<tr>
<td>• Be a part of exploration process (innovation hubs, etc)</td>
</tr>
<tr>
<td>Closely monitor and address any potential risks</td>
</tr>
<tr>
<td>Publicity &amp; Launching of Organized Awareness Campaigns</td>
</tr>
<tr>
<td>Maintaining Close Cooperation</td>
</tr>
<tr>
<td>• With Industry</td>
</tr>
<tr>
<td>• With other Supervisors Globally</td>
</tr>
</tbody>
</table>

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