I. SUPERVISING PRIVATE PENSIONS: AN INTRODUCTION

by
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In many countries, an ageing population and high (and growing) public spending on social security programmes have led to structural reforms of the pension system. Privately-managed plans, both occupational and personal, play an increasingly important role in supplementing state-run mandatory schemes and in compensating the reduction in benefits they will be able to secure to beneficiaries.

Public confidence in the fair and correct functioning of privately-managed plans is a crucial prerequisite for assuring political consensus for pension structural reforms. Appropriate regulation and effective supervision of private pension plans are crucial factors to reinforce confidence, protect beneficiaries and guarantee the financial security of pension plans.

Regulation of private pensions has thus received increasing attention in recent years. OECD has played a leading role in this area, first in the context of a research project on ageing societies and then through the activity of the Working Party on Private Pensions (WPPP), established in 1999. Since then, a set of principles and guidelines has been developed, setting standards for appropriate regulation, for the protection of the rights of members and beneficiaries and for the governance of pension plans and funds. Guidelines on further profiles of private pensions are currently being examined and will be issued in the near future. In July 2004, the OECD Council issued a *Recommendation on core principles of occupational pension regulation,* that is based on the work developed so far in the WPPP.

There has been little work until recently, however, in the specific field of supervision. Even amongst those responsible for pension fund supervision in

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different countries, their knowledge of supervisory structures, strategies and practices put in place elsewhere is limited. This is in contrast to other fields of financial intermediation (*i.e.* banking, insurance, etc.) where the development of cross-border activity and the need for a level playing field has encouraged, since the 1970s, agreement on a set of rules leading to similar regulations and supervision between countries.

Although cross-border activity in the area of pension funds is still limited, ensuring and maintaining confidence in the proper functioning of private pensions is increasingly viewed as a public policy priority. As such, knowledge of other countries' supervisory frameworks is an important opportunity to identify good practices and to learn from other countries' experiences.

In 2002, the OECD Working Party on Private Pensions initiated work in the field of supervisory structures and methods. A detailed questionnaire on supervisory structures was completed by OECD Delegations. In addition, a small, informal task force was set up to examine supervisory practices and methods. The work of this taskforce has been undertaken jointly by the International Network of Pension Regulators and Supervisors (INPRS), an informal worldwide network established with the support of OECD. This partnership has made it possible to extend the scope of the analysis to a much larger group of countries.

This book brings together the work accomplished so far on supervisory structures and institutions, and supervisory methods and practices. The first six chapters part contains survey papers that offer a comparative analysis of different profiles of supervisory structures and methods in OECD countries, and/or in specific regions or groups of countries. The following chapters second part contains five seven "country-case-studies" describing in detail the supervisory structure and methods put in place in the five different countries. It provides a wide variety of situations as well as different "styles" of supervision.

The authors of the papers are, in almost all cases, officials personally involved in defining strategies and/or carrying out day-to-day managing day-by-day operations in national supervisory agencies. This book represents, therefore, a unique, first-hand source of information on how pension fund supervision is organized and conducted across countries.

Supervisory structures

The Fifteen principles for the regulation an supervision of private occupational pension schemes, approved by the OECD WPPP in 2000, contain the following principle concerning supervisory structures:

Effective supervision of pension funds and plans must be set-up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.

On the basis of the information that has been collected, it is possible to be confident that in almost all OECD countries the institutional design of supervision is very much in line with the above stated principle. However, two main observations can be made.

First, while the requirements identified in the principle are all very important, other features of supervisory structures should also be considered as crucial, such as:

- the provision for a well-defined mission statement for the supervisory authority. This should be accompanied by sufficient financial means and a not too detailed legal definition of specific tasks and controls to be performed. An appropriate mission statement provides for adequate flexibility, allowing the supervisor to effectively adopt a risk-based approach and concentrate his activity and resources on the factors that are most important for the protection of beneficiaries and the security of funds;
- the recognition of the need for co-operation and for information sharing arrangements between different supervisory authorities, or between departments within the same authority in the case of integrated supervisory structures;
- the design of the governance of the supervisory authorities. In the composition and the functioning of the governing boards, while it is crucial to ensure operational independence and professional expertise, it is also important to provide for accountability mechanisms, not only with respect to the government and/or the Parliament, but also to the interested parties from the pensions industry. In fact (as well as the top managers of the supervisory authority), representatives of employers, trade unions and the financial industry are sometimes included in the governing boards.

Secondly, the findings presented here show a large degree of diversity between national institutional structures of the private pension funds supervision in OECD countries as a function of different factors. These include the institutional history of supervision, the political and administrative organisation of the state (federal, unitary, centralised, decentralised); characteristics the pension scheme (mandatory, voluntary, occupational, personal, defined contribution or defined benefit); and market structure (number of funds/plans, type of fund/plans, market concentration degree).

Three private pension supervisory structure models have been identified: (i) a specialised pension model, with one or more agencies dedicated exclusively to pension fund supervision; (ii) a partially integrated model, with one agency responsible for insurance and private pension supervision; and (iii) an integrated model, with one institution responsible for the overall financial sector supervision, including banks, securities, insurance companies, and pensions funds, and sometimes also banks.

None of these three models currently holds a general position of dominance. In the 28 countries examined in the paper by Carvalho-Pinheiro, there is an even spread of these three models (Table II.2). In several of the country replies quoted in both this study the mentioned paper and the one by Demaestri and Ferro, several arguments are presented in favour of integration. These include the expansion of financial conglomerates, economies of scale and scope in supervision, avoiding the problem of overlapping authority, consistency between supervisory objectives in different sectors, and efficiency of information flow.

Arguments in favour of specialisation are related to the specificities of private pension arrangements with important social profiles and specific tax treatments, which require a different approach regarding the supervision of their risks and their relations with members. This seems particularly to be the case as regards occupational schemes, where the role of employers and often of trade unions is crucial, and the pension fund frequently is a non-profit institution that serves as an intermediary between its members and financial markets. In fact, there are countries with integrated agencies for the financial sector that maintain separate, segregated agencies for occupational pension plans (Japan, Sweden and the UK).

A single case (Australia) is also reported as having two agencies competent for all financial sectors/intermediaries (included pension funds), and functions specialised by objectives (prudential supervision *vs* consumer protection). More recently, also the Netherlands decided to adopt a similar model.

The observed diversity suggests that the final objectives of supervision (protection of members, security of funds and plans) may (and probably should) be sought by means of different institutional frameworks in different countries as a function of the institutional context and the structure of the pension system. This finding is in line with the conclusion already reached by other OECD studies (Lumpkin, 2002) for the supervision of the financial services industry. In fact, when the peculiarities of pension funds are considered, the case for a variety of different possible approaches to supervisory institutional design seems even more convincing than in the case of the financial industry *stricto sensu*.

Supervisory methods

The OECD WPPP initiated work on supervisory methods by establishing a small, informal task force in 2002. Two meetings, in December 2002 and June 2003, were held under the joint aegis of OECD WPPP and the INPRS. The work aimed to review and describe supervisory procedures used in different countries in order to improve mutual knowledge and provide international comparative information, with the possibility of identifying good practices. The objective to set standards and define guidelines seemed too far away and was not considered during this first stage.

It was decided to produce a set of country-case-studies that would cover a variety of situations and possible approaches to supervision. The comparison of country cases would show how different practices and techniques are used in different situations and would lead to the identification of regularities, and possibly "good" practices as a function of circumstances.

The focus of the analysis was the operational management of the supervision in the context of its customization to the market, legal framework and supervisory structure. It was agreed to give attention to the operational and day-to-day aspects of the management of supervision, and to the changes in the supervisory methods that occur in response to changes in the economic conditions, legal framework, government philosophy, supervisory structure, and/or market conditions.

The primary attention was put on occupational pension plans, although treatment of personal pension plans was demanded where such schemes are important. On the other hand, the scope of the study excluded insurance contracts as such (although they may be used in both occupational and personal pension plans) in so far as the supervision on insurance is a topic that already receives attention in other contexts.

Despite their potential and actual diversity, national supervision systems were to be analysed using as a reference the model proposed by the Basle Committee for the entire financial sector, that comprises three components: *ex ante*, on going and *ex post* supervision.

Authors from five countries volunteered to produce and actually delivered their own case-studies: Australia, Hungary, Ireland, Mexico and United States. Other two case-studies (Bulgaria, Hong Kong) were later added in collaboration with the World Bank. The seven country papers are reproduced in this book.

The country papers offer a synthetic, introductory description of their approach and of the main elements of the actual organization and management of supervision (i.e. reactive vs. proactive, risk-based, etc.). Primarily as a function of the institutional and market context, the general approach to supervision and its organization and procedures varies significantly. Countries characterized by a very large number of pension funds (Ireland, United States) – have a reactive approach, while countries with a smaller number of funds (Mexico, Hungary) are able to choose a proactive stance. A mixed reactive-proactive approach is followed by Australia, the country (among those covered in the country papers) that shows most distinctly a risk-based approach.

As regards ex ante supervision, the necessary entry requirements are described: licensing procedures, registration processes and any other methods of restricting and controlling entry in the private pension market. A description is also given of the procedures and documents required for licensing and registration of the fund and of the internal rules related to corporate governance. Where relevant, requirements for pension fund managing companies, and minimum capital and reserve levels are also considered. Moreover, the bureaucratic requirements to qualify for tax advantages are examined.

In countries where the number of schemes is large, these rely on registration and self-compliance, while countries with a small number of entries can afford detailed licensing procedures. It should be noted that licensing procedures are required where funds or fund managing companies compete on the retail market offering personal plans (e.g. Mexico, Hungary).

On the other hand, the need for a prior authorization is not obvious in the case of occupational plans, where fund members are not offered any alternative vehicle for their supplementary pension and there is no risk of mis-selling practices.

On-going supervision, i.e. the organization and the day-by-day conduct of the oversight of fund operations, was requested to be a central topic of country studies. In particular, country studies provide a description of the mix of instruments and techniques that are used in order to collect information and to check the compliance with regulation: off-site monitoring, on-site inspections, meetings and interviews with pension funds' directors and managers, contacts with external and internal auditors and actuaries (whistle-blowing), complaints from members/beneficiaries.

In countries characterized by a reactive approach, whistle-blowing is the main source of information for supervision. For example, actuaries and auditors in Ireland have a statutory duty to report the supervisor of any irregularities they encounter. In general, this source of information may be very effective and reliable for supervisory purposes, as it is entrusted to well-trained professionals who are in the best position to detect problems at an early stage when they arise. However, recent developments in another country (the United Kingdom) which relies very much on whistle-blowing, suggest that there might also be pitfalls. This is the case when regulations do not offer the possibility to discriminate between futile and serious irregularities, thus exposing the supervisory authority to the risk that whistle-blowers exaggerate reporting, blowing the whistle also when there is no material danger for members or beneficiaries.

In countries where pension funds are relatively recent, reliance on frequent (even daily), electronically-based flow of information is observed. This is the case of Mexico, Hungary and Bulgaria. In the case of Mexico, the approach tries to address the problem of building confidence in the initial stage of the system. The Mexican country paper, in fact, declares the intention to gradually ease direct control, allow a degree of self-regulation, and make fund managers more responsible.

Specific attention is addressed to on-site inspections, their periodicity and the way subjects to be inspected are identified, time and resources allocated. Although the power to make on-site inspections is considered essential in all country studies, the actual utilization varies. Ireland (where the balance between the number of funds or plans to supervise and the staff available is less favourable) has not used this instrument so far. Hungary is planning to reduce on-site inspections in favour of off-site monitoring which is less resource intensive and often just as effective.

Country studies focus also on the way the supervisory authority processes and analyses the data, and the criteria it uses to evaluate performance of supervised pension funds/plans (*i.e.* rating, informal methods, etc.). In a risk-based approach, such as the one followed in Australia, the analysis of data is central to the assessment of risks that characterize the activity of the fund; the estimates that are thus created are then supplemented by the assessment – judgemental in nature – of the ability of the pension fund to manage its risks.

The papers provide information on compliance assistance programs that are incorporated into the supervision process in order to assist funds in understanding the requirements and facilitating compliance. Countries with a large number of funds tend to rely more on communication and guidelines made available to trustees and fund administrators. Reliance on communication and advice prevents the emergence of problems and is generally considered an effective way to save resources otherwise to be spent on *ex post* investigation and remedial action.

Finally, country studies describe compliance enforcement methods and sanctioning. Administrative remedies, punitive or compensatory sanctions, are described, as well as civil monetary penalties and criminal sanctions, and the intervention and liquidation procedures. In countries with a reactive approach, correction mechanisms are very important, as supervisory action typically starts when the irregularity has already occurred. In mature systems such as the United States corrective measures often take the form of voluntary compliance, aiming more to remedy the consequences of the failure to comply with rules than to punish the misbehaviour. This approach favours a cooperative stance between the supervisory authority and the pension entities, although it requires a high level of integrity of the financial and administrative environment, and the credible threat of effective and timely penalties/redress mechanisms should voluntary compliance not occur.

Richard Hinz, former Chairman of the OECD WPPP, presents an original methodological framework for evaluating the characteristics of private pension supervision with a view to obtaining initial observations on the way in which the supervision is organised and conducted, and how it relates to the environment in which it operates. He identifies six primary elements of pension fund supervision – licensing, monitoring, communication, analysis, intervention and correction. The manner in which different systems implement the basic elements defines what may be viewed as the "style" of pension supervision. He then lays down the scale of intensity of private pension supervision along a spectrum of attributes and identifies the factors that influence the degree of intensity of supervisory oversight. He argues that mandatory systems require more intensive supervision due to greater reliance on pension for subsistence, whereas more developed economies with a large number of funds and with high per capita GDP seem to lower the intensity of supervision. This correlates with a stronger social safety net, better capacity of the population to exercise individual oversight, and greater reliance on communication and market-based competition to create discipline in the market. Financial market development and an effective "rule of law" facilitate less intensive supervision as more financial products enhance competition and allow greater reliance on market forces. The respect of rule of law implies greater reliance on negotiation processes and litigation, thus diminishing the need for public intervention.

As a final summary, a large diversity of supervisory methods and practices is observed, even within the small sample of country case studies conducted so far. If a single common ground has to be identified, one could point to the need to organize supervision in such a way that there is consistency between the endowment of resources available for supervision and the extent of tasks entrusted with the supervisor, which is primarily a function of the number of funds and plans to be supervised, but it is also connected with the regulatory approach.

In cases where the need to build confidence in private pension system is the main concern, and the financial environment is not fully developed, there is a tendency for supervisory authorities to carry on a sort of monopoly in the exercise of regulatory and supervisory powers. In this case, the centralization of controls is felt to be necessary, and the flow of information requested and collected by the supervisory authority may be very detailed and frequent. This approach often goes hand-in-hand with quantitative limits set on pension funds' investments.

In cases where the financial and the private pension systems are more mature, controls tend to be decentralized to parties that are closer to the entities to be supervised and are therefore in a better position to appreciate specificities of a single plan or fund and the materiality of potential threats to the interest of members and beneficiaries (this is consistent with the trend for a risk-based approach that makes efficient use of scarce supervisory resources). Supervisory functions are therefore distributed in the system and their effectiveness depends largely on the appropriate functioning of the "regulatory space" as a whole and not only on the way the supervisor is able to perform his tasks. In such a context, more flexible rules are provided for (as the prudent person approach to pension funds' investments), and self-regulation and appropriate governance of pension funds are central elements of the supervisory strategy.

Further work

Contributions collected in this book represent a unique, first-hand source of information on how supervision of pension funds is organized and conducted across countries. However, this should be considered as a starting point. Mutual understanding and recognition of national regulatory and supervisory frameworks continue to have a long way to go, as does the careful identification of good practices and eventually the elaboration of guidelines.

In the future, several international fora will be involved concurrently in the analysis of regulatory and supervisory systems for pension funds.

This is already the case in several instances. The International Organization of Pension Supervisors (IOPS), established in July 2004 as an evolution of the OECD-connected INPRS, constitutes a natural forum for the continuation of the analyses collected in this book. The discussion that took place in the INPRS Technical Committee between 2002 and 2003 led to an agreed solution on the way to define the scope of the new organization and to differentiate it from the OECD WPPP. IOPS will be an institutional-based organisation with members coming from supervisory agencies and not countries. It will focus on supervision and regulatory issues linked to supervision. It will be a world-wide organization, with regional committees put in place.

The European Union also became active in the field of private pensions, adopting a directive concerning the supervision and the activity of occupational and professional pension funds. In the context of the so-called Lamfalussy approach to financial regulation in the European Union, committees were created to co-ordinate work between the competent ministries (EIOPC) and the supervisory authorities (CEIOPS) of member states competent in the field of insurance and of occupational pensions. In the framework of CEIOPS, a permanent working group on occupational pensions was established.

The International Association of Pension Fund Supervisors (AIOS) will continue to constitute an important forum for supervisory institutions from countries where, as in Latin America, pension systems are based on mandatory personal pension plans.

The OECD WPPP, while focusing more on policy and regulatory issues, will also continue to consider supervision within the scope of its activity when it is linked to regulatory issues.

The activity of the above-mentioned fora will certainly stimulate rapid progress in mutual understanding of supervisory structures and practices and in cooperation between competent authorities of different countries. A degree of specialization between the different fora will certainly emerge. Co-operation will be favoured by the fact that in most cases the same national institutions are represented in the diverse fora.

Let me conclude this introduction pointing out the topics regarding pension fund supervision that I foresee as among the most useful to analyse in the future. In my view, the three following topics deserve particular attention.

- Risk-based supervision is already receiving increasing attention by supervisory authorities in many countries. It is a way to concentrate scarce resources on the factors with the largest expected impact on members' interests. It goes hand-in-hand with a more proactive stance with respect to the funds most at risk. Risk-based supervision is already standard practice in other fields of financial intermediation (*i.e.* banking, insurance). It is not obvious, however, how methods and tools that are used in these fields can successfully be applied to private pensions, especially in the case of occupational schemes. One example is capital requirements, as the non-profit nature of most pension funds may change their impact fundamentally with respect to the case they are applied to profit-making financial intermediaries.
- In many countries, there is the intention to ease or abandon quantitative limits to pension fund investments and substitute them with the prudent person approach. While pros and cons of the two different approaches have been discussed at length, it is less obvious how supervisory authorities will manage the transition between the two approaches, in terms of day-by-day supervisory practices, including the development of appropriate skills of the supervisory staff.
- The general trend in favour of defined contribution schemes implies the diffusion of member-directed schemes, as it is fair that those who bear the risk of investments are also offered the possibility to make choices on their risk profile. However, even in the case where adequate information is supplied to them, the actual ability of pension fund members to make knowledgeable choices may be inadequate anyway Therefore there is an urgent need to empower fund members with effective programs improving their financial literacy, as well as to keep offered investment options as simple as possible. In particular, the risk of allowing the mis-selling of high-cost pension products to workers that do not fully perceive those costs and do not in fact need unduly sophisticated products should be minimized. Also, the provision of carefully designed default options in all cases where fund members are not able or willing to make their choices is going to be a crucial element in the design of a successful framework. In my view, the development of supervisory practices that help minimize the risk of ill-based individual choices will be one of the most challenging tasks for private pension supervisors in the coming years.

Mutual exchange of information on the experience gained by pension fund supervisory authorities in different countries in addressing these issues will be very helpful.

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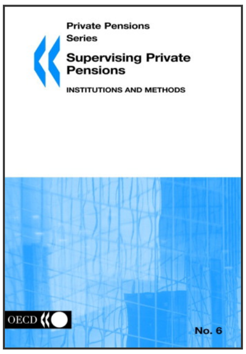

From:

Supervising Private Pensions: Institutions and Methods

Access the complete publication at:
https://doi.org/10.1787/9789264016989-en

Please cite this chapter as:

Rinaldi, Ambrogio (2005), "Supervising Private Pensions: An Introduction", in OECD, *Supervising Private Pensions: Institutions and Methods*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264016989-2-en