SUPERVISION MODELS: TRENDS IN PENSION FUND SUPERVISION

JOHN ASHCROFT¹ ²

¹ Formerly Head of Strategy at the UK Pensions Regulator and President of the International Organisation of Pensions Supervisors from 2004 to 2007. Accountant by training, Ashcroft has over 20 years' experience in the UK National Audit Office. From 2003 to 2005 he worked as Strategic Policy Director at the predecessor body, the Occupational Pensions Regulatory Authority (Opra), playing a key role in its transition to a new risk-based regulator.

² I was asked to give this presentation in place of Ross Jones, my successor as President of the International Organisation of Pension Supervisors (IOPS). IOPS has a possibly unrivalled perspective on the trends to be found in the supervision of private pensions. I should, however, stress that the views expressed are my own.
CHAPTER IV.
SUPERVISION MODELS

INTRODUCTION

This article starts by setting out the role and work of IOPS and then reflects on the diversity of pension systems and their supervision, as expressed in the experiences of IOPS members. It goes on to outline the common principles of pension supervision, and some notable trends discernible from the outputs and concerns of the IOPS and its members, namely:

i. Increasing supervisory integration.

ii. Moves towards a risk-based orientation.

iii. Emphasis on communication with members, and

iv. A greater focus on pension plan governance.

Finally, I draw some conclusions of my own.

I. THE INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS (IOPS)

IOPS was founded in July 2004 on the instigation of the informal International Network of Pension Regulators (INPRS). It has grown rapidly and now has over 50 members with a wide spread of geographical location and type of pension system (including Latin America); alphabetically it ranges from Australia to Zambia.

IOPS meets three times a year, most recently in Washington DC, Beijing and Basel. Meetings are often back-to-back with those of other international organisations such as the OECD, the International Association of Insurance Supervisors and the World Bank. IOPS works hard to build strong links with other international organisations concerned with private pensions, such as FIAP.
IOPS sets out to enable the sharing of experience between pension supervisors by articulating common principles and guidelines and disseminating good practices. All members gain much from learning how others tackle common challenges, but there is particular value for supervisors from those countries where private pension provision is in its infancy. With this in mind, IOPS held its first regional seminar in Dakar, Senegal, in February 2008. More generally, the IOPS website provides a source of invaluable information about individual countries’ pension supervision.

The first IOPS publication set out common principles of private pension supervision. In 2007, IOPS published working papers covering:

i. Integrating supervision – pros and cons;

ii. Supervisory education, outreach and communications;

iii. The utilisation of IT in off-site supervision; and

iv. Experiences and challenges in introducing risk-based supervision.

These papers were followed at the end of 2007 by guidelines on the licensing of pension entities in private pension systems, and in early 2008 by draft good practices in the risk management of alternative investments by pension funds. IOPS has a large and varied programme of work in hand or in prospect, covering:

i. Information requirements for DC pension beneficiaries.

ii. Supervisory oversight of pension fund governance.

iii. A review of supervisory systems.

iv. Costs and fees: an international comparison.

v. Comparative information on the pricing of annuity products.

vi. Guidelines on the use of intervention, sanctions and enforcement powers.

vii. IOPS toolkit for risk-based supervision.

viii. Governance for pension supervisory authorities and performance indicators for pension supervisory authorities; and

ix. Mortality tables information.
All of these outputs and projects reflect current or topical trends in modern pension supervision, and most of them are covered in this presentation.

II. THE DIVERSITY OF PRIVATE PENSION SYSTEMS AND THEIR SUPERVISION

The IOPS work programme provides a good indication of the concerns of many pension supervisors. Anyone who wishes to obtain a good overview of trends in modern pension supervision must recognise that the forms and traditions of private pension provision prevalent in each country heavily condition supervisory activities. Therefore, the wide diversity in these pension systems across the world results in a similar wide diversity in supervisory approaches. Major differences between systems include:

i. The extent to which contributions to, or employer provision of, private pensions varies between purely voluntary systems, through quasi-mandatory social partnership or State imposed arrangements, to the mandatory systems with which many FIAP members will be most familiar.

ii. Private pensions providers can range from the pensions trusts found in the Anglo-Saxon tradition, through other forms of employer or commercially sponsored stand-alone pension companies, to contractual arrangements between financial services institutions and employees with different forms of employer facilitation.

iii. Provision can be defined benefit (DB), either final salary or cash balance, purely defined contribution (DC), or various forms of hybrid where minimum benefits are guaranteed or targeted or risk is shared between member and employer, with some countries having a mixture of these different types.

iv. Some countries have a small number of large pension plans – others, notably the Anglo-Saxon nations, can have many thousands of mostly small plans.

v. The extent to which the social welfare system relies on private pensions varies from mature systems which provide the larger part of (long-term) members’ retirement income and have assets approaching or in excess of GDP, through recently instituted systems which have been consciously designed to achieve the same objective, to those systems where the benefits do no more than enhance very substantial State benefits and comprise a relatively small proportion of GDP.
Given this degree of variation, which is far greater than that found in other types of financial service, substantial variation in supervisory approaches is inevitable. Three archetypes can nonetheless be discerned:

i. **Structural**: where the State has defined the structure of the private pension market, commonly in the context of emerging financial markets and mandatory provision, and there is close supervision of compliance with explicit rules covering the pensions products and good governance by the provider. This is the Latin American and Eastern European model.

ii. **Fiduciary**: where there are well-established financial markets and fiduciaries responsible for the pension plans, which have been established either on the initiative of employers or as part of social partnership arrangements. Supervisors place considerable reliance on fiduciaries, their advisers and financial markets to deliver the requisite standards of governance, and focus more on remedying governance failures and promoting effective risk management. This is the Anglo-Saxon (and Dutch) model.

iii. **Insurance style**: where pension plans are voluntarily provided to employers or individuals on a contractual basis by financial services companies (or their subsidiaries) on a basis that is analogous to the products sold by insurance companies. Supervision has strong similarities with the supervision of insurance companies, based on licensing and the enforcement of licence conditions.

Within each of these archetypes there can be varying emphases on seeking to target and mitigate risks or on achieving legislative compliance.

**III. THE PRINCIPLES OF PRIVATE PENSION SUPERVISION**

In view of the diversity outlined above, can IOPS members be expected to agree on anything? Yes. IOPS has established 10 principles that hold good regardless of the type of system or supervision (see Figure 1). These echo many of the more general principles to be found in the literature of State-sponsored regulation. The principles have already proved influential and are increasingly referenced.

---

CHAPTER IV.

SUPERVISION MODELS

FIGURE 1

IOPS PRINCIPLES OF PENSION SUPERVISION

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Objectives: national laws should assign clear and explicit objectives to pension</td>
</tr>
<tr>
<td></td>
<td>supervisory authorities.</td>
</tr>
<tr>
<td>2</td>
<td>Independence: pension supervisory authorities should have operational independence.</td>
</tr>
<tr>
<td>3</td>
<td>Adequate resources: pension supervisory authorities require adequate financial, human</td>
</tr>
<tr>
<td></td>
<td>and other resources.</td>
</tr>
<tr>
<td>4</td>
<td>Adequate powers: pension supervisory authorities should be endowed with the necessary</td>
</tr>
<tr>
<td></td>
<td>investigatory and enforcement powers to fulfil their functions and achieve their</td>
</tr>
<tr>
<td></td>
<td>objectives.</td>
</tr>
<tr>
<td>5</td>
<td>Risk orientation: pension supervision should seek to mitigate the greatest potential</td>
</tr>
<tr>
<td></td>
<td>risks to the pension system.</td>
</tr>
<tr>
<td>6</td>
<td>Proportionality and consistency: pension supervisory authorities should ensure that</td>
</tr>
<tr>
<td></td>
<td>investigatory and enforcement requirements are proportional to the risks being</td>
</tr>
<tr>
<td></td>
<td>mitigated and that their actions are consistent.</td>
</tr>
<tr>
<td>7</td>
<td>Consultation and co-operation: pension supervisory authorities should consult with</td>
</tr>
<tr>
<td></td>
<td>the bodies they are overseeing and co-operate with other supervisory authorities.</td>
</tr>
<tr>
<td>8</td>
<td>Confidentiality: pension supervisory authorities should treat confidential information</td>
</tr>
<tr>
<td></td>
<td>appropriately.</td>
</tr>
<tr>
<td>9</td>
<td>Transparency: pension supervisory authorities should conduct their operations in a</td>
</tr>
<tr>
<td></td>
<td>transparent manner.</td>
</tr>
<tr>
<td>10</td>
<td>Governance: the supervisory authority should adhere to its own governance code and</td>
</tr>
<tr>
<td></td>
<td>should be accountable.</td>
</tr>
</tbody>
</table>


IV. DRIVERS OF CHANGE IN PENSIONS SUPERVISION

As well as being able to subscribe to common principles, pension supervisors are also experiencing some common trends in societal or market change that are impacting on their work:

i. Ageing societies and the pressures these place on pay-as-you-go pension provision or financial security in old age, resulting in an increasing acceptance by governments that funded private pensions can head off these problems, as long as participation is mandated or at least strongly facilitated.

ii. The increasing commercialisation and globalisation of the pension industry.
iii. Increasingly sophisticated forms of investment product designed to hedge risks or diversify returns.

iv. Concerns about the burdens that the State places on employers and financial service providers.

v. The shift of risks from employers to individual plan members (i.e. through DB to DC) and the consequential challenges of ensuring that members understand the risks they are taking.

vi. The widespread adoption, by many different types of market regulator and supervisor, of risk-based or principle-based approaches to regulation, in place of a focus on compliance with detailed rules and regulations.

These pressures have led, in particular, to the four trends in pension supervision that are the subject of the remainder of this presentation:

i. Increasing supervisory integration;

ii. Moves towards a risk-based orientation;

iii. Emphasis on communication with members.

iv. A greater focus on pension plan governance.

**Supervisory integration**

This is a contentious area, but the key points can be put simply, echoing some of the findings from the IOPS working paper on this subject:

i. The integration of pension supervision with other forms of financial service supervision is part of a more general trend to concentrate all financial service supervision in one or two bodies, so as to achieve economies of scale, accumulate expertise and avoid supervisory arbitrage.

ii. On the other hand, integration may run the risk of reducing focus on private pensions where they comprise a major part of the economy, or of reading across approaches that are not well-suited to the special features of the pension market.

---

4 *A review of the pros and cons of integrating pension supervision with that of other financial activities and services*, D Madero (CONSAR, Mexico) and S Lumpkin (OECD), IOPS Working Paper Number 1 (August 2007).
iii. Integration fits better when treating pensions as a financial product rather than a form of social welfare.

iv. There is no absolute right or wrong answer to the question of whether supervision should be integrated, although some systems or environments may be better suited to integration than others.

It should also be noted that there are moves towards harmonisation of regulatory and supervisory approaches across national borders, most notably in the European Union.

The moves towards risk orientation

This trend, which can be found in many countries, is also the subject of another presentation. I would note that IOPS experience\(^5\) shows that different supervisors have embarked on the move for a variety of reasons, including:

i. Changes in supervisory structure, for instance integration;

ii. The desire to avoid distortions or arbitrage between different financial service sectors.

iii. Finding a way of defensibly resolving the mismatch between a large number of supervised entities and a limited supply of supervisory resources (people and powers).

iv. High profile fund failures.

v. Adverse market conditions.

vi. Concern about incomplete compliance with conduct rules and poor fund governance, particularly among small and medium-sized funds.

vii. A desire to target resources towards the improvement of fund risk management and governance.

But, it is important to be aware that the phrase ‘risk-based’ has different meanings for different supervisors, and can mean one or more of the following, depending on circumstances:

i. Applying quantitative techniques to the evaluation of the risks posed by pension funds so as to inform strategic supervisory responses.

ii. Varying explicitly the scope and intensity of supervision of individual funds according to the risk which each is estimated to pose.

iii. Enabling a proactive approach to pre-empt problems.

iv. Making choices transparent, so that members or fiduciaries understand the risks involved.

v. Supporting a public stance that supervisory action will not prevent all risks materialising.

As a consequence, the move towards a risk-based orientation can look quite different in different countries.

Communication with pension plan members

It would be fair to say that in the past this has not been a preoccupation of many pension supervisors – except maybe those overseeing trust-based pension systems. But the shift towards mandatory and DC provision has increased the importance of members understanding what the pensions contract does and does not entail, and commonly increases the choices they are expected to make (in particular of investment funds and retirement options).

DB plans are relatively easy to understand and administer and, from the member’s perspective, the risk is mainly limited to default by the plan sponsor, where plan assets are insufficient to deliver the full benefits. DC is very different. The biggest systemic risk for ‘pure’ DC plans (that is plans without minimum guarantees of some kind) is that members will not understand the consequences of their decisions or the risks that they face. If their retirement income is less than they expected because of inadequate contributions, investment losses or high fees, they may be inclined to blame inadequate communication, or simply feel they were cheated. The provision of guarantees or underpins within the DC plans mitigates this risk to some extent, but still runs the risk that the value of these safeguards will be overestimated.

This is not just a risk for pension plans but is shared by the whole regulatory system, especially in systems where participation is mandatory. While supervisors may have limited powers to improve matters, they can work to help plans improve communication or perhaps communicate directly with members. They can also
work with the government to improve the regulatory system, but they face the serious difficulty that most plan members have low levels of financial literacy. Providing information is insufficient – approaches also need to be developed to facilitate understanding of choices.

It is therefore timely that IOPS is well-advanced with a project to document what different supervisors can require of communications in DC plans and to draw some conclusions of wider applicability. It is also clear that this issue is moving up the agendas of many regulators and supervisors. Indeed, the communication issue may also be working its way up the DB agenda, at least where plans have significant discretionary elements. This is evidenced by the ongoing development by the Dutch regulator of an easy-to-understand diagram providing members with an easily understood view of the plan’s ability to index benefits against inflation, in different risk scenarios. This uses a yacht sailing (or sinking) in the sea to illustrate the information.

Other examples of the types of initiative appearing include:

i. The development of principle-based regulations for disclosure, that focus on the outcome rather than the content of plan communications, leaving it to pension fund management to determine how effective communication can best be achieved (Netherlands and UK).

ii. The ‘SCOMP’6 online annuity choice system developed in Chile, to guide members through the process of choosing the best value annuity (the UK is also making steps in this direction).

iii. Various initiatives in countries with relatively new DC systems to compare plan charges on an equal footing and hence improve the transparency of disclosure.

iv. The emphasis on communication to be found in the recent US regulatory provisions for communications where there is auto-enrolment into a DC plan and the fiduciaries wish to claim ‘safe-harbour’ protection.

Greater focus on governance

The final trend is a growing recognition that the ultimate achievement of supervisory objectives relies at least as much on the quality of plan governance as it does on other forms of supervision. After all, many of the problems that concern supervisors would have not happened had plans been well run. Furthermore, a corollary of

6 Pension Consultations and Offers System.
the move to risk-based supervision is to expect effective risk management to be embedded in plan governance. Unfortunately, many supervisors have found that fiduciaries often have insufficient understanding or skills to undertake their role effectively, or pay insufficient attention to risk management.

IOPS has recognised the importance of governance for effective supervision. The types of supervisory initiative to strengthen governance include:

i. Explicitly including assessments of fiduciary capabilities and risk management within the quantified models that they use to place a ‘score’ on the risk posed by individual funds. These scoring models are used to vary the intensity of supervision and to provide incentives for improvement (e.g. Australia, Germany and Netherlands).

ii. ‘Raising the bar’ by introducing licensing requirements that raise the expected standards of fiduciary capability and risk management - Australia and Nigeria are two particularly relevant counties, but this approach is used by a wide range of countries, many of which contributed to the IOPS guidelines on licensing.

iii. Targeted education programmes for fiduciaries, aimed at improving their ability to run their funds effectively. These are explained in some depth in the relevant IOPS working paper.

iv. Encouraging the pension industry to put a self-regulatory code of conduct in place that encompasses independent review of fiduciary performance (e.g. Netherlands).

A further topical governance issue, covered in a recent IOPS publication, is the risk management of alternative investment classes, which could be loosely defined as assets that are not traded on a regulated market: derivatives and synthetic bonds, for instance. Supervisors are still feeling their way on this issue. These assets appear to provide considerable potential to reduce or diversify the risks in pension plans, but they bring new types of risks, not least that plan management will not understand what they are buying or be transparent about the changes to their risk exposure.

---

7 See also OECD Guidelines on Pension Fund Governance http://www.oecd.org/dataoecd/18/52/34799965.pdf
8 Retirement Benefits Authority, Kenya; The Pensions Board, Ireland; Financial Services Board, South Africa; The Pension Regulator, UK. Supervisory education, outreach and communication, including training of trustees. IOPS Working Paper No. 2 (August 2007).
IV. CONCLUSIONS

It should now be clear that, despite the different environments and supervisory models evident worldwide, there are some common principles of supervision and some common challenges for pension supervisors. I would conclude with three observations on the way forward for pension supervision:

First, pension supervision has increasingly drawn on approaches, notably risk-based approaches, found in other forms of market supervision, especially where pension supervision is integrated with other forms of financial service supervision. Such a shift is likely also to promote greater convergence of approaches across borders.

Second, while risk-based approaches to supervising the financial position of pension funds have done much to add rigour to the supervision of pension funds, supervisors are recognising increasingly that other types of risk, such as member understanding and fiduciary ability, can be equally important. This is especially the case in DC environments. But tackling what are essentially behavioural risks is a major challenge.

Third, the outputs and work programme of the IOPS are highly relevant to the challenges and trends in modern pension supervision, and will increasingly influence the directions and practices adopted by pension supervisors worldwide.