PENSION NOTES

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EXISTING RISK-BASED SUPERVISION IN THE PENSION FUNDS: REVIEW OF THE CHILEAN CASE[1]

Background Information

1. As pointed out in a recent publication of the Inter-American Development Bank (IADB, 2011), for many years the supervisors of financial agencies have carried out their supervision processes focusing on *ex post* verification in compliance with rules and regulations (generally associated to the parameters of liquidity, solvency and financial solidity). More recently, best supervision practices worldwide have focused on Risk-based Supervision (RBS).

2. RBS originated in bank supervision with the application of the Basel II[2] agreement, AIMED AT relating a bank's minimum capital requirements to its risk profile. Thus, bank supervisors were the first ones to adopt RBS. RBS was subsequently adopted in the insurance industry **and more recently in the pensions industry**.

3. As stated in the IADB publication (2011), this new focus enables supervisors to assess and follow up on different financial and non-financial risks, which are inherent and relevant to the supervised agencies (based on their size and complexity) and from an *ex ante* perspective, i.e. before such risks can affect the financial and operating situation of the agency; thus, the supervisor currently gauges whether the risk management systems of financial agencies allow each one of them to implement a risk-management approach (internal and external) known as "IMMM" (Identification, Measurement, Mitigation and Monitoring).

4. As a presentation of the Chilean Superintendency of Pensions (2010) shows, supervising authorities worldwide have been adopting RBS approaches aimed at: (i) a more rational use of resources; (ii) ensuring their proportionality and consistency as supervisors; and (iii) providing flexibility for greater efficiency in the industry, with adequate risk control.

5. Chile and Mexico are pioneering countries in Latin America with regard to the introduction of RBS in their pension systems, in 2001 and 2002, respectively. Other countries that have adopted this approach are Australia, Denmark and Holland, as highlighted in a World Bank

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[1] Document drawn up by FIAP.

[2] Basel II is the second of the Basel Agreements, consisting in recommendations regarding banking legislation and regulations issued by the Basel Bank Supervision Committee (CSBB). The purpose of Basel II, initially published in June, 2004, is the creation of an international standard that will serve as a reference for bank regulators, for the purpose of establishing the necessary capital requirements to ensure the protection of agencies in the face of financial and operating risks.

publication (2008) and a publication of the International Organization of Pension Supervisors (IOPS, 2007).

RBS and its implications for Pension Fund Managers in the Chilean case

6. The new RBS approach focuses on the riskiest areas of each pension fund manager, and its objectives can be summarized as follows: (i) Detect infringements or non-compliance with the obligations imposed on the fund managers by law; (ii) Ensure that fund managers provide their members and beneficiaries with the services, benefits and entitlements established by law in an efficient and timely manner; and (iii) Ensure that the fund managers adequately manage the risks associated to their activities, limiting their risk exposure while obtaining suitable returns and safeguarding the managed funds.

7. Taking the Chilean case as an example, there are three regulations that have been crucial for the practical implementation of RBS:

    - Resolution 42 (17/6/2010). Establishes the RBS methodology applied by the Superintendency of Pensions, denominated the "Risk Assessment System and Guidelines for Supervision Procedures," whose main objectives are: (i) Identify the risk profile in five areas (the Board of Directors, Management, Risk management, Operating Risk and Financial Risk; and (ii) Assess the quality of risk management.
    - Circular 1727 (27/9/2010). Sets standards regarding the principles and general guidelines fund managers must adopt for managing their risks, and the minimum requirements for compliance in this area.
    - Official Letter 22.142 (8/7/2010): sets out detailed requirements for the risk areas of each fund manager (input for the risk matrix).

8. The objectives the Superintendency of Pensions has established for the fund managers are the following: (i) They must adopt risk management as part of their "good practices;" (ii) They must be aware of the nature and extent of the risks they face; (iii) They must properly manage risk in order to reduce it to an acceptable level; (iv) They must have proper control over their operations so they have the ability to reduce risks; and (v) They must foment a risk-management culture.

9. Aforementioned Circular 1727 (27/09/2010) in practice imposes the following requirements on the fund managers:

    a. **Manual of risk management policies and procedures**. In order to be considered a "good practice," this manual must: (i) Identify the main risks; (ii) Evaluate the probability of such risks occurring and the impact they would cause; (iii) identify and describe the executives responsible for applying the policies and procedures; (iv) identify the individuals responsible for supervising the execution of such policies and procedures; (v) identify the individuals responsible for authorizing exceptions; (vi) Describe the process of monitoring, documenting and reporting of compliance/non-compliance with the risk management and internal control procedures; (vii) Describe the contingency plan updating procedures; and (viii) Describe the procedures updating process. It is considered advisable that at least the employees of the investments, business, risk, legal, operations, benefits and auditing departments, or units, be acquainted with the manual, so that all their activities are performed pursuant to the guidelines set out therein.

b. **Internal Audit**. Management must put in place an internal auditing process to ensure that policies and procedures are effectively applied. The purpose of this audit is to provide the Board with an independent first-hand account for assessing the agency's risk management processes. The auditing reports must be expediently communicated to the Board and the General Manager.

   An annual auditing plan approved by the Board must be in place for verifying: (i) The nature and extent of the risks faced by the fund manager and the managed funds; (ii) The degree of risk acceptable to the agency and the managed funds; (iii) The probability of the occurrence of such risks; (iv) The ability of the fund manager to mitigate the risks that materialize; and (v) Follow up of the implementation of observations made in previous audits.

c. **External Audit**. Although the external auditors are not part of the fund manager's internal control system, they have a significant impact on the quality of risk management through their auditing activities. External auditors can have a bearing on risk management systems, mainly through discussions with management and their recommendations for improvements. The external auditors must also be acquainted with and understand the internal control system in order to be able to gauge its trustworthiness and thus determine the nature, applicability and scope of their own auditing procedures. Finally, the external auditors must have direct access to the Board and the Committees, in order to be able to inform them of the weaknesses identified in the fund manager's risk management and express an opinion on its internal control system.

d. **Ethical principles or guidelines of the agency**. The fund manager's Board of Directors must approve the ethical principles or guidelines that will affect the activities and decisions of the directors and senior executives, as well as the rest of the personnel. The following are considered good practices: (i) Place emphasis on conflicts of interest; (ii) Generate specific policies for handling the securities and investments of the pension funds; (iii) Establish rules and regulations for safeguarding the confidentiality of information; (iv) Draw up a code of ethics; and (v) Put procedures in place whereby employees will understand that the fund manager must strictly comply with the obligations imposed by the laws and regulations and that conduct leading to infringements of the regulatory framework is contrary to the best interests of management and members/beneficiaries.

e. **Requirements for the Agency**. It is advisable that the fund manager's organizational structure be suitable to its size and activities, taking into account the number and type of members/beneficiaries, the total amount of assets managed, the complexity of its relationships with other related agencies and the assignment of responsibilities associated to key aspects. Thus, it is considered appropriate that the organizational structure of the fund manager should consider the following aspects for proper risk management: (i) Fluid communication of information at all levels; (ii) Well-defined, consistent and documented responsibilities; (iii) Proper separation of functions; (iv) Definition of the duties and responsibilities of each employee; (v) Personnel trained for substitution in key activities of the organization; (vi) Criteria for the prevention, management and elimination of conflicts of interest; (vii) Competent levels of management; and (viii) Key employees with knowledge and experience.

f. **Duties of the Board**. The Board of Directors of the fund manager is the body responsible for approving the risk management and internal control policies and procedures. Hence, good practice requires the Board to: (i) Establish policies for management to adopt the necessary measures (controls and operating system); (ii) Regularly check compliance with policies; (iii) Effectively supervise management; (iv) Propose external auditing companies; (v) Approve and monitor the auditing plans; and (vi) Set up a Risk Management Committee.

g. **Duties of Management**. It is considered good risk management practice in fund managers for the general manager to assume responsibilities in this regard, especially: (i) Apply the risk management policies and procedures approved by the Board; (ii) Draw up and propose risk management policies and procedures to be submitted to the approval of the Board; (iii) Facilitate the implementation of a risk management culture as defined by the Board; (iv) Manage the risks affecting the fund manager and the managed funds through the implementation of strict procedures for identifying and assessing risks; generate mitigation actions, carry out general control activities and generate and disseminate the available risk management information; (v) Adopt measures whereby the agency's employees will understand their responsibilities with regard to risk management; (vi) carry out formal strategic planning processes at least once a year, it being advisable to disclose and transmit them to the corresponding personnel.

10. In order to assess risk, management must construct what is known as a Risk Matrix, which is a report summarizing the risk exposure profile of each fund manager. This is the instrument the Superintendency of Pensions uses as a guideline for carrying out its supervision. The main risk areas identified are the Board of Directors, management, risk management, operating risk and financial risk, each one of them comprising sources of risk and risk mitigating factors, as shown in the following table.

Risk Areas / Sub-Areas in the fund managers[3]

The Board of Directors
Aptitudes and suitability of the Board of Directors Definition and follow up of the overall risk management policy Functioning of the Board and the Directors' Committees Definition of the strategy Reputational Risk Management Disclosure and Transparency Policy
Management
Composition and structure of management Planning and management process, disclosure and transparency Management information systems
Risk Management
Risk related to members Accounts management risk Benefits risk Technological risk Business continuity and recovery from disasters Subcontracting risk
Financial Risk
Investment process risk Market risk Credit risk Liquidity risk Agency solvency risk

Source: Superintendency of Pensions, Chile.

[3] Management is responsible for executing the policies and following the strategic guidelines defined by the Board of Directors, and also entrusted with making the decisions that affect the overall performance of the fund manager. Risk management entails the policies and practices of identifying and gauging the inherent risks associated to each of the fund manager's processes, considering the probability of occurrence and the impact on the strategic, tactical and operational objectives, the establishment of suitable controls for such risks and the assessment of the net risks the agency is exposed to, together with due independence in performing its duties. Operating risk is associated to the risk of losses caused by inadequate or insufficient processes, individuals or systems, or by external events that affect internal or subcontracted operations. This includes the specific risks of the execution of processes, their prior planning phase, their continuous updating, pursuant to the specific needs of the business and its regulation, ongoing improvement, the risks associated to human resources, considering the personnel hiring and dismissal processes and the policies and practices for controlling and compensating performance. It also includes the risks associated to technological systems that can result in possible failure of computer and communications equipment and systems. Financial risk is associated mainly to the investment of the funds and comprises the quality of the tools used for estimating the risk the investment portfolio is exposed to. It also includes the quality of the liquidity management policies which will allow it to meet unforeseen cash requirements, the ability to comply with existing rules and regulations regarding investment limits per issuer, instrument and asset class, and the correct assessment of counterpart risk.

11. As defined by the Superintendency of Pensions, the possible degrees of criticality for the risk areas shown in the previous table are: A = Critical, B = Very Significant, C = Significant, and each risk area is classified from 1 to 6 considering the level of policies and procedures each fund manager must have in place and the quality of the practices whereby it complies with its policies and carries out its processes (1 = Solid; 2 = Sound; 3 = Adequate; 4 = Vulnerable; 5 = Weak; and 6 = Extremely weak or without information).

12. Then, using the assessment of the areas and their relative significance, an Overall Classification of the fund manager is constructed, which will be used for directing supervision activities towards agencies with greater overall exposure to risk and detailed examination of the components that require greater priority in revision and improvement. The overall classification of the fund manager can range from 1 to 5 (1 = Good; 2 = Sufficient; 3 = Regular; 4 = Weak; and 5 = Very weak), providing the supervisor with the order of magnitude of the net risk the agency is exposed to. This classification is not public; it is only communicated to the respective agency, which will be able to refute the regulator's conclusions.

13. Depending on the overall classification obtained, the supervisor's approach can be visualized in the following chart:

OVERALL CLASSIFICATION	**SUPERVISION APPROACH**	**ACTIVITIES OF THE SUPERINTENDENCY**
GOOD (1)	**SATISFIED**	The follow-up plan entails general monitoring and follow-up for ensuring that the strengths detected in the assessment remain in place.
SUFFICIENT (2)	**MINOR OBSERVATIONS**	The follow-up plan focuses on the most important factors assessed in the worst categories.
REGULAR (3)	**WATCHFUL**	The supervision strategy will be focused especially on the critical and very significant factors assessed in the worst categories.
WEAK (4)	**URGENT OBSERVATIONS**	Very intense supervision strategy focused especially on critical and very significant factors assessed in the worst categories.
VERY WEAK (5)	**INTERVENTION**	The gravity of this situation calls for an intense supervision effort, focusing on the main weaknesses, in a semi-intervention regime.

Source: Superintendency of Pensions, Chile.

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