SAVING THE NEXT BILLION FROM OLD AGE POVERTY

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REGULATION, SUPERVISION, MARKET STRUCTURE AND **MEMBER PROTECTION**

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INTRODUCTION

Governments establish policies on a wide range of topics that they consider to be important and use various policy instruments to help achieve their objectives. Pensions are important from many perspectives, both social and economic, to workers and their families, employers, and the economy. Strong pension systems can be rewarding to all stakeholders, but weaknesses can pose risks. This chapter looks at how to make choices in relation to regulation, supervision, market structure and member protection for the pensions sector that will support the achievement of government policy objectives.

Regulation is the framework of rules, principles, and guidelines that set out expectations for the way the pension system will work. Regulation sometimes requires or prohibits actions; for example, restricting the investments of a pension fund. Regulation might also be used to affect behaviour; for example, requiring good governance and risk management. Alternatively, regulation might specify rights or outcomes for entities or individuals; for example, the right of a member to appeal a decision of the plan administrator regarding eligibility for benefits.

Supervision consists of the mechanisms and systems used to monitor the implementation of regulation and to take enforcement action if expectations are not being met. Used together, regulation and supervision reinforce one another; using one without the other is unlikely to be effective. Regulation without supervision provides little assurance that market participants will behave in accordance with expectations. Supervision without regulation provides little guidance to market participants on how they are expected to behave.

The market structure of a pension system can be profoundly important in determining its success. Market structure is affected by and might be considered as an element of the overall regulatory framework. But it is important enough to be considered on its own – indeed Chapter 17 on Governance and Investment and Chapter 18 on Costs show how differences in structure can have profound impacts on results. For many types of markets, governments tend to leave the market structure to evolve in response to market mechanisms. But pension markets have many special features. Achievement of broad coverage might require mandatory or quasi-mandatory approaches, to produce outcomes that are not simply the result of the interplay of supply and demand between providers and consumers, such as seen in a typical consumer goods market. The economies of scale in administration and investment management are such that in small markets pension administration can have a quasi-utility nature. And lifelong portability across time, geography, occupation and formal and informal labour markets argues for co-ordination or interoperability in certain elements of the value chain to cut costs and avoid multiple small accounts. Moreover, pension markets are one of the few where not-for-profit governance structures are very common and have been shown to deliver outcomes as good as, if not better than, for-profit alternatives (see Chapter 18 on Costs and Returns). So, the approach is not a rarity, as in some markets, but is the governance structure under which most global pension assets[1] are currently being managed.

Market structure is also highly relevant to determining the most effective approach to member protection. Many of the standard elements of the member protection toolkit – disclosure, cooling-off periods, redress mechanisms and financial education – exist in pension markets. But there is not much evidence that they are hugely effective in improving outcomes. Even highly-educated people can find pensions daunting. Simple changes to default rules, such as auto-enrolling people into a pension plan, can very significantly increase participation, as shown in Chapter 3 on the U.K.. In theory, such approaches should not work if members have the right information and are making clear choices. However, it is clear not only that members find it very challenging to understand pensions but also that even high quality (and often relatively expensive) financial education is often unable to bridge the gap. In a normal market this would mean that people simply would not buy the product. However, lack of pension provision can be unacceptable from a public policy perspective because of the consequences for old-age poverty. In this challenging policy context, a critical part of the member protection toolkit can be having institutions with strong governance acting in the members' best interests. There is a wide range of alternatives for doing this, which might involve "traditional" private sector providers, well-run employer-sponsored pension funds with expert trustee boards, or arm's length not-for-profit providers set up under statute with a specific mission.

The rest of this chapter begins with a discussion of possible policy objectives and how regulation, supervision, and market structure and member protection strategies can support their achievement. Section 3 highlights the need to have a solid understanding of the current situation before designing the framework of regulation, supervision, market structure and member protection. Section 4 discusses the development of the framework itself. Section 5 highlights the importance of establishing specific goals and indicators that can be used to measure their achievement. Section 6 deals with the identification of risks to the achievement of goals, while section 7 discusses strategies that can be used to deal with the risks. Sections 8, 9, and 10 describe steps that might be taken in the implementation of regulatory, supervisory, and market structure and member protection strategies, respectively.

ESTABLISH **POLICY OBJECTIVES**

Governments can have diverse policy objectives related to the pension system. Some objectives might focus on the outcomes the pension system is expected to achieve, such

[1] See, for example, the make-up of the world's 300 largest pension funds in the annual Towers Watson P&I survey of the Global 300 largest pension funds. The point is not to assume that one structure or another is necessarily superior, but to be rigorous in evaluating the most effective value chain for the pension market in a jurisdiction – particularly in relation to whether it is compulsory, quasi-mandatory or voluntary.

as: efficiency, coverage, adequacy, sustainability, and security. Other objectives might be more far-reaching, relating to the economy or social welfare.

The outcomes-based diagnosis and assessment (OBA) framework for private pensions[2] puts the pension outcomes that will improve people's lives at the heart of an assessment methodology designed to identify how private pensions can contribute to improving those outcomes. The five key outcomes are defined in Box 21.1. Of course, these outcomes overlap. For example, good governance may contribute directly to security and efficiency and indirectly to sustainability. Effective supervision may affect all the outcomes. Furthermore, trade-offs between the outcomes are often important when considering policy objectives.

The pension system can contribute to the achievement of various economic objectives. For example, the pools of capital accumulated in pension funds can be a source of financing that can support economic growth and the development of broader and deeper financial markets. The long-term nature of pension obligations means that the investments of pension funds can contribute to financial stability. A well-designed pension system can also provide incentives for the formalization of the labour market.

A government's specific social welfare objectives in terms of poverty reduction or enhancing the rights of women and minorities can be set out in terms of objectives for coverage and levels of adequacy. Such outcomes can be expressed not only in aggregate – for example, average pensions to reach 50% of average earnings – but also in relation to achieving a minimum level of income or to ensuring gender equality in adequacy.

Ideally, government's policy objectives should be clearly identified, realistic, and internally consistent. Sometimes this is done in a comprehensive and formal manner, for example, in a policy paper. But even where this has not been done, it is essential that those responsible for pension regulation and supervision obtain as much clarity as possible regarding policy objectives. This will help them to develop appropriate strategies and weigh the trade-offs that might be involved. It also facilitates rigorous monitoring and evaluation of the policies and approaches that are implemented.

Box 21.1

Key Outcomes for Private Pensions
(definitions taken from Price and others 2016)

Efficiency: Maximizing net-of-fee returns by improving investment and cost performance subject to acceptable risks. Efficiency also relates to the efficiency of the labour and capital markets, as each interacts with the pension system through direct contributions to pensions (through longer working lives and contributions, lower costs of capital, or greater financial inclusion) as well as through indirect contributions to

[2] Outcome Based Assessments for Private Pensions: A Handbook, William Price, John Ashcroft, and Michael Hafeman, World Bank, June 2016.

jobs and investment. For labour markets, this includes removing disincentives for work or formal work caused by excessive contributions or contributing to growth by increasing labour market participation at older ages. For capital markets, it relates to capital market depth through the development of non-bank financial capital to fund productive investment and maximize the benefits of wider capital market reforms – for example, in securities markets and infrastructure financing.

Sustainability: Ensuring that the promised retirement income will be delivered for this and future generations without placing burdens on government, employers, or workers for financing that will not be met. Sustainability is inherently improved by a diversified set of pillars or tiers so that one part of the system, public or private, does not have to bear all the weight of long-run demographic trends. Sustainability also relates to political and individual support – with a technically viable reform having sustainability challenges if political consensus is weak, public expectations are not realistic, the system is not equitable, or intergenerational inequity is high.

Coverage: Maximizing the proportion of the working-age population that is accumulating retirement income entitlements and the proportion of retirees receiving such financial support in retirement. Coverage encompasses measures to include informal and other difficult-to-reach workers within retirement benefit accumulation. This includes building on innovations in ID and IT and having multiple channels into contributory pensions. It also includes a recognition that expanding targeted non-contributory "social" pensions will be necessary if full coverage of income in old-age is to be achieved – emphasizing there are limits to private pensions and hence the need to build diversified pension systems. The coverage outcome includes the impact of a wide range of policies, including broad eligibility rules, tax relief, educational support, and improved compliance and formality. This is a rapidly developing area in relation to the informal sector. Extensions to the OBA framework will be developed in the future – integrating insights from work developing coverage expansion strategies, pilots and implementation initiatives in a number of jurisdictions.

Adequacy: Ensuring people accumulate retirement benefit entitlements that protect them from poverty, allow them to share in increased prosperity, and that people are protected against a severe drop in living standards at retirement, taking account of other sources of financial support. In contributory systems, adequacy involves ensuring sufficient and equitable contributions during retirees' working careers in order to generate adequate retirement benefits. It can be measured in a range of ways, which include retirement income as a percentage of average wages, poverty levels, and own (career) earnings. It also relates to outcomes immediately after retirement and, as people age, to reflect the impact of inflation on retirement income over time. And it is essential to see who has inadequate pensions – for example, to include the distribution by gender, income, and other characteristics.

Security: Ensuring the security of assets to minimize the risk that funds that have been (or should have been) accumulated to provide retirement benefits are lost or misappropriated before the benefits are delivered. The importance of long-run growth in assets is central to the promise of pensions. But this is of no use if the assets are not there in 50 years when they are needed to generate income. So, security covers a wide range of elements, including basic conditions, such as the enforceability of law; accounting, actuarial, and auditing capacity; data and payment systems; valuations and risk management; and control frameworks. It also covers the processes to ensure the recovery of any permitted shortfalls in assets (for example, in defined-benefit plans). Security relates to the performance of the supervisor as well as compensation mechanisms and protection of assets from government or employer expropriation.

Regulation, supervision, market structure and member protection programs play important roles in the achievement of policy objectives, in a variety of ways. As well as the core elements of regulation in terms of how pensions will be structured and who can provide them, there are a wide range of other interventions to consider, such as whether to provide guarantees of returns or outcomes rather than have a pure defined-benefit or defined-contribution system, and whether to provide incentives for pension participation and, if so, how – for example, through taxation or matching and whether to include limits on the incentives available for a given individual to avoid a pension system becoming regressive.

The OBA framework can be useful in considering what steps might be taken to strengthen the pension system and how various policy instruments, including regulation, supervision, market structure and member protection programs, might be applied in implementing such steps. It identifies key features, which help to drive the various outcomes. The key features were derived from a broad range of sources and were mapped against international principles, standards, and guidelines on pensions.

Many of the key features can be addressed, either in full or in part, through regulation, supervision, or member protection programs. But this cannot be done well without a clear understanding of the current situation in a particular jurisdiction.

UNDERSTAND THE CURRENT SITUATION

Private pensions are not only part of the wider pension system and hence social policy, but also intimately related to the macroeconomic environment, the capital and labour markets, and, through them, the long-run growth prospects for an economy. It is useful to identify those elements that are within the scope of a supervisor and those elements that are important to outcomes but outside its scope. However, even where areas are outside their scope, supervisors might engage in an active dialogue with a Central Bank, Ministry of Finance, Ministry of Social Affairs, or Ministry of Labour through which to communicate the importance of broader reforms.

Understanding the economic and political environment of a jurisdiction and whether the preconditions for pension regulation and supervision – or reforms to the pension system more generally – exist is an essential element of developing reforms tailored to the needs of a jurisdiction (Holzmann and Hinz 2005; IEG 2006; Rocha and Rudolph 2008; Barr and Diamond 2009). These include economic factors such as the macroeconomic situation as well as the availability of legal, accounting, and actuarial professionals. These preconditions are always important areas to consider, because even if they have previously been met in a jurisdiction the situation can change.

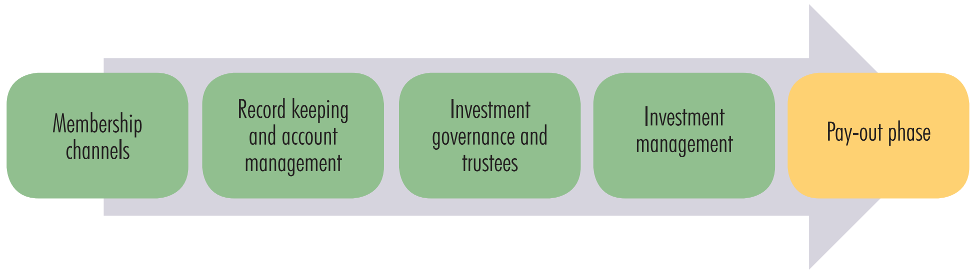
One critical precondition for successful regulation and supervision is the development of a political consensus in support of it. Politics are always challenging, but successful regulators and supervisors need to be aware of the political situation and find ways to build the case for change.[3] The variety of stakeholders involved in the pension sector, often including multiple government bodies, creates a high risk of confusion and conflict regarding objectives and responsibilities, which can compromise the effectiveness of regulation and supervision. The guidance provided by a policy for the pension sector that sets out clear objectives and responsibilities can significantly mitigate that risk.

Regulators and supervisors need to understand the overall framework for pensions in a jurisdiction. This includes the various pillars, such as social protection programs, employment-based social security pensions, private pensions, and other sources of retirement income that are available. How these pillars operate, their contributions to pension coverage and adequacy, and the sustainability of their costs are all relevant. The legal arrangements for pensions, including taxation and other regulatory requirements, set the parameters within which the market must operate.

There is a very wide range of options regarding exactly how a pension system can have its private assets collected, managed, and paid out. Market analysis should identify the entities involved at each stage of the value chain; for example, those playing key roles in promotion and access may not be the same as those doing the administration of accounts or managing the pay-out of the assets. How the different players are governed is important, particularly in the administration, fund management, and pay-out parts of the value chain. Finally, it is important to look at the programs, products and services that are currently available; how they are distributed; and the types of customers who are using them – as well as options for improving on all these elements. A high-level value chain is set out in Figure 21.1.

[3] Action Planning Guide, Toronto Centre, October 2015.

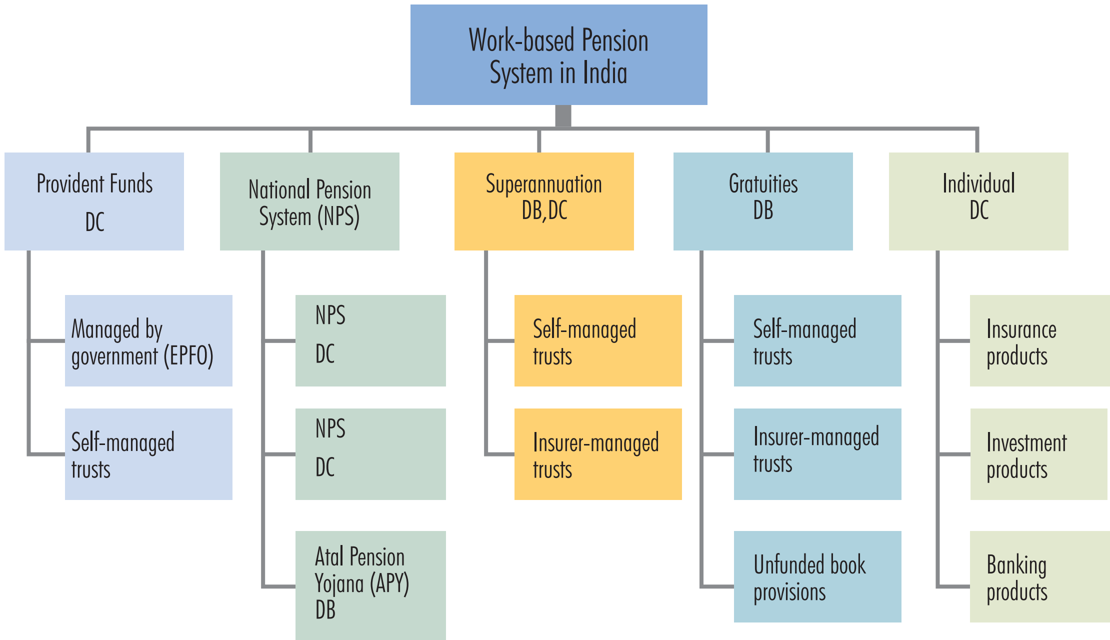
Figure 21.1
Stages of the Pension Value Chain



The identification process should extend beyond the offerings of regulated financial institutions to include programs offered by others, which might include government agencies. The market structure and entities involved in private pensions will affect the demand and supply sides of the market and can have a significant impact on pension outcomes, particularly on costs and investment returns (Impavido, Lasagabaster, and García-Huitrón 2010), and can create regulatory challenges. For example, distribution mechanisms for obtaining contributions and converting them into invested assets can be very costly, and the use of sales agents might lead to excessive churning of pension investment portfolios. Regulatory and supervisory actions might be needed to deal with such market problems.

It can be useful to map out the market structure, to provide a visual overview of the programs and entities involved and how they relate to one another; see, for example, Figure 21.2 regarding the work-based pension system in India. It is not always easy to identify who is involved, but discussions with stakeholders such as known market participants, government institutions, and employers about who they deal with can help to provide a more complete picture. Then consider each entity from a functional standpoint and identify what roles it plays in the delivery of pensions. Also, seek to understand the objectives of the market participants and the ways the pension-related functions support their objectives.

Figure 21.2
Work-based Pension System in India



The complexity of the pension sector can sometimes extend to the involvement of multiple institutions in regulation and supervision. Some might be financial supervisors, while others might be regulators or supervisors of non financial activities. Still others might have development responsibilities—for example, for economic or agricultural development—or deal with taxation. Many of the steps discussed in relation to understanding the market apply similarly when dealing with diverse authorities. For example, it is useful to develop an understanding of the objectives of each authority, as well as both the entities and the functions that are within the scope of its responsibility.

CREATING THE INSTITUTIONAL FRAMEWORK

If regulation, supervision, and member protection are to be effective, they should take place within a clear, appropriate, and enabling framework. The regulatory perimeter should be clearly defined and an institutional framework established to carry out regulation and supervision. The institutions involved should have the mandates, powers, and resources needed to operate. They should also organize themselves to operate effectively and efficiently.

Government might broadly support the need to regulate and supervise private pensions to achieve its policy objectives. However, this does not necessarily mean that legislation will clearly set out what parts of the pension system will be subject to regulation and supervision. For example, some pension programs might be operated by a government agency and exempted from supervision. Some financial products used to fund private pensions might be covered by another sector's regulations, but neither clearly within or outside the scope of pension regulation.

The regulatory perimeter should be clearly defined. All aspects of the market should be considered, including pension programs, pension entities (such as pension plans, pension funds, and pension companies), service providers (such as investment managers, administrators, and advisors), the various products and services that they provide, and the activities that they undertake. In each case, it should be clear whether the matter is subject to regulation. If not, steps should be taken to clarify the regulatory perimeter. This might require consultation among various authorities, as well as with industry, and changes to legislation.

The institutional framework should include a pension regulatory authority, but often includes other institutions as well. For example, many of the entities that provide products and services to the private pension sector might already be regulated and supervised by authorities responsible for other parts of the financial system, such as insurance, banking, or securities. When more than one institution is involved, clarity is important with respect to who does what within the pension regulatory perimeter. The responsibilities of the various authorities with respect to pensions (and more generally, as well) should be delineated as clearly as possible and they should cooperate with one another in carrying out such responsibilities. Policy objectives and instruments should be appropriately matched to the institutions involved, and any regulatory and supervisory gaps and overlaps should be identified and dealt with. For example, it is not uncommon to find an insurance supervisor who thinks the pension supervisor is examining the pension business of insurers, while the pension supervisor assumes the insurance supervisor is doing so.

For example, the following delineation of responsibilities might be appropriate in many jurisdictions:

- **Government ministry:** policy and legislation regarding types of programs, eligibility or requirement to establish or participate in pension plans, and minimum and maximum standards for plan design and funding (benefits and contribution levels) to obtain favourable tax treatment.
- **Pension regulatory and supervisory authority:** regulation and supervision of pension plans and the entities that provide services to them, with respect to their activities in providing such services. Cooperate with primary supervisors of the entities with respect to regulatory requirements, licensing, ongoing supervision, and intervention.
- **Other regulatory and supervisory authorities (insurance, banking, and securities):** regulation and supervision of the entities that provide financial services to pension plans, as primary supervisor of the entity. Cooperate with the pension authority with respect to regulatory requirements, licensing, ongoing supervision, and intervention, to facilitate that authority's regulation and supervision of the activities of

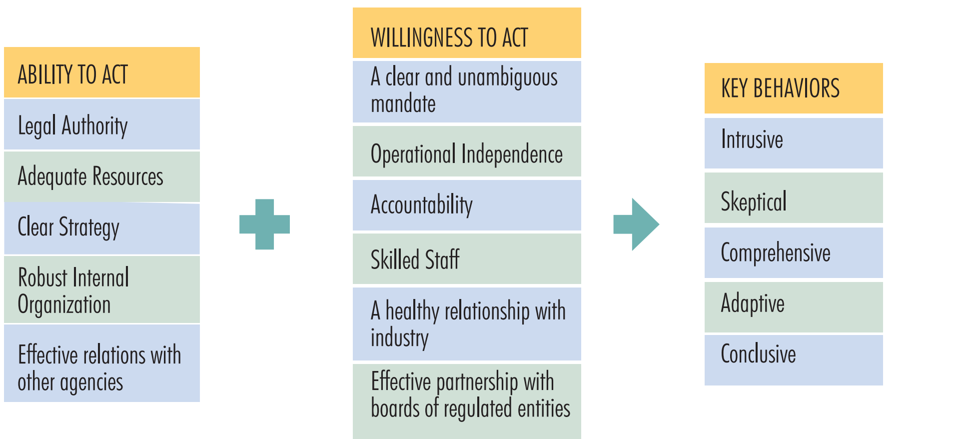
these entities in providing services to pension plans.

The institutional framework often evolves over time and can become quite complex. It will reflect the history, politics, and culture of the jurisdiction. If it is to be effective, it should also be appropriate to the level of economic development of the jurisdiction, the nature and scope of its financial system, and the financial and human resources available to carry out supervision. For example, if there are no publicly traded securities or private sector pension plans in a jurisdiction then it might well be inappropriate to establish separate institutions to regulate and supervise the securities and pensions sectors.[4]

Variations can occur in the scope of responsibilities assigned to the authorities. For example, authorities might be established that are specialized by sector (such as pensions, insurance, banking, and securities); integrated across sectors; specialized by type of supervision (such as macro-prudential, micro-prudential, market conduct, financial integrity, and competition policy); or specialized by function (such as regulation, supervision, or member protection). Variations can also occur in institutional form: government agency; central bank; autonomous agency; or self-regulatory organization. But there are probably relatively few jurisdictions that adopted any of these variations in a "pure" form. The approaches can be mixed to develop hybrid models that will best respond to the situation in a particular jurisdiction.

There is no dominant structural solution. A careful analysis of arrangements that worked well during the global financial crisis highlighted instead that regulators and supervisors needed to display both the ability and willingness to act. It was not enough to have sufficient powers, because many who had the powers did not act. So, in addition, the institutional culture needs to support effective supervision.[5]

Figure 21.3
Ability and Willingness to Act Drive Effective Regulation and Supervision



[4] Organizational Alternatives for Supervisors, Michael Hafeman, Toronto Centre, January 2016.
[5] The Making of Good Supervision: Learning to Say "No", Jose Vinals and Jonathan Fiechter, with Aditya Narain, Jennifer Elliott, Ian Tower, Pierluigi Bologna, and Michael Hsu, IMF Staff Position Paper SPN/10/08, 2010.

Design of the overall institutional framework can be challenging, since each of the many alternatives presents the need to trade-off various advantages and disadvantages. The OECD has developed guidance on this subject,[6] which includes several principles for design: maximize synergies; ensure consistency and coherence in the use of policy instruments; align incentives and minimize potential conflicts; promote accountability; and minimize risks for the taxpayer.

The institutions responsible for regulation and supervision should have clear mandates and responsibilities, with their objectives being set out in legislation. They need operational independence, along with adequate resources and powers, to pursue and achieve their objectives. These fundamental needs are highlighted in the IOPS Principles of Private Pension Supervision,[7] which are set out in Box 21.2.

Several of the IOPS Principles are interrelated and can be particularly difficult for new supervisory authorities in developing markets to achieve. In developed markets, it is often possible for the authorities to obtain adequate resources by imposing fees and levies on the regulated entities. But in developing markets, the size of the pension sector might be insufficient to generate adequate resources without imposing unreasonable costs on the sector. To secure adequate resources, it might therefore be necessary to obtain funding from the government budget. However, this poses a risk to independence. The risk can be mitigated by strong governance mechanisms for the supervisory authority, which impose accountability while preserving independence.

Box 21.2

IOPS Principles of Private Pension Supervision

Principle 1: Objectives – National laws should assign clear and explicit objectives to pension supervisory authorities.

Principle 2: Independence – Pension supervisory authorities should have operational independence.

Principle 3: Adequate Resources – Pension supervisory authorities require adequate financial, human and other resources.

Principle 4: Adequate Powers – Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives.

Principle 5: Risk-Based Supervision – Pension supervisory authorities should adopt a risk-based approach. Note that this relates to risk-based structures and processes, not how individual risks are to be supervised, which is covered under other features.

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6 Policy Framework for Effective and Efficient Financial Regulation: General Guidance and High-Level Checklist, OECD, 2010.
7 Methodology for Review of Supervisory Systems using IOPS Principles, International Organization of Pension Supervisors, November 2010.

Principle 6: Proportionality and Consistency – Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent.

Principle 7: Consultation and Cooperation – Pension supervisory authorities should consult with the bodies they are overseeing and cooperate with other supervisory authorities.

Principle 8: Confidentiality – Pension supervisory authorities should treat confidential information appropriately.

Principle 9: Transparency – Pension supervisory authorities should conduct their operations in a transparent manner.

Principle 10: Governance – The supervisory authority should adhere to its own good governance practices – including governance codes, internal risk-management systems and performance measurement – and should be accountable.

An institution involved in regulation and supervision should organize itself to operate effectively and efficiently. Key aspects of an organization are its structure, culture, business processes, strategy, and human resources. There are two main types of structures used by regulatory and supervisory authorities: functional and divisional. Functional structures are particularly common among institutions that focus on a single sector. For example, the structure might include three main departments: regulation, supervision, and administration. An advantage of a functional structure is that the staff within each department specialize in carrying out a particular function, which can enable them to become efficient at performing certain tasks. A disadvantage of such a structure is that communication is often upward and downward within the organization, which can compromise cooperation among the various departments.[8]

Divisional structures are organized into self-contained divisions, each of which carries out a full range of functions. For example, an integrated supervisory institution might include divisions such as: pensions, banking, insurance, capital markets, and non-bank financial institutions. Each division would carry out regulation, supervision, and administration functions related to its assigned financial sector. Organizations often develop structures that are hybrids of the functional and divisional models. They do so to try to capture the advantages of each while minimizing the disadvantages.

The organisational structure should seek to avoid internal conflicts that might compromise the independence or effectiveness of the organization in achieving its objectives. For example, regulation and supervision responsibilities might be separated from those related to the development of the pension sector. It should provide clear accountabilities for results, while at the same time including mechanisms to promote internal cooperation and avoid a "silo" mentality.

[8] Organisational Alternatives for Supervisors, Michael Hafeman, Toronto Centre, January 2016.

Regulatory and supervisory responsibilities require the application of a wide range of technical, professional, and managerial skills. Particularly in newer and smaller institutions in developing jurisdictions, some skills gaps might exist. For example, some specialized expertise, such as actuarial, might not exist at all within the organization, while types of expertise might be possessed by just one or a few people. Organizations should undertake a detailed assessment of skills needed – both currently and prospectively – as well as an inventory of skills available, and develop plans to deal with the gaps. This should help to ensure that recruitment and development of staff can be dealt with proactively. Many regulatory and supervisory authorities also make use of outside experts to help them obtain the necessary expertise.[9]

An institution will also need systems, procedures, and internal controls to facilitate its work. If regulation and supervision of pensions is being carried out by a well-established institution, these things will probably already be in place. If the institution is new, it might be able to leverage the work done by other institutions in the jurisdiction, by adapting their systems and procedures to meet its own needs. Much can also be learned from those in other jurisdictions, either by communicating with them directly or making use of outside experts.

If more than one institution is involved in the regulation and supervision of pensions, it is essential that they cooperate in carrying out their responsibilities. Legislation should permit them to do so and written agreements, such as memoranda of understanding, should be reached to document the way the cooperation will take place. Cooperation should occur at all levels, from the establishment of policy, to the development of regulation, to the implementation of supervision.

ESTABLISH SPECIFIC **GOALS AND INDICATORS**

Regulation and supervision exist to help achieve various policy objectives. But rather than just saying that "we want things to improve", it is useful to establish specific goals and develop indicators that can be used to measure progress toward them. Doing so helps those carrying out regulation and supervision to develop strategies. It also enables both them and policy makers to assess the effectiveness of the strategies and their implementation. This contributes to accountability and should prompt a rethinking of strategies that are not having the desired effects. Ideally, goals should be established for each policy objective. But it is particularly important for an institution responsible for regulation and supervision that goals be established for the policy objectives that are most directly related to its mandate.

In practice, it can be easier to set specific goals after considering possible indicators of progress toward desired outcomes and the actual situation in the jurisdiction with respect

[9] How Can Outside Experts Help a Supervisor? Michael Hafeman, Toronto Centre, November 2016. How Can a Supervisor Manage Outside Experts? Michael Hafeman, Toronto Centre, November 2016.

to those indicators. The OBA framework provides a wide range of indicators for each of the five outcomes and identifies the data needed to calculate each indicator. For example, coverage indicators include the current number of contributors and pension recipients and their shares of the relevant segments of the workforce and population. Security indicators cover a wide variety of factors. They include the funding ratios of defined-benefit plans and others that provide guarantees, as well as the extent to which pension assets are held separately from other assets. Data on assets lost to insolvency, fraud, or theft are relevant, as are the potential losses that were avoided through coverage by compensation schemes. The existence of mortality data and the availability of projected improvements support the secure funding of pensions. The existence of large data gaps for any outcome sets a baseline for improvements.

While the full range of indicators could be considered, the focus should be on those most relevant to the pension system in the jurisdiction. Sources of the information needed to calculate these indicators should be identified. In some cases, the information is likely to be readily available. In other cases, it might not exist or might have to be obtained from a variety of sources, such as the government statistical bureau, other financial supervisors, or the labour ministry.

Where possible, historical information should be collected and the indicators calculated. It might be necessary to make estimates or assumptions to deal with shortcomings in the data. For some of the indicators, for example, those related to coverage, it is useful to prepare projections of the data to show how the indicators might be expected to evolve over time.

Goals for the improvement of key indicators should be established. The goals should take account of the historical information, projections (where relevant), and the policy objectives. Goals should be both challenging and realistic, with respect to both the levels of the indicators and the time frames within which they are to be achieved.

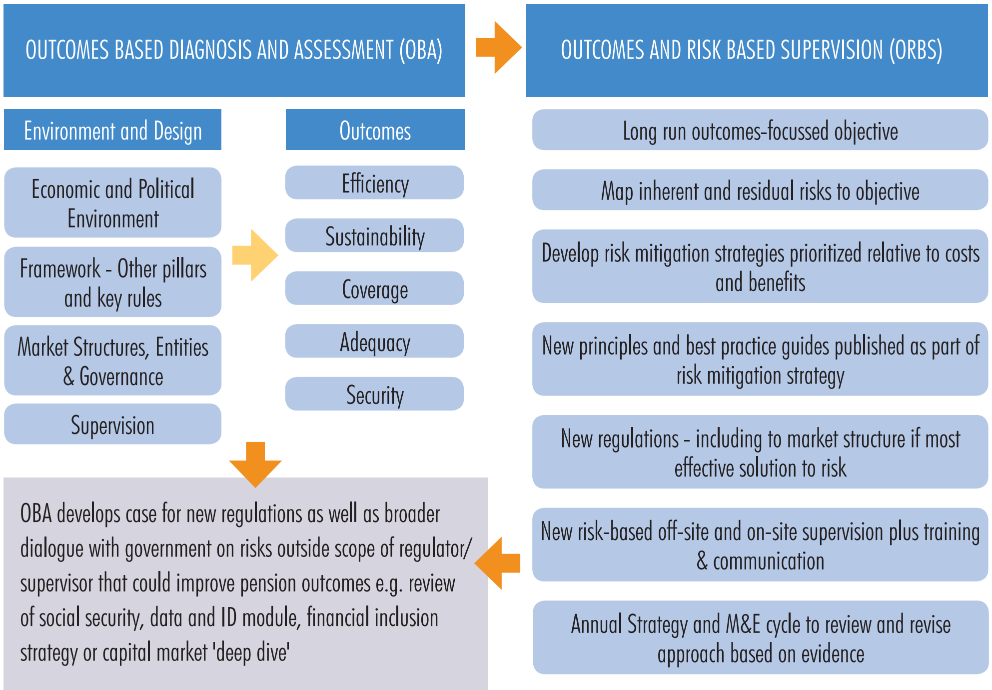
IDENTIFY RISKS TO THE **ACHIEVEMENT OF THE GOALS**

One of the most important uses of the OBA framework is as the starting point in the development of risk-based supervision for pensions. The risk-based supervision approach is enhanced by having a clear statement of the outcomes and goals that the supervisor wants to achieve. This enables the supervisor to focus on the risks to the achievement of the desired outcomes and goals. An updated approach to risk-based supervision, known as Outcomes and Risk-based Supervision or the ORBS methodology.[10] It is summarized in Figure 4 and discussed in the paragraphs that follow.

[10] This section sets out the ORBS approach at a high level. A detailed Handbook has been developed – see Ashcroft, Hafeman and Price (2017).

Figure 21.4

Outcomes and Risk-Based Supervision



Risks to the achievement of desired outcomes might include adverse events at various levels within the pension system, such as a program, a pension plan, a product, or a service provider. They might also occur outside the pension system, such as in the capital markets, the economy or because of the actions of Government. The OBA framework has identified key features that support the achievement of desired outcomes. Weaknesses in the key features indicate risks, so the key features can serve as a checklist for identifying risks. For example, each of the IOPS Principles is a key feature under the security outcome, so weaknesses in observance of these principles pose risks to achieving secure pensions.

The current situation can be considered with respect to each key feature and weaknesses identified. Consideration should be given to the level of the system at which each weakness is relevant. For example, would it pose a risk only to the members of a pension plan that suffers from the weakness, or might it affect the outcome for the entire pension system?

The weaknesses identified can be rated in terms of their inherent risks, in other words, the level of risk that they present before considering steps that have been or could be taken to mitigate the risk. Each inherent risk can be rated in terms of both the probability of its occurrence and the impact that it would have on the achievement of the outcomes or goals if it does occur. In some cases, data might be available to support quantification of the probability or impact. However, in most cases, qualitative assessments must be made based on knowledge of the situation and judgement. The results of the risk identification and rating can be summarized in tabular form or as one or more two-dimensional risk maps. For example, one risk map might capture weaknesses that are relevant for the pension system while another might relate to those at the entity level.[11]

Then existing mitigants of the risks should be identified. The residual risks, after taking mitigation into account, can also be rated in terms of probability and impact.

For example, consider a key feature for security: investments are sufficiently secure, liquid and diverse. A possible weakness is that pension fund managers might make poor investment selections, which could result in low rates of return and the loss of business to other pension fund managers. The probability of this being a system-wide risk to security was considered low in the jurisdiction, but its impact would be medium if it did occur. The risk is mitigated by investment regulations and disclosures of performance, which are considered to reduce the residual probability and impact to low.

Before developing strategies for dealing with the risks, it is useful to prioritize them. Priorities should be heavily influenced by the risk ratings, but other factors might also have to be considered in assessing the relative importance and urgency of dealing with the various risks. For example, an independent task force might be developing recommendations for changing certain aspects of the pension system, so it might be necessary to defer dealing with related risks until its recommendations have been received. Or there might be too many high- or medium-rated risks to deal with soon given the staff and other resources available. In addition, the interventions should be prioritized in relation to how well their benefits justify their costs.

DEVELOP STRATEGIES FOR **DEALING WITH THE RISKS**

The process for developing risk strategies is integral to risk-based supervision. It provides the bridge between the system-wide risk analysis and the specific supervisory actions taken. It enables priorities to be objectively analysed and set. Monitoring of the implementation of the chosen actions then completes the cycle.

Strategies should be identified for dealing with each of the risks. The identification might be carried out in a workshop, by management and key staff members. It might be supported by using a template, which could document information such as:

- A description of the risk;
- The inherent and residual risk ratings, with reasons;
- The scope for the institution to influence the situation, which when combined with the risk ratings led to the assignment of priority;

[11] Outcome Based Assessments for Private Pensions: Methodology with a Case Study for Costa Rica, William Price, John Ashcroft, and Evan Inglis, World Bank, June 2016.

- The behaviours that need to be sustained or changed to maintain an acceptable risk rating or reduce the residual risk to a tolerable level;
- Options for sustaining or achieving these behavioural changes;
- An analysis of the expected cost-effectiveness of each option, to enable them to be prioritized; and
- An action plan template to identify the steps involved in implementing the prioritized options.

Various types of strategies might be employed, either alone or in combination with one another, to deal with each of the risks. It is useful to categorize the strategies, because there can be synergies among them. For example, if regulations need to be revised to deal with a high-priority risk then this might provide the opportunity to make revisions at the same time to deal with several other risks. Strategies might be categorized as follows, although some strategies will probably fall into more than one category:

- Regulation;
- Off-site analysis;
- On-site inspection;
- Communication;
- Supervisory intervention;
- Staff training;
- Data collection and IT; and
- Member protection initiatives.

The process should be integrated with the institution's planning process. This will facilitate prioritization of the strategies, scheduling of the action plans, and monitoring of progress. The risk analysis, identification of strategies, and prioritization should be repeated periodically to keep them up to date as conditions change. Doing so enables staff to see that decisions are revisited in the light of experience and that there will be further opportunities to revisit assumptions and update the approaches to regulation and supervision.

IMPLEMENT REGULATORY STRATEGIES

As noted above, regulation is the framework of rules, principles, and guidelines that set out expectations for the way the pension system will work. Regulatory strategies can be much more diverse than simply enacting laws or enforceable regulations, and sometimes a less-formal approach can be more effective. Alternatives approaches that might be used to set expectations include:

- Primary legislation – although this is in the hands of lawmakers, institutions involved in regulation and supervision often provide the impetus for pension legislation and should provide considerable input;
- Regulations – legally enforceable, and often within the control of the institution or the ministry to which it is accountable;
- Guidelines – support operationalization of the primary legislation and regulations, and typically issued by the institution on its own authority;
- Communication with key stakeholder groups; and
- Communication with individual key stakeholders.

There are two main approaches to regulation: principles-based and rules-based. In the principles-based approach, regulation sets out objectives and general principles and industry participants determine how they will satisfy them. In the rules-based approach, regulation sets out detailed and uniform requirements. Each of these approaches has some key objectives, but also comes with potential disadvantages, as summarized in Table 21.1.

Table 21.1
Approaches to Regulations

	Key Objectives	Potential Disadvantages
Principles-based	• Focus on outcomes • Respond to a wide range of business situations • Promote dialogue on expectations • Provide flexibility for innovation • Suitable even in changing market conditions	• Expectations can be unclear, so guidance is needed to operationalize the principles • Legal uncertainty for industry • Enforcement can be difficult
Rules-based	• Provide clarity and certainty regarding expectations • Provide transparency and fairness • Support enforceability	• Focus on details and compliance, not the spirit of the requirements • Can stifle innovation • Difficult to write rules to deal with all situations, especially as innovation occurs • Compliance with the rules does not guarantee that objectives will be achieved

In practice, jurisdictions often use a blend of these "pure" approaches. Several factors might influence the approach used by a jurisdiction. One is the legal system, with civil code jurisdictions tending to be more rules-based than common law jurisdictions. This is sometimes erroneously thought to indicate that civil code countries cannot adopt risk-based supervision. They may have to be more specific in their regulatory requirements, but civil code jurisdictions such as Chile and Canada (in the province of Quebec) have successfully implemented risk-based supervision. Another is the culture regarding compliance in the jurisdiction, where a weak culture of compliance might require enforceable rules. Finally, if the industry is not well-developed then its interpretation of the principles might not be in line with good practices.

Regulations can cover deal with many aspects of a pension system, as indicated by the scope of the OECD Core Principles of Private Pension Regulation; see Box 21.3.[12] Private pensions are typically also subject to other regulations, such as those dealing with taxation and employment standards.

Box 21.3

OECD Core Principles of Private Pension Regulation

Part I – General Principles

Core Principle 1. Conditions for effective regulation

Core Principle 2. Establishment of pension plans, pension funds, and pension entities

Core Principle 3. Governance

Core Principle 4. Investment and risk management

Core Principle 5. Plan design, pension benefits, disclosure, and redress

Core Principle 6. Supervision

Part II – Principles Specific to Occupational Plans

Core Principle 7. Occupational pension plan liabilities, funding rules, winding up, and insurance

Core Principle 8. Access, vesting, and portability of occupational pension plans

Part III – Principles Specific to Personal Pension Plans

Core Principle 9. Funding of personal pension plans, wind-up and insolvency

Core Principle 10. Equal treatment, business conduct, competition and portability of personal pension plans

[12] OECD Core Principles of Private Pension Regulation, Organisation for Economic Cooperation and Development (OECD), 2016.

When developing regulatory strategies and materials, considerable resource materials are available as references. They include the OECD Principles, OECD and IOPS papers, regulations of other jurisdictions, and case studies, such as those included in this book. Although there is much that can be learned from others, caution should be exercised to ensure that any regulation used as a model is carefully adapted to the local situation and needs. In any case, the process of implementing regulatory strategies should include consultation with key stakeholders, as highlighted by IOPS Principle 7 on cooperation and consultation.

IMPLEMENT SUPERVISORY STRATEGIES

As with regulation, there are two main approaches to supervision: risk-based and compliance-based. In the risk-based approach, the supervisor assesses the risks assumed by industry participants and how effectively they are managing the risks. In the compliance-based approach, the supervisor assesses compliance with regulatory requirements. Under either approach, the supervisor intervenes based on its assessments. Each of these approaches has some key objectives, but also comes with potential disadvantages, as summarized in Table 21.2.

Table 21.2
Approaches to Supervision

	Key Objectives	Potential Disadvantages
Risk-based	• Identify risks and respond proactively • Focus resources on the most significant risks • Promote good governance and effective risk management	• Requires highly-skilled supervisory staff • Enforcement can be difficult • Customers of smaller entities might receive less protection
Compliance-based	• Supervisory assessment is straightforward • Enforcement is facilitated	• Supervisory focus on the details, rather than the bigger picture • Difficult to deal with significant risks, unless there has been non-compliance • Difficult to form an overall view on an entity, group, or sector

In practice, jurisdictions often use a blend of these "pure" approaches. Several factors might influence the approach used by a jurisdiction. One is the level of supervisory experience and expertise, since effectively performing risk-based supervision requires a highly-skilled supervisory staff. Another is the level of industry development, because if the industry is not well-developed it might be less able to manage its risks effectively, but might nevertheless be expected to comply with regulatory requirements. The culture regarding compliance in the jurisdiction is important, because supervisory intervention under a risk-based approach is often based on judgements regarding the quality of risk management rather than objective evidence of non-compliance with legislation. Finally, the legal system can be a factor, although even civil code jurisdictions have successfully implemented risk-based supervision.

One critical misunderstanding to be avoided is that adopting risk-based supervision increases risk. In fact, the opposite is true – the risk-based approach directs scarce supervisory resources to the areas of greatest risk. In a compliance-based system, some important risks might be missed because they are in areas that are not currently subject to detailed checks. Sometimes, a risk-based approach operates in tandem with a principles-based approach to regulation, for example, allowing well-governed organizations greater flexibility in investment strategies. But even this does not necessarily mean more risk. Enabling those who can manage it effectively to take on more investment risk helps to mitigate the risk of lower pensions or higher required contributions, which can be consequences of the lower returns achievable with restrictive investment requirements.

The risk-based approach is prescribed by IOPS Principle 7, so many supervisors who do not currently use this approach are working toward implementing it. IOPS has developed a comprehensive Toolkit, which explains many aspects of risk-based supervision and provides numerous examples of the models used by various jurisdictions and the challenges they faced in implementing them.[13]

The implementation of risk-based supervision is not a quick or easy process. Typically, it takes at least two years — and often longer, depending on the starting point. Box 21.4 illustrates some of the key action steps that are typically required. It follows on from Figure 21.4, which set out the high-level steps of the Outcome and Risk-based Supervision approach, and takes these down to the next level in terms of how to implement entity-level supervision.

Outcome and Risk-based Supervision approach, and takes these down to the next level in terms of how to implement entity-level supervision.

[13] IOPS Toolkit for Risk-based Pensions Supervisors, IOPS, https://www.iopsweb.org/toolkit/ Modules: 0 – Introduction; 1 – Preparation; 2 - Quantitative Risk Assessment Tools; 3 - Identifying Risks; 4 - Risk Mitigants and Risk Scoring; and 5 - Supervisory Response.

Box 21.4

Illustrative Action Steps for Implementing Risk-based Supervision at an Entity Level

1. Decide which types of entities will be assessed.
2. Identify the significant activities performed and risk management functions used by each type of entity.
3. Determine the categories of inherent risks to be used and which ones are relevant for each significant activity.
4. Determine how inherent risks, quality of risk management, and net risk will be rated and how the relative importance of each significant activity will be reflected in the overall net risk rating.
5. Decide which types of financial assessment will be performed for each type of entity.
6. Determine how the composite risk rating will be assigned.
7. Develop a guide to intervention.
8. Document the risk-based supervision framework for communication with industry and other key stakeholders.
9. Review existing regulations, guidelines, and assessment tools and map them to the various cells in the entity risk matrix. Identify gaps.
10. Review existing supervisory activities and map them to the various cells in the entity risk matrix. Identify gaps and activities that might be discontinued or reduced.
11. Identify information needs and sources. Review existing information requirements imposed on supervised entities. Identify gaps.
12. Communicate with industry and other stakeholders about the risk-based supervision implementation project.
13. Identify skills needed by supervisors. Develop training and recruitment plans to deal with any gaps.
14. Develop and consult with industry on draft guidelines.
15. Develop tools and design supervisory processes for risk assessment.
16. Train some staff and perform pilot assessments of a few entities.
17. Modify assessment tools and supervisory processes, as necessary.
18. Finalize guidelines and communicate with industry about the assessment framework, in more detail.
19. Train (all) staff to perform assessments.
20. Begin performing assessments of all entities.

IMPLEMENT MARKET STRUCTURE AND MEMBER **PROTECTION STRATEGIES**

As highlighted in the introduction, traditional member protection strategies can and should be put in place in a pension market. But policy makers should be cautious about expecting too much in terms of their contribution to the long-run outcomes of a pension system. Instead, greater attention should be placed on the market structure of a pension system and what exactly will be delivered to the average member, particularly in a mandatory pension plan, who may have little interest in or understanding about pensions but needs one and has been mandated to have one.

It could be argued that some other financial products are compulsory – for example, motor third-party liability insurance in many countries, so why are pensions so different? Compared to most compulsory products, pension products extend over a much longer period, pose a more complex combination of investment and other risks, and have much less sense of immediacy – unlike the need to purchase motor insurance before driving a car. But perhaps the most important difference is the benchmarking evidence on the performance of alternative pension delivery approaches. It shows that structures that make use of a single administrator, or an arms-length not-for-profit governance body determining a default investment strategy, often perform very strongly. This is not universally the case, so each jurisdiction should determine whether the potential market structure benefits seen in countries as varied as Sweden, Kosovo, Malaysia and India can be replicated there. Wholly-private systems may be more appropriate if there are concerns about expertise, capacity, or political interference, as outlined in Chapter 17 on governance and investment. The key point is that if there is a robust market structure for getting people into pensions that are run effectively and in their long-term interest, then the traditional consumer protection toolkit may not be needed as much. Or in other words, good structural solutions are likely to deliver much more value added than the standard consumer protection toolkit.

That said, it is worthwhile to have in place a standard set of consumer protection features as a necessary but not sufficient part of the overall framework. These would include financial literacy and member awareness programs, information hotlines and websites, dispute resolution mechanisms, and safety-net schemes.

Financial literacy and member awareness programs: There is not a great deal of evidence for the benefits of trying to teach people to understand the difference between stock and bonds, and to be active choosers of their investment strategies. Many people do not feel comfortable with making such choices, even where support is provided. For example, over 99% of the members of NEST in the U.K. use the default fund. The figure for the default fund in Sweden's defined contribution pillar is over 90% and these kinds of numbers would also be seen in many company-sponsored plans that provide a default. This is an entirely rational response from consumers, who (often rightly) assume that the selection of the default fund will have received very significant attention and there will be a faithful attempt to ensure it provides a good option for the "average" member.

However, this is not to say that no financial education is worthwhile. Simple, well-run, campaigns that focus on critical decisions such as joining or not opting-out of a system, or of delaying retirement, can be very important. As Chapter 3 on the U.K. highlights, the levels of opt-out were far below expectations. One part of the explanation is the effective campaign around the concept of "I'm In" –using extensive advertising and communication – in simple terms and with high profile figures – around a single, simple decision or non-decision. Although less impactful in terms of total numbers, there is also evidence that such campaigns can be cost effective for other pension plans.[14] The campaigns tend to be relatively inexpensive, so if they have even a small impact they can be cost effective. But they are not likely to be the tool that will achieve high levels of coverage or adequacy.

Information hotlines and websites: Although many members may never seek information, it is important to have easily-accessible information for those who do. Moreover, even members who are happy to take the line of least resistance during the accumulation phase are likely to seek information as they approach retirement. There will also be those who suffer from adverse life events, from disability to bereavement, who will need support at critical but infrequent stages.

Having a simple and easily-usable website is a standard requirement for a modern pension plan. Being able to access human operators is also standard and important – but the costs need to be very closely monitored As Chapter 18 on Costs shows, member service is an important element of overall performance, but it can be expensive. Many of the world's leading pension plans spend quite a large amount on such services – but can do so because their vast scale means that this is still a very small percentage of assets under management and hence has only a small drag on net-of-fee returns. For smaller or newer pension plans, designing simple, low-cost and automatic pathways – as part of a strong, member-focussed governance – can help to keep costs low by reducing the need for members to make choices.

This is an area however, where information and communications technology innovations, including social media, are developing rapidly. As Chapter 9 on Mexico and Chapter 22 on Financial Inclusion show, there are a growing number of innovative ways to engage consumers that are eminently scalable and may bridge the gap between truly bespoke advice and interaction and generic information. This is an interesting area, which policy makers, governing bodies of pension plans, and supervisors should keep under review.

Dispute resolution mechanisms: Even if overall governance and expertise are very high and the whole pension value chain is well-run, there will always be a need for some form of dispute resolution. Mistakes happen, systems fail, and differences of opinion occur. Some jurisdictions require pension plans and service providers to establish mechanisms

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[14] Madrian (2014) Presentation at the World Bank's 6th Global Pension and Saving Conference.

for resolving complaints, and to communicate their existence and relevant procedures to the members. Many jurisdictions provide regulatory redress mechanisms that come into play once a member has approached the relevant pension plan or service provider and given them a chance to make good on the situation.

Safety-net schemes: The inability of a pension plan to meet its financial obligations can impose significant hardship on members and beneficiaries. Some jurisdictions have created safety-net schemes (or pension guarantee funds) to help mitigate the potential losses to members and beneficiaries, for example, the Pension Benefit Guarantee Fund (PBGF) in the US and the Pension Protection Fund (PPF) in the U.K.. Safety-net schemes typically guarantee the benefits promised by a defined-benefit pension plan in the event of the bankruptcy of the sponsoring employer, if the assets in the pension fund are insufficient to meet the plan's liabilities. The guarantees are generally subject to limitations, such as a cap on the amount of an individual's monthly pension that will covered. Setting up, operating, and financing a safety-net scheme is not simple. Also, the existence of such a scheme creates potential moral hazard risk. For example, decision makers might adopt riskier investment strategies and weaker funding approaches if they know that the members have some protection in the event of failure. Strong regulation and supervision are needed to reduce the risk that the guarantees provided by a safety-net scheme will be needed – and to keep the safety-net scheme itself financially sustainable.

These are all important elements, but the aim should be to try to reduce the need for member protection mechanisms, as they inevitably add time and cost to a system. Prevention is better than a cure!

CONCLUSIONS

At the heart of any pension system should be the achievement of good outcomes that will benefit citizens of the jurisdiction in old age. The pension system needs to have broad coverage and be politically and financially sustainable, while delivering adequate pensions that help to alleviate poverty and to avoid steep drops in income as people retire. Ideally, this should all happen efficiently and securely, so that money contributed now will be well invested and reliably available when it is needed – often many years later. Good regulation and supervision are essential to achieving these goals. Regulation, in broad terms, can also help to create an effective market structure, since mass-market pension products with very high coverage are seldom, if ever, the result of organic market forces alone. This chapter has set out a high-level framework that helps to deal with the challenges – and emphasizes that a rigorous process – from identifying long-run outcomes to implementing entity-level supervision is the most important part of the story. There is no ideal, standardized solution that will work well in all jurisdictions. But it is possible to develop robust, jurisdiction-specific solutions, if attention and resources are devoted to analysing the jurisdiction- and entity-specific risks and opportunities and developing the most effective regulatory, supervisory, market structure and member protection approaches to tackling these risks.