VIII. PRIVATE PENSIONS SUPERVISORY METHODS IN HUNGARY

by
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Institutional framework, market structure and general approach to supervision

The Hungarian pension system is composed of the following three pillars.

a) First Pillar: a state managed, pay-as-you-go system. Participation in this system is mandatory for all insured people. The retirement age is 62 for men (by 2003) and will be 62 for women by 2009. The social security contribution is 8.5% for non–private pension fund members, 1.5% for private pension fund members, and 18% for employers. While employees contribute no more than twice the amount of their average wage, there is no upper limit to employer contributions.

b) Second Pillar*:* a privately managed, fully funded, defined contribution (DC) system without minimum benefit guarantees. Participation is mandatory for new employees (new entrants to the labour force). Institutions operating in this area are private pension funds. Fund members pay 7% of their gross salary, with an upper limit imposed by law. An individual may join only one fund.

c) Third Pillar is also a privately managed, fully funded, DC system without minimum benefit guarantees. Participation is voluntary for members. Pension funds have the same institutional framework as the second pillar. Members pay a minimum fee, set by fund regulations, taken from their own personal savings. However, employers are encouraged to support their employees' fund through generous tax and social security allowances; this implies that employers may pay the pension fund fee on behalf of their employees. Individuals have the legal right to join as many pension funds as they wish. Although the objective of the regulation is to ensure that officials benefit from this fund only when they officially retire, it is nevertheless possible to have access to the fund after ten years membership. Given that this fund was created in 1994, third pillar funds will become operational in so far as disbursements are concerned as of 2004. However, no major structural changes are anticipated once this process begins.

Features of the system which strongly influence the supervisory framework

***Institutional form of private funds*:** The owners of the funds are also its members. They make strategic decisions at general assemblies (election of the board and supervisory committees, etc.). The efficiency of this type of direct democracy is limited to certain funds (*i.e.* those funds with more than 100 000 members) and to certain financial groups, generally those operating personal plans. Employer-supported funds (occupational type) operate under strict member control.

Outsourcing of different functions: Pension funds may choose between in-house asset management and out-sourcing, the latter being more frequent. To a certain extent, this choice is based on administrative reasons in that pension benefits can be bought from insurance companies in the second pillar, but not under the third pillar.

One fund in two pillars: Pension funds are allowed to act in both the second and thirds pillars, but with separate accounts in the administration.

Decentralized collection system (Second Pillar): Each pension fund is responsible for the collection of contributions. This work dominates the administration work, since the largest funds collect fees from approximately 100 000 employers, respectively.

Mixed systems (occupational and personal) with same basic requirements: The pension system is based on personal and professional private funds, with only minor differences in their institutional framework. through Essentially, these differences pertain to relations between the board of directors and the supervisory committee.

Limited employer rights: Employers have the right to nominate one person to the supervisory committee if their financial support towards the payment of members' fees exceeds half of the fund's income. Although, employers often support the funds, they have only limited legal rights to influence its operation (indirect influence). .

Common investment risk bearing strategies: A fund has a single investment strategy. This is true for second pillar funds, and although third pillar funds can by law invest in more than one strategy, in general they limit themselves to one. In practice, members join a fund in order to ensure they will have a pension, but they do not base their choice according to the investment strategy of a particular fund.

The market

From the start, there has been rapid and continuous growth of membership and assets of pension fund markets, although this growth has in general been characterized by a continuous process of consolidationand mergers. By the end of 2003, 18 pension funds operated under the second pillar (as opposed to 38 pension funds in 1998), representing 2.2 million people (55% of the working population). Market concentration is very high, with the six largest funds (all sponsored by financial institutions) representing 87% of the membership and 83% of assets. Total assets exceeded HUF 410 billion (€1.7 billion) by the end of 2003.

Market concentration is slightly lower in the third pillar, even though consolidation of funds was very high (190 pension funds in 1998, and 82 in 2002). The market share of the fifteen largest funds is 83% of the total market membership and 80% of the total market assets. Employer-sponsored pension funds play a more significant role in that they represent 29% of the market's membership and 34% of the total assets. The market consists of 1.1 million people (about 15% are non paying members) and HUF 358 billion (€1.5 billion) asset.

Total assets collected by pension funds (both types) amount to approximately 5% of the GDP.

Supervision

The introduction of a third pillar also saw the introduction of a single supervisor in 1993. The State Supervision of Private Funds controlled only pension funds, health care funds and self-support funds. In April 2000, three different supervisory agencies (the State Supervision of Private Funds, the State Supervision of Insurance Companies, and the Money and Capital Market Supervision) were merged to form a single institution, the Hungarian Financial Supervisory Authority (HFSA)s. The HFSA is an integrated supervisory agency for all financial sectors and financial institutions in Hungary. At present, 541 persons are employed by the HFSA, which is financed exclusively by market participants. The most important income sources are the licensing and supervisory fees (the latter is currently set at 0.5%), which are regulated by law. Payment received from fines cannot be used for operational purposes, and must therefore be channelled back into the market (education, associations, etc.). The supervisory budget was 7.6 billion HUF (€32 million) in 2001. Financing is cross-sectorial, although the supervision of funds is not divided into cost-centers (neither on functions, nor on institutions).

The HFSA is based on directorates and departments, which represent the different functions of the supervisory body.There are four directorates operating in the organization: 1) on-site and off-site financial supervision, 2) licensing and legal enforcement, 3) analytical and methodology, and 4) the IT. The first two directorates are the largest, with 182 employees (including: 24 for healthcare funds, pension funds, and self supported funds) and 84 co-workers (9 for healthcare funds, pension funds, and self supported funds), respectively. There are several departments dealing with pension fund issues in the above mentioned directorates; however, not all directorates have departments dealing with pension fund issues. The research, strategy planning, customer service, and actuarial tasks are integrated under one directorateIn order to express the institutional specialties, there are four senior advisors overseeing the following sectors: money market, capital market, insurance and pension funds, and working directly under the president. The advisors coordinate the work of the same institutional departments from different directorates, and lead different projects. However, they do not have wide-range powers (*i.e.* establishing salaries or deciding on staff employment).

The supervisory approach is a pro-active one. The HFSA produces daily, quarterly and annual reports on the objectives and results of the pension funds. The Supervision Department of Pension Funds is composed of inspectors and supervisors, the latter lawyers from the Licensing Department for Pension Funds, the Monitoring Department, and the Actuarial Department. While inspectors are responsible for on-site examinations, the role of the supervisor is to maintain contact with the supervised entities and carry out off-site supervision.. All mandatory pension funds — mixed (mandatory and voluntary together), voluntary and problematic — are supervised. (). In view of the financial efficiency of a high number of pension funds, the HFSA is trying to institute a greater number of off-site supervision as opposed to on-site ones.

HFSA organizes preventive and prudential meetings with fund managers. Preventive meetings offers the opportunity to obtain non-quantifiable information, such as changes in management, in service providers and in strategic plans. In many cases, these meetings are required by fund regulations. Our experience shows that these meetings are more effective in attaining supervisory objectives than they are in collecting financial fines. Prudential meetings are necessary when the on-site or off-site controls reveal business activities which although legal, remain doubtful.

All activities are integrated so as to allow the control and compliance functions of the supervisory body to be fully operational. Current research calls attention to the risks associated with the top-down approach of the different institutions in the financial sector. (The Monitoring Department is responsible for the bottom up approach.) In addition, the HFSA publishes its recommendations for the supervised entities, which aim to communicate good practices for the various sectors. Market participants closely follow these recommendations.

Entry requirements

Legal requirements to licence or register a pension fund

The fund should ensure the smooth functioning of general assembly meetings, and accept business plan strategies and the election of the executive management staff. The HFSA provides the operational license if the fund is registered by the competent court and is registered with the Tax Authority. In the case of mandatory private pension funds, there is an additional requirement which is to obtain a social security registration number.

An HFSA license is necessary to:

a) establish a fund;

b) start the fund's operation;

c) implement the benefit regulations and to start the provision of fund services.

The organizations concerned shall certify the existence of the requirements specified. The HFSA may grant a three-year exemption from the actuarial degree or the required experience.

All funds require an HFSA license in order to be established. Voluntary pension funds must obtain an operational license from the HFSA if they intend to provide fund services, in which case the requirements for granting the operational license is identical with the provisions governing the foundation license.

The HFSA shall grant the foundation license and the operational license if the applicant fulfills the requirements listed in the law. The application for the foundation license and the operational license (hereinafter referred to as the "foundation license") shall contain:

- the draft deed of foundation,
- realistic estimates as to the planned membership,
- a presentation of how the founder intends to ensure the personnel, material and financial resources necessary to establish the fund, and
- the deed of foundation.

Based on the foundation license, the founder shall establish a deed of foundation, and, pursuant to the provisions, convene the first delegates meeting and commence to organize operation of the fund.

Documents requested in the case of mandatory private pension funds

The deed of foundation shall contain:

- the founder's name and registered office,
- the name of the fund,
- the date of establishing the fund,
- the scope of activity and the fund's registered office,
- the membership scope,
- the starting date of operation,
- the name and particulars of the person acting on behalf of the founder,
- the budget,
- the date of issuance of the deed of foundation, and
- the official signature of the founding organization.

The fund shall submit the following documents when applying for an operational license:

- the foundation's deed,
- the fund regulations,
- evidence that the application for registration has been submitted to the court, or the final legal decision on registration,
- document verifying that the fund has a tax number, a bank account and a social security registration number,
- documents verifying the number of members specified in the law
- the business plan,
- the regulations governing asset management, benefit provision, and, if the fund's assets valuation regulations is more detailed than required by the legal regulation, the assets valuation regulations,

- the particulars of the members of the Board of Directors, the Board of Supervisors and the auditor,
- documents verifying fulfillment of the personnel and material conditions necessary for conducting fund activities in accordance with the law,
- a declaration on the intended starting date of operation,
- a declaration certifying that the fund is prepared for the data reporting obligation in accordance with the law,
- the regulations referring to the fund's internal control and auditing system,
- any contracts concluded by the fund commissioning other organizations to conduct operational and administrative activities,
- the contract concluded with the custodian, and
- a declaration certifying that the fund shall disclose to an independent assessor registered by the HFSA information as is indispensable for evaluation of the fund's performance. Such information, however, shall not include trade secrets.

Documents requested in the case of mandatory in case of voluntary private pension funds

The deed of foundation shall contain:

- The founder's name and registered office,
- The name of the fund.
- the date of establishing the fund,
- the scope of activity and the fund's registered office,
- the membership scope,
- the starting date of operation,
- the name and particulars of the person acting on behalf of the founder, the budget made available,
- the date of issuance of the deed of foundation, and
- the official signature of the founding organization.

The fund shall attach to the application for the operational license:

- the minutes and the registration sheet of the General Assembly
- the deed of foundation,
- the Fund Regulations,
- evidence that the application for registration has been submitted to the court, or the final legal decision on registration,
- tax number, a bank account number and a social security registration number,
- the financial plan,
- employer contract (if any),
- the regulations governing asset management, and benefit provision, and
- the contract concluded with the custodian (service providers if there are outsourced activities).

Procedures for analysis of the documents

All documents are verified by the Licensing Department of Pension Funds, by the Fund Controlling and Enforcement Department, the Department of Actuaries, and the Department of Policy and Methodology.

The licensing department examines the completeness of the foundation request, the documents of the foundation General Assembly (GA) meeting, and its constitution. They also examine the necessary declarations, tax number, and court registration.

The Supervision Department for Pension Funds examines the business plan. The Actuarial Department examines the preliminary business plan as a whole, including the services, the calculating methods and its accuracy, the detailed plans and working ability of these plans.

The Department of Policy and Methodology examines the whole of the documentation and the correlation between all the documents submitted.

The Licensing Department of Pension Funds summarizes its professional opinion (and if necessary, consults with other involved colleagues and fund members).

The fund's application for the operational license shall be rejected by the HFSA if the application and the attached appendices fail to meet the requirements established by law. It is also rejected if the fund fails to fulfill any request for remedy of deficiencies by a given deadline.

The HFSA may call for the modification of the submitted documents if, based on such documents, it can be assumed that the fund's operation is not safe, or if the submitted documents contain professionally inappropriate provisions.

Evaluation of the business plan

A business plan is required for the licensing of a fund. The HFSA analyses the licensing, and its on-site control of the current plan, which has certain requirements laid down in the law. (Until the end of 2003, pension funds had to report their plans to the supervisory agency on an annual basis.) Actuaries, economists and lawyers examine whether:

- membership and asset development is realistic,
- fixed and variable costs are covered by income and operational reserves,
- all costs are included in the plan concerning the activities,
- all fund functions are taken into account, in comparisons with the contracts,
- outcomes (including benefits) are planned in timely fashion,
- rate of returns are in conjunctions with the expected capital market developments, and
- the plan is consistent with capital and pension fund market developments, and the plan own regulation.

Applying for tax benefits

As mentioned above, the pension fund – following its foundation but awaiting its operational license – is registered with the Tax Authority and given a tax registration number. With this number, the fund is able / authorized to issue tax certificates and at the end of each year issues a certificate on membership contributions to each member. That person will then indicate the amount in his/her personal income tax avowal, enabling him thus to receive a tax allowance or reduction. If the employer deducts the member's fund contribution, then the tax allowance is deducted from that member's salary along with other monthly tax deductions.

Provisory and permanent licenses

The HFSA issues only permanent licenses. However, when the new pension system began operation, there were cases when the HFSA gave out licenses for clearly defined periods of time.

In the case of mandatory private pension funds, licensing is a two-step process. The pension fund can start its operation — organize its activities, recruit members, and collect membership contributions — when the fund receives its foundation license. Providing services, however, can only be started when the fund receives its operational license. There are 180 days between these two steps, during which time all necessary documents must be assembled and up to 2000 members recruited. Should these requirements not be fulfilled, the fund loses its foundation license. It must then decide whether to apply again or withdraw / liquidate its application / assets.

Revocation of licenses

The number of voluntary private pension funds is decreasing because of market concentration (due to mergers, liquidation, etc.) Although all three types of funds have developed dynamic strategies, the results are such that the funds seem to be precarious. Operational licenses can be revoked for the following reasons: not adhering to legal obligations and establishing rules which are contrary to the law. It can also be revoked if the fund is not properly registered. The funds existing prior to the institution of the new rules have in most cases been liquidated.

Table IX.1. HSFA — Registration of pension funds

	1999	2000	2001
Mandatory private pension funds	3	—	—
Voluntary private pension funds	2	2	1

Table IX.2. HFSA — Applications for pension funds registration denied

	1999	2000	2001
Mandatory private pension funds	—	—	—
Voluntary private pension funds	—	2	1

Reporting and approving posterior changes in the initial status of the pension fund structure

In the case of voluntary private pension funds, it is generally not necessary to seek approval for changes made *a posteriore*. Amendments to the foundation's licenses and to contracts with service providers must be sent to the HFSA. In certain cases, the HFSA can require further amendments to these documents.

The voluntary private pension funds have the opportunity to run / operate supplementary business activities; however, they need special authorization / approval from HFSA for this. In the case where the fund wishes to operate an optional portfolio system (different portfolios with the same fund), it needs to receive special approval of the HFSA for this.

In the case of mandatory private pension funds, the HFSA should approve the rule of services and all of amendments related to it. For other rules and contracts, the same regulation is in practice as for voluntary private pension funds.

On going supervision

Information and the documents required, the frequency and the procedures for off-site supervision

Compliance with governance rules: Funds must invite representatives from the supervisory agency to their general assembly (GA) meetings and report the minutes. Supervisors attend these meetings and are often queried about legislation by fund delegates. In so far as off-site supervision is concerned, lawyers examine the GA minutes, the election of new board members, and the fulfilment of their legal requirements. This task is comprehensive at the time of licensing. Member complaints often initiate investigations.

Contribution rules: The rules of contribution (amount, timing, collection) are regulated by law in the second pillar, and by the fund constitution in the third pillar. The latter are less restrictive and take into account that fund members join these fund on a voluntary basis and cannot be forced to pay. In the mandatory pension fund rules, compliance is strictly imposed. Special processes regulate the task of pension funds if contributions are not paid correctly and on a timely basis. If the employer does not solve the problems on fund request, this must be reported to the tax authorities and to fund members. During on-site inspections, the supervisory agent examines whether or not the fund adhered to regulations.,. Quarterly reports present the development of the "not clear" contributions paid to the fund (off-site), and where this figure is increasing, HFSA requires clarification and measurements to deal with it. It is intended that there will be a central supervisory administration which manages personal and payment data on every fund member in the second pillar. This project has not yet been completed. Many recommendations are published for the funds about the collection of contributions, the reconciliation with employers, and the processes with tax authorities.

Membership and portability (enrolment process, transfers and compliance): Members in the second pillar must adhere for a period of least for six months. Switching funds is not limited to voluntary funds. Members who wish to change funds must submit a written request with either the new or the former fund. The amount of the personal account is transferred to the new fund on a quarterly basis, which in turn is based on its market value. Between the last day of the quarter and the time of the transfer (legally regulated) funds must yield the required amount. The law limits the costs, which are deducted at the time of transfer. Inspectors verify that transfers are done properly. Such verification includes compliance with the transfer schedule, the correct calculation of the transferred amount, and the pricing and cost of deductions resulting from that transfer.

Investments, asset allocation, performance measurement and attribution, risk management: Mandatory pension funds and large voluntary pension funds must submit to the supervision the asset allocation of their portfolio (securities, prices) through their custodian on a daily basis. Quarterly reports and annual reports contain more data on membership, contributions and outcomes (costs, benefits). Although the reporting of the achieved rate of return is part of the quarterly report, HFSA focuses more on the annual data. The supervision emphasizes and examines not only fund compliance with legal investment limits, but also the investment policy of that fund. Daily reporting, which also presents this information (off-site and on-site controlling combined), can verify asset pricing.

Within the framework of on-site investigations, inspectors examine the correct performance calculation and cost deduction (asset management and custodian fee). Attribution analysis is not a supervisory task (it is done by rating agencies), although HFSA has issued a research paper on the different performances, fee structures and amounts of different institutions of the same financial group. This "fine tuning" measurement has achieved its market impact. The lack of historical data over the long-term renders difficult the use of risk management tools. However, HFSA analyses the differences between fund and benchmark performances (alpha), relative to the market average. More sophisticated models (VaR) are in the preparation phase.

Minimum capital and reserves: There is no requested minimum capital for the operation set by law. However, HFSA examines the income-outcome balances in comparison with the invested capital, verifies that there are reserves for operation and, where it is applicable, the actuarial fair calculation of the benefit reserves.

Custodian procedure: The custodian is the most important market partner of a supervisor to control pension funds. Every transaction (securities and payments) must flow through the custodian. He is responsible not only for technical functions (settlement, safekeeping, etc.), but must also verify the work of asset managers (if the limit is exceeded, this must be reported to the fund and the HFSA) and is responsible for the pricing of securities. The Delivery Versus Payment (DVP) system enables pension funds to avoid partner risks. Asset managers may not hold securities and money from the bank (with few exceptions). HFSA, as an integrated supervisory agency; is able to check any transaction at the different stages of the deal, etc., at the custodian level, at the pension fund level, and at the asset manager level. All can be fined after an investigation, which is not always the case under the separate supervisory agencies.

Checks on the performance of outsourcers: One of the main tasks of the Supervision is to make sure that the supervised institutions adhere to the law. Checking of bad or good performances of the supervised institutions is not a supervisory task. The violation of law, however, could play a role in cases of good or bad returns. Therefore, the main responsibility is verification of compliance with the regulations. HFSA examines the control mechanisms of the outsourcers by the fund management; whether payments and services correspond to the contract, and that these are documented. The supervision also investigates the functioning of internal control mechanisms.

Financial, actuarial and accounting methods: The financial plans of the funds serve as a starting point for the financial control. Increasing the number of members is crucial for the fixed and variable costs, which are backed by contracts. Taking into account the actuarial forecasts, the timing of the outflow from the funds, and the financing of the operation can be evaluated. There are different ratios, which indicate the expected working life of the fund without new members, and without new income. Applied financial ratios belong to EAR (earnings), CAPOZ (capital), LQ (liquidity) and APO (asset and portfolio) groupings, and used for the ongoing monitoring. In order to strengthen the consolidated function of the HFSA, these ratios are set up in a unified function matrix for each supervised sector. For instance, the same activities at pension funds, insurance companies, banks and capital market institutions are measured by the same or similar ratios. The verification of accounting methods starts with the examination of the accounting and controlling systems. The payment and transfer processes are also investigated. The correctness of the bookkeeping is checked by sample tests. Transactions are controlled randomly, taking into account the amount, season, timing and the contracted partners.

Information to potential members and other distribution issues: In the framework of the on-site controlling consulting offices and their documents are checked. It is very difficult to investigate the work quality of the agents; the supervision focuses on payments to them and services rendered. However, the integrated characteristics of the HFSA offer an excellent opportunity to control the agents' registration and history.

Administrative cost, fees and marketing: The supervisory task is to check the title and reason of the costs, compliance with the law (limited amounts), contracts and with the fund's own regulation (entry, switching, withdrawal, retirement), the cost control (internal controlling) mechanism, and the adequate level of operational reserves. Marketing documents can be used as a reason for investigation if they contain unrealistic promises and their content is against the law (annualized monthly performances, false performances, etc.).

Disclosure to members: The copy of the announcement proves the fulfilment of the disclosure requirements. HFSA controls the sending of the annual individual account and its content (on-site).

Funds' websites: Checking of the funds' websites is not part of supervisory investigations. However, based on client complaints it can initiate an on-site examination. Nevertheless, internet does not yet play a major role in the development and functioning of financial institutions (including pension funds).

General organization, IT procedures, internal controls of on going supervision

Investigations will occur if:

- the operation of the supervised institutions, or the whole financial sector (its segment) indicate immediate intervention;
- there is a suspicion of illegal activities, or
- other state or private entities, responsible professionals, or clients report acts which are not in conformity with the law.

Pension funds are informed at least 45 days in advance of any comprehensive investigation. The deadline is three days for planned, targeted and follow-up investigations. In emergency cases or when the information could limit the effectiveness of the investigation, these deadlines may be changed.

According to annual plans, the Monitoring Department prepares ratios for the investigation in order to support its effectiveness. Because of this, the supervisor of the affected fund sets up a conceptual summary about the most important features and information of that fund, and he/she gives it to the head of the on-site inspection with the suggested control points. Based on this information, the head of the on-site inspection prepares the actual, concrete control plan derived from the general control plan and discusses it with the supervisors. According to the emphasis and the type of investigation, the head of the supervision department responsible for the on-site inspection designates the members of the team. The assignment of the off-site supervisors is the right of their heads of departments (for instance, actuarial, legal, IT) on the recommendation of the supervision departments.

People working on off-site and on-site inspections are responsible for different parts of the control plan, but all results of their activities are submitted to the head of the team. During this period, they must follow the instructions of the team leader. If there is an urgent reason to extend the time of the investigations, the team leader is allowed to decide it alone, up to 20%.

Monitoring the risk level of pension fund portfolios

The supervision applies different ratios to monitor the risk level and effectiveness of the portfolio. Simple ones represent the asset allocation by asset type, by issuer, liquidity, and their changes. Liquidity is also measured by the connection to the expected outflow. Relative measurement aims the comparison with the targeted benchmarks: differences with the investment policy and with the benchmark performance (α).

Advanced methodologies are in the preparation phase. The use of Value at Risk model is the most likely methodology to be used for risk monitoring. ALM models are not relevant because of the DC characteristics of the system, and the market is still in the accumulation phase.

Planning on-site inspections

The president of the HFSA regulates the processes and responsibilities in a Presidential Direction. The different types of investigations are: (i) comprehensive, (ii) targeted and (iii) follow-up. Investigations can be targeted towards one entity (alone) or towards a group of entities with the same leadership or belonging to the same financial group. Investigations can be conducted by the HFSA itself or by external firms, and can be carried out either immediately or after advance warning of the dates that this investigation will occur.

Departments must submit all investigations they would like undertaken, along with the reasons for those investigations, by a specified date. A list is the compiled and submitted to the general management meeting for approval. The president makes the decision by the end of the third quarter. Based on the final version of the plan, the department of coordination informs the directorates in order that they may plan the staff necessary for each investigation. The supervision departments inform the supervised institutions about the expected time of the investigation.

On-site inspections take place every two years at mandatory pension funds (determined by law) and every 2-3 years for voluntary funds (by practice). The length of the inspections lasts 3 to 15 working days depending on the asset size and the number of members of the fund. Current changes aim to shorten the time and frequency necessary for effective on-site inspections, and to turn to off-site inspections on a more frequent basis. Targeted investigations, rather than comprehensive investigations, must play a more important role.

As of 2002 the outsourcing of administration activity has been under HFSA control. However, there is no legal obligation for the frequency of their inspections, the supervision having examined all independent companies. The aim of these investigations is to ensure that the pension funds' administration can be checked through these service providers.

Documents required and the procedures for inspection

The most important documents are:

- Regulation about benefits.
- Regulation about the return allocation.
- Regulation about the payments to members (switching).
- Regulation about the reserves.
- Regulation about the handle of the client complaints.
- Regulation about the client services.
- Regulation about the protection of personal data, and business secret.

- Prospects, documents, letters about annual accounts sent to the members.
- Contracts about the rent or the ownership of the offices.
- Announcements about the general assembly.
- Minutes about the board and supervisory committee meetings.
- Accounting policy
- Copies about the disclosers.
- Regulation about the cash and payment processes.

Frequency and intensity of the inspections

Depending on the size of the fund, two to eight people can conduct the investigation. The team leader is always an economist from the supervision department. In the case of inspections of smaller funds, the investigative team is composed of staff from the supervision department only. In the case of inspections of bigger funds, other experts, such as jurists, actuaries, and IT experts take part. These professionals have long supervisory (5-10 years) experiences. In 2001, 160 on-site investigations took place. Apart from on-site inspections, there are six meetings with funds' directors and managers per month. Depository institutions and rating companies are also supervised.

Compliance, enforcement and sanctioning

Main irregularities observed during on-site and off-site supervision and the applicable fines, other penalties and enforcement procedures

Typical or frequent problems are:

- Deadlines for payments (switching) to members are not respected.
- Costs deducted from members are against the law.
- Returns are allocated to members in the wrong way.
- Fund regulations are not updated to reflect current legislation.
- Control and self-regulation of the IT systems is not sufficient.
- Board meetings are not properly documented at smaller funds.
- The controlling of the asset manager (outsourcing) by the pension fund is not effective.
- Auditors do not carry out their duties.
- The calculation of the achieved rate of return is not proper.

Reasons justifying an intervention in a pension fund or a pension fund managing company

In the case of both pension fund types, independency and self-supporting is a basic principle. Therefore, the HFSA can intervene in the operation of the fund only in justified cases. The HFSA intervenes in the interest of the fund members, and that the fund respects legal requirements. The reasons for intervention are similar to those disclosed during the controls

The HFSA can also intervene if the financial condition of the fund is not adequate. However, there was no example of this.

In certain cases, the HFSA intervenes if the management of the fund is not prudent or violates the prudential rules. Until now, there has been only one case of this. Therefore, general conclusions cannot be withdrawn.

Procedures for interventions

Legal assertion has basically three forms, which are the following: a letter from the HFSA management; an imperative letter and public administration resolution.

Legal assertion is the task of the Fund Licensing Department, which basically complies with the memos of involved departments, as well as the observation of the licensing department. The most important documents are the closing resolutions of the inspections (minutes-reports; observations of the fund, evaluation of the observations, executive summary, minutes recorded during the inspection).

According to inspection documents, the licensing department prepares a draft resolution in consultation with the supervision department. Following this, the resolution is signed by the appropriate manager, and sent to the fund. The HFSA closes all its inspections with a resolution. Their observations, which concern actions not necessarily against any law or regulation but which are nevertheless criticized by the HFSA, are notified by letter to the management level of the staff by the head of supervision department .

In the case where the data arrives late or is suppressed, the data control department sends an imperative letter to the fund to fulfill its duty. If this is still not sufficient, then DC department prepares a memo to the licensing department to impose a resolution. All facts are detailed in this resolution and the DC department proposes a fine/penalty. Following this, the licensing department issues the resolution.

In the case of mandatory private pension funds, the Central Registration of Pension Funds Department acts in accordance to the data provided. If necessary, the Central Registration of Pension Funds Department sends an imperative letter to request the missing data. The CRPF Department notifies the supervision department and, if necessary, notifies the legal department if they require a resolution or proposal for fining the fund.

The documents of the General Assembly (GA) meetings arrive at the supervision department, who forwards the documents with an accompanying letter to the licensing and the actuarial departments. The supervision department summarizes the observations of the memos and if necessary sends an imperative letter to the fund. On the basis of the documents received from the fund, the supervision department comes up with a proposal for arrangements and sends it to the licensing department. The licensing department issues either an imperative letter or a resolution which makes the necessary arrangements.

Table IX.3. Number of sanctions in pension funds by type

	1999	2000	2001
Resolutions	350	225	279
Suspension of member recruitments	2	1	4
Calling for Extraordinary GA meeting	20	1	3
Ban of payments*	0	3	2
Suspension of the operation*	0	3	2
Withdrawal of operational license	18	10	16
Launch for liquidation	6	18	14
Penalty	39	26	44

* Same cases

Notes:

- Withdrawal of the operational license can happen as sanction or in cases when the fund winds up without a legal successor,
- launch for liquidation can happen when the fund is not able to close its operation (few members and do not attend on GAs), and is connected to the withdrawal of operational license in many cases.

Conclusions

Supervising pension funds is a challenging task. The legal framework is always changing; and supervisory methods must follow. The most important features of the current Hungarian experiences indicate the following:

- A shift from on-site towards off-site supervision in order to use the supervisory resources more effectively, although on-site cannot be negligible.
- Supervisory goals and compliance with the regulation can be achieved in many ways, such as through preventive meetings with fund management, supervisory recommendations (guidelines), and fines ("last solution"). These must be implemented on an individual case-by-case basis (no general ranking of their effectiveness).
- Although publication of the resolutions is an HFSA basic rule, it also acts as a strong supervisory power for market participants. It is a difficult task to separate objective and subjective measurements because they are interdependent, and many of the subjective characteristics cannot be measured objectively.
- The focus of investigations must comply with the development of the market (life cycle). At the start, it is the administration which assumes the main risks, followed by the market (investment risk), and finally the actuarial sector (liquidity risk). In addition to the risk characteristics of the market, the other influential factors are the size of the market, the maturity of the market, market concentration and role of other professionals (custodians, actuaries, auditors).
- There is no general rule. Every country must find its own way, for instance it is not the structure of the supervision (integrated, separated) that is essential, but rather how the supervisory goals can be achieved more effectively. Development and changes of supervisory tools is a continuous task: HFSA analyzes its own monitoring system with the objective of making changes whenever necessary.

The following are suggestions for further work.

- Watching for trends in the supervisory approaches.
- Selected topics for more in-depth analysis include risk-based monitoring, effectiveness of different supervisory tools (fines, sanctions, guidelines), and the advantages-disadvantages of different approaches (on-site, off-site),
- Benchmarking of the supervisory structures (employments) is also a tempting topic, but it can be misleading because of differences in supervisory activities.

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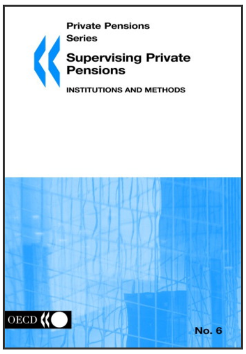

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