PRIVATE PENSIONS:
REGULATORY TRENDS AND BEST PRACTICES

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Why Private Pensions?

- Due to demographic trends, PAYG systems become unsustainable in many countries
- Private pensions make the overall pension system stronger through diversification of retirement income
- Allow pension benefits to reflect workers needs and preferences
- Provide employers with an additional tool to attract and retain employees
- Reduces the role of the government in the provision of pensions
- Increases institutional savings rapidly
  - some estimates indicate that by 2020, pension savings in reformed transition economies will reach 20 - 30% of GDP while in Chile already 50% of GDP
- As long-term savings, private pensions stimulate development of capital markets (increase demand for long-term instruments)
- and create an overall positive impact on the economic growth

Regulatory Framework

- Regulatory framework for private pensions should ensure:
  - protection of interests of members of pension funds,
  - soundness of pension funds operations and
  - stability of the economy overall
- It should be comprehensive, flexible and dynamic
- it should not excessively burden members, employers and pension funds
- but it has to simultaneously pursue 2 goals:
  - security of pension savings
  - profitability of investments of those savings

Two Basic Types of Regulatory Approach

- **“Strict” - suitable for countries with:**
  - underdeveloped capital market and financial systems
  - no tradition in private pension funds
  - workers unfamiliar with capital markets
  - appropriate for mandatory systems
  - lack of good corporate governance principles

- **“Relaxed” - suitable for countries with:**
  - developed capital markets and
  - long tradition in private pension funds

Characteristics of the Strict Approach

- licensing requirements (authorization criteria)
- single pricing rules
- types and ceilings on fees regulated
- detailed investment rules
- Mandatory use of custodian services
- Professional asset management, actuarial reviews and external audits
- guarantees for minimum rates of return (Pillar II)

Usually the need for strict regulations reduces as markets develop and public becomes more educated (Chile)

Characteristics of Relaxed Approach

- voluntary participation in the system
- high degree of individual choice
- no special licensing requirements
- a company can manage several pension funds
- types and ceilings on fees are not regulated
- “prudent person” rule for investments
- no minimum return requirements

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Other Determinants of the Regulatory Approach

- individual choice - mandatory vs. voluntary nature of pension funds
    - voluntary pension savings less strictly regulated
    - in mandatory systems countries need to ensure security of system
- nature of mandatory system - for whom pension funds are mandatory - employers or workers?
- nature of benefits - DC vs. DB plans or individual vs. collective capitalization plans
    - individual capitalization plans - members assume performance risk of the fund and to some extend solvency risk of the management company. Regulations aim at mitigating risks of members
    - collective capitalization plans - performance risk is assumed by the sponsor (or insurance companies) but workers assume solvency risks of the sponsors. Regulations aim at clarifying contractual arrangements and protecting interests of workers

Other Determinants of Regulatory Approach cont'd

- Tax Regime - necessary for the success of private pension funds, sometimes combined with state subsidies
- EET regime most frequently used:
  - avoids double taxation of retirement savings
  - but offers tax deferral benefit that has higher value for high income workers
  - requires limits on contribution exemptions and eligible earnings
  - different taxation of benefits may reduce frequency of lump sum withdrawals
- State subsidies:
  - do not discriminate among low income and high income workers
  - more efficient in attracting greater participation
  - may subsidize operating costs of low balance accounts

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Regulation of Financial Market

- private pensions industry requires well functioning capital market to enable diversified investments of pension savings and proper risk management
- therefore, private pensions regulatory framework can not be developed in isolation - it has to go hand-in-hand with development of capital market
- this usually requires development of new financial instruments and annuity market
- otherwise, pension savings will finance growth of foreign markets instead of domestic economic growth !!!

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Regulating: Adequacy of Private Pensions

- private pension funds have important role in supplementing / substituting retirement income paid from the state pension system
- therefore, parameters of private pension system (specially risks, benefits and coverage) has to fit well within the context of the overall pension system in a country
- in addition, adequacy of private pensions should be evaluated in respect to all other potential sources of retirement income (tax-and-transfer systems, private savings and earnings, advance-funded systems)

Regulating: Rights of Beneficiaries

- non-discriminatory membership (no exclusions based on age, salary, period of service, type of employment, civil status, and similar)
- protection of vested rights regarding contributions paid by employers and members themselves
- portability of pension rights is important in promoting mobility of workforce

Regulatory System and Legal Separation

- regulatory system should ensure that adequate legal, technical, accounting, financial and managerial criteria apply to pension funds
- however, these criteria should not place an excessive administrative burden
- legal separation between pension funds and management companies (or pension schemes and sponsors) is necessary to ensure proper protection of members' pension savings
- in countries where legal separation is not possible, such separation must be irrevocably guaranteed with appropriate mechanisms
- proper winding-up mechanisms are required to ensure that contributions owned to the fund by the employer are paid in the event of insolvency

Regulating: Funding

- private pensions should be <u>funded</u>
- DC schemes provide full funding
- DB schemes must have minimum funding rules to ensure adequate funding of pension liabilities
    - there should be adequate criteria for minimum capital/guarantee having in mind long-term nature of pension liabilities
- only temporary and limited under-funding can be allowed under strictly controlled circumstances
- DC schemes require asset valuation rules (mark-to-market)
- while DB schemes also require rules for liability funding, actuarial techniques and amortization rules
- risk and asset liability management techniques should be promoted

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Regulating: Fees

- company schemes have low selling and marketing costs. No need to regulate fees because they are charged between professionals (companies and trustees)
- in individual participation, workers are usually uneducated to deal with professionals offering pension funds and there is a need to protect them by regulating fees
- specially it is useful to regulate:
  - contribution fee,
  - asset management fee and
  - types of expenses charged to members

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Regulating Investments

- Regulation of investments should aim at providing security, transparency and integrity of pension savings (reduces volatility of investment returns)
- Important because of social and economic impact
- Issues to consider when defining investment rules:
  - in DC schemes, must ensure security and profitability of pension funds because investment returns have key impact on future pensions
  - take into account risks related to the investments and commitments those investments should cover
  - should not be over regulated (companies should be encouraged to set up appropriate internal controls)

Principles of Investment Rules

- **Approaches to regulation of investment rules:**
  - quantitative rules and/or
  - prudent-person rules

- **General principles for both rules:**
  - diversification and dispersion
  - currency matching
  - maturity matching

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Quantitative Rules

- list of assets allowed for pension funds investments (take into account ability to value them daily)
- maximum limits for investments in allowed assets in proportion to the total portfolio
  - allow exceeding limits in specific conditions
  - take into account impact of valuation of assets
  - differentiate depending on their inclusion into solvency calculations
- no minimum limits
- potential additional limits for special types of investments (e.g. real estate, unquoted shares, shares that may represent conflict of interest)
- rules for investments in derivatives
- general principles for matching maturity of assets and liabilities necessary

Prudent-Person Rule

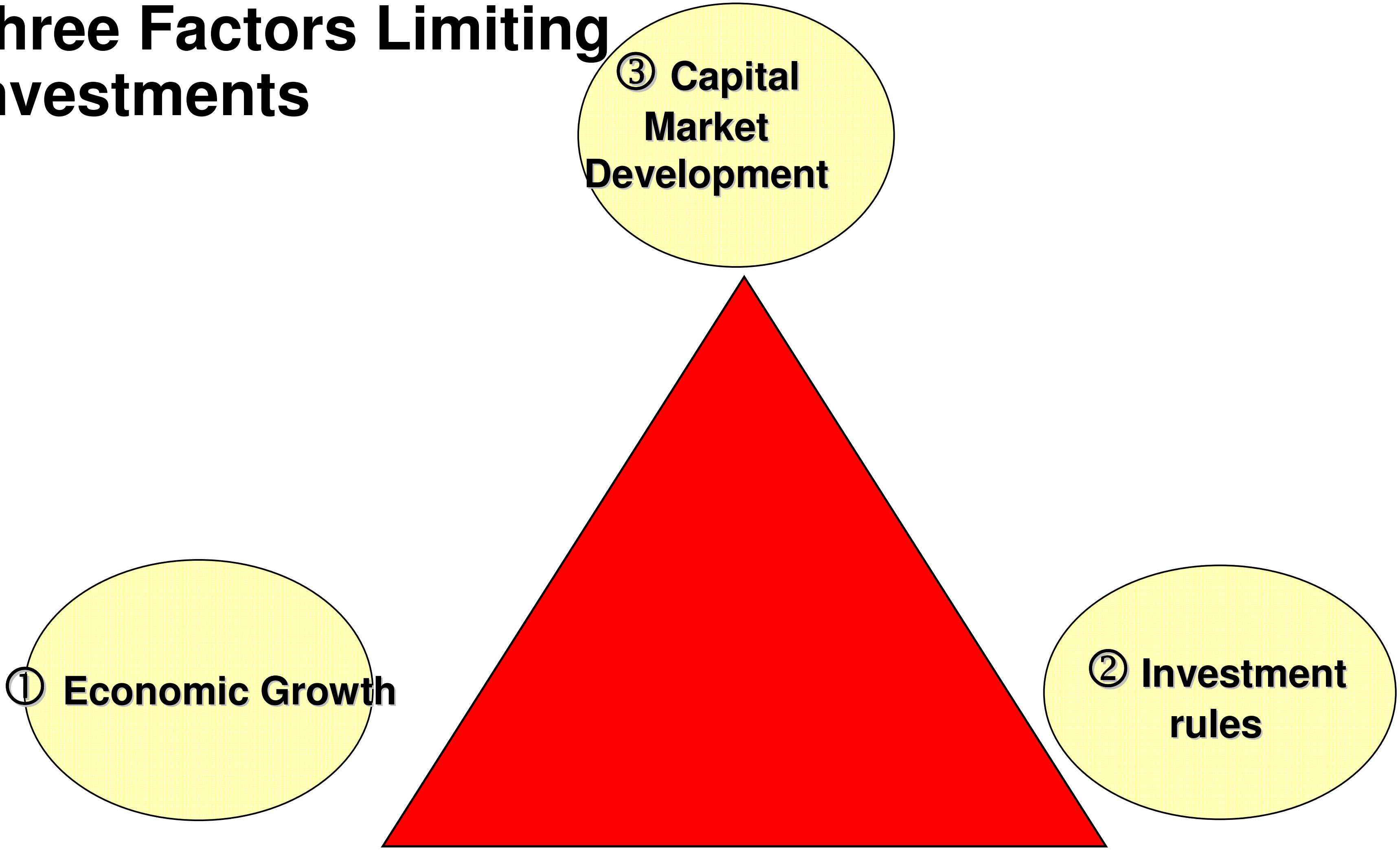
- can reduce the number of quantitative rules
- require internal systems of investment management and controls in pension institutions, strict legal sanctions for imprudent behaviour, good corporate governance practices
- must be combined with smaller or larger body of rules depending on the concrete situation in the local market
- most countries either use quantitative rules only or combine them with prudent-person rules

How Pension Funds (PF) have been invested in transition economies?

- Actual PF portfolios are influenced in each country by:
  - investment rules for pension funds
  - capital market development
  - investment strategies and policy of pension funds

- Investment practices so far show:
  - Different levels of diversification
  - Heavily invested in fixed income (specially Government Securities)
  - Low international diversification
  - Low differentiation of portfolios of PFs

Three Factors Limiting Investments



Constraints to Diversification in Transition Economies

- Low economic growth is correlated to low levels of investment
- Level of development of capital market
- Limited presence of foreign investors
- Some financial instruments still do not exist and are not regulated (futures, swaps, options ,etc)
- Need to improve infrastructure and operation of capital market

Disclosure and Education

- disclosure and education must be promoted regarding costs and benefits of private pensions
- pension funds must be required to disclose information on fees, returns, payout and withdrawal options together with information on accumulated savings to members in a transparent and regular manner
- population and specially beneficiaries must be educated to understand basic features of the system and understand their impact on pensions
- they should be also educated to recognize potential misuse of their savings and understand how to preserve rights
- educated members will help supervisor execute more efficient supervision

Corporate Governance

- Governments should be concerned with the governance of private pensions industry as they might be required to meet any shortfalls between what plans promise and what they will be able to deliver
- private pension funds are usually heavily regulated - that can mask the role of corporate governance
- primary objective of PF governance should be protection of rights of members and ensure secure source of funding to pay timely and adequate pensions - this requires a robust governance system
- good PF governance contributes to the credibility of the industry
- it is costly but it pays off through increased membership and reduced dependence on state pensions
- regulatory framework should promote good corporate governance practices within the industry and supervisors should consider issuing mandatory and voluntary guidelines
- they should encourage public oversight and activism of members and shareholders

Supervision

- states must ensure effective supervision over private pensions industry
- supervision must be focused on legal compliance, financial control, supervision of management companies and actuarial examination
- supervisory bodies must be properly staffed and funded to conduct efficient off-site and on-site control
- they should also be given adequate powers to fulfill their duties efficiently and allow for comprehensive control of all relevant parties (e.g. funds and custodians)
- self-regulation and self-supervision should be encouraged
- roles of custodians, supervisory boards, auditors and independent actuaries should be promoted

Lessons Learned

- licensing is important to allow in the market only companies with adequate operational and technical capacity that pass fit and proper tests (long-term business)
- fees and administration costs are sometimes high and represent a challenge to regulators
- impeccable record keeping is essential for employers and pension companies
- custodians are crucial in safeguarding pension assets
- efficient supervision is key to build confidence
- trend in supervision is towards integration of functions into single financial market supervisor and the increase incorporation of risk based approach

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Lessons Learned

- The approach chosen for investment rules is key to private pension funds success. Even more critical is the capacity and flexibility of regulators to adapt the rules to the environment
- Investment rules should allow more diversification and differentiation of pension funds.
- Introduce multi portfolios: allow people to choose
- More freedom to manage pension assets required, this could improve performance
- Huge potential of pension savings: boost economic growth and increase employment.
- Pension assets grow exponentially, capital markets should be ready with instruments to respond to PFs demand.
- Investment rules should not be used as an instrument to promote other objectives of social or economic policy.