

“AIOS PRINCIPLES FOR THE REGULATION AND SUPERVISION OF PENSIONS”

COMMENTS

**International Federation of Pension Fund Administrators
July, 2004**

I. Introduction

The International Organization of Pension Fund Supervision Agencies (AIOS) approved the document “Principles of Pension Regulation and Supervision,” during its 9th Annual Assembly held on November 10, 2003, in the city of Santiago, Chile.

This document presents “31 basic principles for achieving the best pension supervision practices in the AIOS member countries.” The Principles are classified in five categories, namely: “Basic Regulation and Supervision Principles” (5 principles); Principles related to pension management” (5 principles); “Principles related to the management of individual accounts and benefits” (9 principles); Principles related to the dissemination of information (3 principles); and “Principles related to investments” (8 principles). The document defines the objectives of the “Principles” corresponding to each category, explaining their scope and meaning. Although the observance of these “Principles” is not mandatory, the AIOS recommends their inclusion in the rules and regulations of each member country.

The development of general regulation and supervision guidelines, based on the best experiences and knowledge accumulated in each country, are an extremely important contribution for improving the respective national regulations. Hence, the International Federation of Pension Fund Administrators (FIAP) applauds the AIOS initiative, highlighting both its value and timeliness.

The new individually funded pension systems are facing some threats and the consolidation of the enormous reform efforts carried out by our countries requires the cooperation of the authorities and the industry. It is in this spirit that FIAP wishes to provide its contribution to the work of the AIOS, drawing up this document in consultation with its members.

Without meaning to deny the merits of the AIOS’ work, our comments concentrate on aspects thereof which, in FIAP’s opinion, can be improved, require further explanation or on which we have different opinions.

II. General Comments

1. With the exceptions indicated below, FIAP has no major disagreements with the 31 Principles put forward by the AIOS.

However, there are differences of opinion regarding some of the concepts and recommendations put forward in the text when explaining the scope of each one of such principles. Furthermore, in FIAP's opinion, in some matters the AIOS principles refer to aspects of the pension system other than the function of supervision. Finally, FIAP believes that the AIOS principles harbor some serious omissions.

We will briefly expound on these comments in the following paragraphs and then, in the second section of his document, we will present our more specific comments on the AIOS Principles.

2. The AIOS document does not clearly state that a social security system can (or should) comprise different types of programs, each one with its specific purpose. In particular, when explaining and justifying the Principles, no distinction is made between pension programs that partially or fully substitute the income workers receive during their active lives, and are financed with the savings of their own beneficiaries, and other programs that provide economic support to those who did not have sufficient savings capacity during their working lives and are financed with transfers and subsidies.
3. The AIOS document also fails to acknowledge the potential conflict between the objectives of a pension system and other public policies. This situation forces supervisors to defend and protect the system from external institutional pressures that could deviate it from its own and exclusive objectives. This is an issue which, in FIAP's opinion, the document should address more vigorously (for example, by explicitly establishing that the supervision must ensure that the pension system complies with its own objectives).
4. The AIOS Principles (for example, Principle 2) suggest that the supervisor must have the faculties for regulating the system. We do not share this opinion. In our opinion, in order to provide the necessary legal certainty to the management of the pension funds, the regulatory framework must be stable and the rules and regulations must not be transformed into an instrument that can be used discretionally by the supervising authority. Thus, although the supervisor must be empowered to interpret the laws and regulations, such faculty must not extend beyond issuing the rules and regulations required for making the legal and regulatory provisions operative.

If, for reasons of flexibility, which we could possibly share, it is deemed necessary to endow the regulator with greater regulatory faculties, it must be given greater independence.

5. In another point, the document states that members and beneficiaries must be protected against the "*risk of bankruptcy of a fund manager*" and the risk of loss of funds due to their poor management. In this regard, it calls our attention that even

though different operational risks do exist, only an explicit reference to “risks of bankruptcy” is included. Furthermore, given the separation between the pension fund and the fund manager, it is not clear what risks for members and beneficiaries can arise from the bankruptcy of a fund manager (in fact, there have been cases of fund managers going bankrupt without this entailing any losses whatsoever for its members).

6. We understand that the purpose of the AIOS document is to establish principles for the *Supervision* of pension systems. Nonetheless, in some aspects, the AIOS Principles go beyond that, since they include references to matters related to the overall design of a mandatory pension system and the way it should be regulated and not to supervision means and mechanisms. Specifically, of the 31 Principles, only 18 refer to supervision obligations and responsibilities, whereas 9 refer to the different obligations of the fund managers and 7 to the general characteristics of the system.
7. At the same time, the Principles do not include references to other issues that are directly related to the function of supervision. In the first place, the *basic characteristics* of supervision are not established: (in FIAP’s opinion this should be professional, impartial and timely). Secondly, there are also no references to the instruments the Supervisor should dispose of for exercising its activities (sanctions, fines, the faculty for interpreting the laws and regulations etc.) and the way they must be used (they must be known, proportional and appealable). Thirdly, references are lacking to the responsibility of the supervisor for promoting the improvement of the regulation of the system. Finally, no Principles are included that refer to the supervision of companies that provide benefits (pensions and disability and survival insurance) and the supervision of the custodians of the pension funds.
8. Finally, it also calls our attention that in some cases the AIOS Principles go beyond what is currently required in the respective national regulations (see, for example, the “Principles for the regulation of investments” vs. the regulation of this issue in Uruguay, and the explanations of Principle 17).

III. Specific Comments

1. *”Principle 2: The supervisory and regulatory agencies must establish rules and regulations that enable transparent, effective and efficient management for safeguarding the rights of members and beneficiaries.”*

We suggest adding a reference to the safeguarding of the *equity* of members, represented by the accumulated balances in their individual accounts.

2. *”Principle 3: The Supervisor must have its own resources for satisfying high technical standards and performing its functions independently.”*
The concept of the “independence” of the Supervisor must be specified, since, In FIAP’s opinion, the supervising agency’s officers cannot enjoy administrative and legal immunity.

On the other hand, the Independence of the supervisor does not stem exclusively from its economic independence, but also from the mechanisms used for appointing and removing its officers. This is why we recommend including a proposal on this matter in the AIOS document.

3. *"Principle 4: The Supervisor must promote the strengthening, improvement and development of pension culture and the pension system. It must also ensure non-discriminatory access to the system."*

Promoting the system and educating the population should also be part of the responsibilities of the supervisor. Hence we recommend including a proposal on this matter in the AIOS document.

4. *"Principle 5: While exercising its duties, the supervisor must coordinate control and regulation actions with other related agencies."*

It would be inconvenient for the pension fund managers to be subject to supervision by more than one agency. Hence, the agency responsible for supervising the pensions industry must assume the responsibility for coordinating the activities of other agencies related to the pension system, always ensuring that the sole purpose of the private pension system should be the safety and profitability of the funds.

It is also important to establish the supervisor's obligations regarding the confidentiality of the information it receives from companies.

5. *"Principle 6: The supervisor shall ensure that all bodies corporate interested in becoming pension fund managers subject to established rules and regulations, comply with the following:*

- *Manage pension funds separately from their equity. This separation must be irrevocably guaranteed either by legal provisions or other suitable mechanisms previously approved by the supervisor.*
- *Have a well-defined organizational structure that will enable avoiding conflicts of interest in decision-making.*
- *Contribute and maintain an initial capital amount solely and exclusively for pursuing its objective, in accordance with its importance in the system."*

The reference to initial capital suggests that it will depend on the size of the fund manager. However, this does not appear to be a necessary condition for the proper performance of the system and there are in fact examples of national regulations that do not include obligations of this type.

On the other hand, the reference to *"other suitable mechanisms previously approved by the supervisor"* is a mistake. The pension fund manager licensing process should be subject to precise and known rules, with minimal leeway for discretionary decisions by the supervisor.

Finally, the supervisor's obligation to use objective and not discriminatory criteria when granting licenses and applying fines and sanctions, must be established.

6. *"Principle 7: The fund managers must apply the principles of equity, justice and non-discrimination of members, as well as respecting the exercising of their rights."*

In FIAP's opinion, this is not a supervision principle, but rather a "Principle for the Design of Systems," or a "Regulation guideline."

Furthermore, this Principle could be used to justify regulations demanding full equality of gender, which would have negative consequences for the level of pensions of men and women (Common life expectancy tables? The same retirement ages?).

Finally, within the context of the commercial relations between a company and its clients, the scope and meaning of the concepts "justice" and "equity" must be very clearly defined in order to avoid ambiguities that could at any time justify inappropriate regulations.

7. *"Principle 8: When managing pension funds, the fund managers must pay special attention to:*

- *A comprehensive and preventive risk management outlook.*
- *The prevention of conflicts of interest, especially with related parties.*
- *Maintenance of working capital proportional to its operating and financial risk.*
- *International accounting and auditing rules and regulations within the framework established for such purposes.*
- *Operate transparently and in market conditions in its transactions, with special care in transactions with related companies."*

In our opinion, this is not a supervision principle. In any case, if it is decided to keep it, the following would have to be established: the convenience of the fund managers and pension funds using common account plans; the obligation of the fund managers to provide advice and full and timely service to their members; and, finally, the prohibition of offering bonuses, money or any other incentives for transfers.

We also recommend making specific reference to the international reference rules and regulations (IAS or US GAAP).

8. *"Principle 9: In order to minimize damages and losses for members and contain the systemic risk, the regulator will establish procedures for cases of bankruptcy, liquidation or merging of the pension fund managers, as well as the transfer of funds linked to these processes."*

As previously mentioned, if the funds are separated from the fund managers, the bankruptcy of the latter should not affect members.

9. *“Principle 10: The pension fund managers must establish self-regulation processes within the framework of the principals put forward and the rules and regulations governing their activities. Such processes must be made known to the public, the supervisor or both.”*

The concept of self-regulation is very broad; hence its scope must be defined to make it operative in practice. In any case, it should be pointed out that it should be aimed at correction and not sanctions, working together with the supervising agencies.

10. *“Principle 15: The portability of the individual accounts of members will be promoted.”*

A declaration stating that the supervisors will promote the necessary rules and regulations for facilitating the portability of funds should be included in this principle.

11. *“Principle 16: The supervisor must establish uniform requirements for accessing benefits and ensure that members obtain a regular pension income at the time the disability, old age and survival risks materialize.”*

This principle could be interpreted as limiting pension options only to life annuities, which would be a mistake.

Furthermore, it should also be established that the procedures in the retirement process must ensure correct and timely calculation and payment of the corresponding benefit

12. *“Principle 17: The most ample information on available options in the market and their respective costs must be available at the time of choosing the pension mode.”*

As previously mentioned, the AIOS document must highlight the fact that the supervising agency and the fund managers are responsible for ensuring the dissemination of the relevant information. It must also be clearly stated that it is the member who must be provided with the relevant information.

Moreover, when explaining the principles referring to individual accounts, the AIOS document states that “Contributions and yields will accumulate until the retirement date.” In FIAP’s opinion, this definition is unnecessary and is in fact contrary to the real situation in many member countries.

13. *“Principle 18: The systems for classifying the degree of disability must be governed by clear, consistent, fair and transparent rules.”*

It should also be established that the impediment causing the disability should be effectively proven.

14. *“Principle 19: The supervisor must promote transparency in the definition of the technical parameters and biometric tables for calculating pensions in their different modes.”*

In FIAP’s opinion, transparency alone is not sufficient. The definition must also be based on objective criteria.

15. *“Principle 20: Members shall have the right to access information on their individual accounts at all times.”*

In FIAP’s opinion, this is not a supervision principle.

Furthermore, reference to a right could be interpreted as imposing the obligation of gratuity. This would be inconvenient, especially considering the condition that imposes the Principle of availability of information “at all times.” We therefore suggest replacing the latter expression with the word “regularly.”

16. *“Principle 21: The supervisor will provide ample information on the pension system and the pension fund managers on a regular and timely basis. This information must enable, at least, the comparison between fund managers in terms of commissions and yield.”*

It must be stated that this information must be made available to the public.

Furthermore, the information on the requirements for accessing benefits, their characteristics, state guarantees etc. is also relevant.

17. *“Principle 24: The supervisor shall establish the basic rules and regulations that will enable minimizing the operating risk of the investment process.”*

In FIAP’s opinion this Principle is very broadly stated, due to which it does not serve as a basis for designing regulations.

The treatment of this issue is also asymmetric with respect to others. Why is the same not said of risks of solvency, information etc.?

18. *“Principle 25: The Supervisor must establish certification mechanisms for the fund managers’ officers entrusted with managing investments that will enable objectively documenting their knowledge in matters of investment and risk.”*

In FIAP’s opinion, it is not the supervisor’s task to certify competencies, although it may establish minimum qualifications (studies, experience etc.), for occupying any position.

Furthermore, on explaining and justifying this principle, the AIOS document recommends incorporating an “independent councilor” in the Investment Committee.

In FIAP's opinion this recommendation is arguable, since the concept of independence is not applicable to the fund manager's shareholders and the management of investments is marked by conditions of confidentiality and separation with respect to the management of other funds.

19. *"Principle 26: The supervisor must establish regulations that promote the formation of efficient portfolios."*

The advantages and disadvantages of different models of investment regulations are currently being discussed (quantitative limits and prudential regulation). Although the existence of limits would appear to be necessary, it is also important to point out that they can limit the possibilities of portfolio diversification (with costs in terms of returns and risk) and they should be gradually relaxed over time.

With regards to limits on foreign investment, FIAP does not agree with the AIOS document when it states that "when a financial system has few available assets, the regulators must encourage foreign investment." Foreign investment helps to diversify portfolios and should be a non-exceptional option always available for the pension funds.

20. *"Principle 27: Transactions must be performed in authorized markets with an adequate inspection and control system and regularly available public information. These characteristics are also applicable to the transactions performed by agents."*

Funds should also be allowed to participate in direct auctions, to the extent that they are open to the public and are first issuance instruments.

On the other hand, it would be convenient to establish that the "delivery against payment" mode should always be used in the liquidation of investments. Reference to controlling the use of privileged information in the financial operations of the pension funds is also lacking.

21. *"Principle 28: Investments must be made in instruments whose issuers have investment status. Foreign investment must also be authorized and regulated with diversification and risk management criteria."*

It calls one's attention that this Principle is inconsistent with regulations existing in some countries ("freely available margin" and cases in which there is no risk assessment).

22. *"Principle 29: The regulator must ensure the correct appraisal of all managed assets and quota values by means of assessment at market prices by a third party with no conflicts of interests."*

In FIAP's opinion, the most important aspect is not the person performing the assessment, but rather the methodology used and the possibility of controlling the process and the result.

23. *“Principle 31: The fund manager must adopt adequate corporate governance practices in its management policies as well as its management of the resources of members through authorized instruments. The fund manager must adopt corporate governance practices in its management policies related to the participation of the managed funds in authorized instruments.”*

In FIAP's opinion, the corporate governance practices must not only be “adequate” but the best, within the framework of the legislation of each country.

On the other hand, the lack of any specific reference to the control, use and dissemination of privileged information on the financial transactions of the pension funds is noteworthy (in this or any other of the Principles that refer to investments).

Finally, the scope of the last paragraph of this Principle is difficult to understand, since “corporate governance practices” have always existed and the difference lies in their quality.

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