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Supervision

Building public confidence in mandatory funded pensions

The regulation and supervision of individual pension accounts has been a neglected issue. In contrast, much has been written on financing the transition to funded pensions and the design of benefits. Yet effective regulation and efficient supervision are crucial to the success of pension reform. This note explores six issues in the design of a supervisory regime. It makes some comparisons between the performance of agencies in different countries and looks at four important areas of supervision: institutional and financial controls, and membership and benefits procedures.

A new agency?

Most of the activities of a pension supervisory agency are already carried out by existing authorities, such as central banks, tax collectors and capital-market regulators, such as securities and exchange commissions or insurance regulators. Grafting responsibility for the new pension system onto these existing agencies would be efficient. But a new, specialized agency might be more effective, for a number for reasons. First, the scheme is mandatory, unlike other kinds of savings. So the government has a greater responsibility to ensure that managers comply with basic rules and are carefully supervised.

Secondly, pensions are more complicated than most other forms of savings. They are long-term contracts and there are complex interactions between capital markets, insurance and social security.

Thirdly, consumers are often suspicious of the efficiency and transparency of existing supervisory agencies. Existing pensions in some reforming countries were under-regulated or even unregulated in the past. Public confidence in the new system would be undermined if the perceived inadequacies of existing supervision were carried over to the new system.

However, a new agency alone will not be sufficient. The financial system is interwoven. Problems elsewhere, in the banking system, for example, are likely to damage the new pension regime. And the same problems are likely to develop in the pension fund supervisor unless the underlying causes of regulatory ineffectiveness are addressed.

The relationship between pension-fund supervisors and other agencies in OECD countries is shown in Figure 1. In six — including two former-socialist countries, Hungary and Poland— and France and Italy—an independent, separate pension-fund agency has been established. Pension funds fall under the insurance regulator in seven countries, including Germany, and are part of a universal financial-services supervisor in a further six, including Canada and the United Kingdom. Finally, ministries of finance or labor supervise funds directly in six countries, including Japan and the United States.

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Pension supervision in OECD countries 1

Independent Separate	*Independent Insurance*	*Independent Universal*	*Ministry*
France	Australia	Canada	Austria
Hungary	Belgium	Denmark	Finland
Ireland	Germany	Korea	Greece
Italy	Luxembourg	Norway	Japan
Poland	Netherlands	Sweden	Spain
	Portugal	United Kingdom	United States
	Switzerland		

Regulation versus supervision

Regulation—setting the rules—and supervision—enforcing them—are distinct activities. They can either be assigned to one institution or divided between different institutions. Regulation is mainly the responsibility of the same institution as supervision in 13 of the 25 OECD countries in Figure 1. Ministries mainly set the rules in the rest.

The advantages and disadvantages of these two approaches are finely balanced. A single institution probably enjoys economies of scope. Separate agencies can be more effective, as supervisors approach their job without preconceptions. The only caveat is ensuring that lines of responsibility are drawn clearly, to avoid duplication or gaps.

Models of supervision

The philosophies of different supervisory systems can be divided into two broad camps. First, proactive models involve detailed specification of most of the activities of pension-fund managers. This requires equally detailed supervision and audit to check the rules are being kept. Secondly, reactive models involve a greater degree of self-regulation. The incentives for pension-fund managers are assumed to be in the right place, and so supervisors need to intervene only rarely.

It is unsurprising that many reforming countries have chosen a proactive model, because they have little tradition of regulatory enforcement and an unreliable record of supervision.

The main danger of the proactive model is that it can stifle innovation. Supervisors will naturally be keen to avoid the failure of any fund, which might indicate a failure of supervision. This leads many to forbid any new development by fund managers unless it can be positively proven to be in members' interests. The system's stability will be bought at the cost of much slower development of the industry, to the detriment of members. In reactive models, in contrast, fund managers are free to innovate provided change does not imperil solvency. The market determines the shape of the financial sector, not the supervisor.

Supervisory autonomy

The authority of the supervisor must be shielded from political pressures to protect the long-term stability of the system and security of individuals' funds. As funds grow—they are worth 45 per cent of GDP in Chile, 17 years after pension reform—supervisors will be lobbied vigorously. To minimize this risk, the agency should preferably be autonomous. Its director should be appointed transparently—perhaps with parliamentary confirmation—for a fixed period.

Figure 2 shows that supervisors are administratively independent in three Latin American countries. They are also financially independent, levying their own supervision fees directly on pension funds. In Colombia and Uruguay, pension funds supervision is part of the central bank (although these institutions can of course be independent in turn). Chile is a halfway house: the agency is formally autonomous, but administratively, politically and financially

dependent on the ministry of labor and social security.

Financing

A separate supervision fee is appealing compared with financing from the central budget. First, it bolsters the independence of the supervisory agency. Secondly, it avoids cross-subsidies from people who do not participate in the new system. Argentina is a good example. The legislation sets a budget ceiling of 1.5 per cent of the pension system's total revenues. The agency then spends as necessity dictates and takes periodic transfers from the managing companies (AFJPs) to cover expenses. Budgeted costs have been below 0.5 per cent of total revenues.

Supervision in Latin America 2

	Government	*Funding*
Autonomous		
Argentina	Labor ministry	fee
Mexico	Treasury	fee (partial)
Peru	Economy ministry	fee
Dependent		
Bolivia	Treasury	fee
Chile	Labor ministry	budget
Colombia	Central bank	fee
Uruguay	Central bank	budget

Staffing the supervisory agency

Finding the right staff for a new supervisory agency can be a challenge. Professionals with broadly relevant experience might be scarce. And the supervisory agency will be competing with pension-fund managers to hire qualified staff and to train others with the right aptitude.

It is important that the agency is able to attract and retain the right workforce, so it must be free to offer competitive pay and benefits. This will probably surpass the packages offered to other government officials. But this is probably unavoidable. In Argentina, for example, the pensions law requires that supervision employees receive a salary greater than or equal to the average paid by the 50 per cent of pension-fund managers with the highest wages. This rule has the advantage that salaries keep pace with the private sector, where pay in financial services has tended to increase more rapidly than in other industries. Other countries have set competitive salaries initially, but these have eroded over time.

Although it might be tempting to staff the agency with secondees from existing agencies and departments of government, this should be avoided. The agency will need a mix of staff with public- and-private sector experience. To ensure that knowledge of the industry is kept up-to-date, there needs to be a continual flow of recruits from the fund-management industry, including at senior levels.

Supervisory 'capture'

The risk of a 'revolving door' between the fund management companies and the supervisory agency is that of industry capture, where the supervisor puts the interests of the industry before the protection of pension-scheme members.

The best answer to this problem is a separation of responsibilities for the market as a whole from individual fund managers. Regulation and analysis of the system's performance, where the damage from capture is large, can be separated from prudential supervision, where detailed knowledge of the industry is needed but the damage from capture is smaller.

Supervisory performance

Comparing different systems is complicated because of their different characteristics. Figure 3 concentrates on Latin America.

The Mexican agency is the largest and most costly, with 214 employees and a budget of $26 million. This probably reflects the fact that over 11 million employees are covered in Mexico, compared with around 6 million in Argentina and Chile, 2½ million in Colombia, just over 1 million in Peru and fewer than half a million in Bolivia and Uruguay. Consequently, the ratio of supervision employees to pension-fund members is the second lowest in Mexico, after Colombia.

The very high ratios in Bolivia and Uruguay probably result from the relative youth of their systems and the small number of pension-fund members, which may cause problems due to lack of scale. In contrast, the high ratio in Peru may indicate inefficiency.

The ratio of employees to the number of operating pension funds is the most consistent indicator: its value is close to 10 in most cases. The exceptions of Colombia and Uruguay reflect the fact that supervision is part of the central bank, and so support services are part of the larger organization and outside the supervision agency.

Performance indicators of supervisors in Latin America 3

Country	*Employees*	*In direct control*	*Budget*	*Employees/ fund members*	*Employees/ funds*
	number	*%*	*$m*	*per million*	*number*
Argentina	183	43	12.5	31	10
Bolivia	21	43	1.9	64	11
Chile	134	69	7.0	23	10
Colombia	30	73	—	12	3
Mexico	214	25	26.3	19	13
Peru	85	19	5.1	74	14
Uruguay	21	81	—	46	4

Institutional supervision

This covers the authorization and licensing of pension-fund managers and, where necessary, their dissolution through merger or liquidation. It also includes vetting company officials and sales forces and registration of fund managers' branches.

Institutional controls will be very important in the first few years after pension reform, but will then contract. The initial effort of licensing new funds—scrutinizing legal and financial requirements, such as minimum reserves and capital—will be complete. Uncertainty over the performance of the new system will diminish as it beds down.

Merger and liquidation will also be more common in the first few years. There were initially 26 funds in Argentina, now down to 15. In Chile, there are 10 funds compared with 21 at the beginning of 199. There have been three liquidations in Chile, but none in Argentina.

Other important issues in institutional control include marketing and advertising controls (covered elsewhere in the Pension Reform Primer), inspections and audits.

Financial supervision

Regular financial reporting from funds to the supervisor is essential, covering investment policies, portfolios, revenues and expenditures. They must also include the finances of the managing companies. These reports can be cross-compared with data from custodians, the stock exchange and other financial institutions.

Other important financial supervisory tasks are valuing funds' portfolios, supervising restrictions on asset holdings, ensuring safe custody of assets and calculating and applying guarantees of funded pensions' returns.

Membership and benefits

Membership control looks at enrolment of members, marketing and transfers between funds. Benefits control, monitoring the calculation of entitlements, becomes more important as the system matures.

Conclusions and recommendations

- the professional expertise, transparency and perceived independence of supervisory agencies is essential to the success of pension reform
- in countries where existing regulation is weak or ineffective, a new, separate agency is probably best placed (but not certain) to avoid repeating past failures
- a proactive model, with detailed specification of funds activities might be needed initially, but the system should move towards reactive supervision over time to avoid stifling innovation
- financial autonomy, with the agency's budget paid by pension funds rather than general government revenues, will protect supervision from undesirable short-term political pressures
- administrative independence is similarly preferable
- salaries must be competitive with the private sector (and remain so) to recruit qualified personnel from public and private sectors and to limit corruption risk
- separation of regulation and supervision can help limit the risk of regulatory capture

Further reading

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