financial & private sector development

Risk based supervision – a horse for all courses?

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V Contractual Savings Conference

Washington DC,

January 9- 11, 2012

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Themes

- Are the existing models perfect?

- Are they always relevant?

- My disclosure……….

What is it and for whose benefit?

Possibilities

- No rules (pension anarchy)
- Managers to focus on managing risk
- Being satisfied that risk management is adequate
- Collaborating to improve risk management
- Prioritizing supervision work
- Reducing rule setters' moral hazard
- Reducing supervisors' reputation risk

Promises, promises, promises ....

Supervisor's role is to ensure that under all reasonable circumstances, a supervised entity can honor its promises

Bank – deposits can be repaid

Insurers – legitimate claims can be met

Pension funds ?????????

Risks

Risk Universe

Accumulation

- Governance
- Investment
- Operational
- Theft and fraud

Defined benefit

- Governance
- Investment
- Operational
- Theft and fraud
- Financial

We’ll have to find some measure

Deviations from the benchmark +credit risk +market risk = measure commonly used

Investment+ governance + operational + theft and fraud = risk of ruin

Supervisor’s perspective – minimizes reputation risk

Contributors’ perspective – part of the story

Let’s muddy the waters some more

Guarantee a minimum return

The issue is not herding *per se* – its going for the short term

Offer managers short term incentives

Lesson for supervisors – never, ever, ever make risk ratings public

So who looks after the poor old member?

The supervisor – half the story as it offers only protection from risk of ruin

The market – oh yeah!!!!!!!!!!!!!!!

So who has the answer?

Refer to session 2 on day one !

What RBS isn't

- An “either or” proposition
- An instant fix
- Pension anarchy
- Cost saving
- Foolproof

Can it be applied universally?

- Legal structure – statutory and case law on fiduciaries – vs.- civil code
- Home grown market –vs.- large number of international conglomerates
- Costs –vs. –benefits

International conglomerates

Country	Percentage of managers part of international group	Funds held by international group
Australia	Less than 2%	Less than 2%
Chile	50%	78%
Colombia	66%	47%
Lithuania	86%	98%
Peru	75%	69%
Poland	88%	70%
Slovakia	100%	100%

Benefits

- Managers more focused on risk management
- Scale economies in the pension sector
- A more manageable population of supervised entities

Scale - Australian corporate funds

Country	Year	Average FUM per manager (USD millions)
Australia	1995	less than 10
	2006	100
	2010	270
Chile	2011	23,000
Colombia	2011	8,000
Lithuania	2011	214
Peru	2011	7,000

Bringing it all together……..

- RBS is a useful tool because it focuses managers' attention on risk
- It still has fundamental measurement issues
- It may not be suited to every supervisor:
  - Differences in the legal environment
  - Pension sector organization
  - Imperatives to adopt RBS are less than the costs

The Fifth Contractual Savings Conference

Reshaping the Future of Funded Pension Systems

January 9–11, 2012
Preston Auditorium, World Bank Group
1818 H Street, N.W.
Washington, D.C.

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http://go.worldbank.org/RGPDC72D60

Risk-Based Supervision of Pension Funds: A Reasonable Approach for Emerging Economies? Some Comments

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Some Practical Aspects of Risk Based Supervision

- Allows more efficient allocation of scarce supervisory resources.
- Requires new skill set from human resources in Supervisory body
- Is there legal backup for RBS outside common law countries?
  - Requires rather strong powers and independence of Supervisory agents
- In many cases it also allows bringing the Supervisor up to industry standards in terms of risk management. However, are they measuring the same risks?

Alignment of Risk motives

- Which system is more effective when trying to align investment horizons between managers and participants?:
  - Risk based supervision (define appropriate measure of risk)
  - Compliance based (Where rules are made with a long term horizon in mind. Even allow life-cycle approach).
- In theory: measure risk as deviations from appropriate benchmark that takes into account long term investment horizon.
- Are rules a viable second best? Or a useful complement?

NATIONAL SUPERINTENDENCE FOR PENSION FUNDS

PREVIC - BRAZIL

5th Contractual Savings Conference

Risk-based Supervision of Pension Funds: A reasonable approach for emerging economies?

Commentary by
José Maria Rabelo

January, 10, 2012

Private Pensions in Brazil

- ► Already a mature pensions market, similar to markets in some developed countries
- ► 338 closed pension funds (plus many open funds)
- ► 1,092 pension plans (34% DB, 36% VC, 30% DC)
- ► 2,327 plan sponsors
- ► 3 million active plan members and beneficiaries
- ► US$ 308 billion aggregate assets
- ► US$ 35 billion aggregate annual benefit payments
- ► In the World 'top 10' private pension systems

Biggest risks similar to those in many other economies

- ► Valuation of DB liabilities could not reflect the risk that investment returns will fall and longevity increase
- ► Use of fixed discount rates rather than market consistent rates
- ► No life-cycling of defined contribution may expose participants to volatility at retirement or over-conservative investment earlier in their careers
- ► Default investment options may cause results that don’t mach the participant expectations
- ► Governance issues, relating to expertise and conflicts of interest

Why risk-based supervision in Brazil?

- ► Previous approach focused on seeking and sanctioning detailed infractions – not necessarily focusing on the biggest risks
- ► RBS identifies the biggest risks and results in a much more intense focus on them
- ► It enables the enforcement of fiduciary, actuarial and prudent person principles
- ► It shifts attention to the quality of governance and control in pension funds - to check that risks are being well managed…
- ► …and hence that detailed infractions should be prevented or remedied without supervisory input

How has PREVIC moved to RBS

► The system restructuring in the begining of 2010 was crucial to the RBS implementation in the new independent supervisor

► World Bank project provided the expertise and skills, helping PREVIC in order to:

- Assess the strengths and weaknesses
- Develop a road-map for risk-based supervision
- Deliver capacity building and cultural change
- Review and propose revisions to regulations with a new approach

► RBS team within PREVIC has helped design and champion RBS

What is RBS delivering?

- ► Guide of best practices for pension fund management (actuarial, governance, investment and risk management) – this makes PREVIC's expectations clear

- ► A new on-site inspection methodology and manual, with a focus on governance, actuarial and investment risks – aiming at compliance with the guide and regulations

- ► Off-site quantification of actuarial and investment risks (on a risk matrix) to identify those funds most needing intervention

- ► Revised actuarial and enforcement regulations to better reflect the risk environment and underpin the enforcement of regulatory principles

- ► A central risk analysis function and a Risk Committee to co-ordinate the response to existing risk and identify new ones

Expected outcomes

► PREVIC is seeking RBS to drive change within the pension fund system, so that:

- The fiduciary managers of pension funds will better understand their role, exercise stronger control and avoid conflicts of interests
- Pension plans will use more acute actuarial assumptions
- The risks in pension fund investments will be better managed, resulting in higher or more secure retirement benefits

Learning points

- Every pension system is different – some features in Brazil may be unique – there can be no single template for RBS
- In a mature systems, compliance with rules can be largely expected – the big risks come from issues that are hard to codify, such as actuarial sufficiency, investment optimisation and quality governance
- Being risk-based is not an alternative to being compliance based – it is a way of achieving compliance with the most important issues regarding the sustainability of the fund
- Attitudes and systems need be changed across the supervisory authority – champions are needed
- Winning hearts and minds at the pension funds is as important as having the right legislation

THANKS!

NATIONAL SUPERINTENDENCE FOR PENSION FUNDS

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