EVOLVING ROLES FOR REGULATORS IN THE PENSION ARENA

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Introduction

- Transformation of role of regulators since 90s
- Underlying forces include:
  - Shift DB to DC
  - Risk based supervision
  - Accounting standards and transparency
  - Market turbulence
- Consequences include lower risk portfolios
- Outstanding issues include:
  - Education
  - Longevity risk
  - Procyclicality

Why regulate pension funds?

- Finance based view focused on market failure - or alternatively member rights and financial security
- Information asymmetry key reason for pension regulation (consumer protection and consumer education)…
- …externalities due possible costs to the state…
- …monopoly where membership compulsory
- Tax benefits, market failures in annuities and economic and financial efficiency
- Pension funds never fully private
- Costs of regulation often not negligible

Investment regulations for collective funds

- Case for quantitative investment regulation
  - focus on investment
- Case for prudent person rule
  - permits frontier of efficient portfolios to be attained
  - Optimise risk and return for maturity
  - Usually requirement for diversification
- Shift to prudent person in recent years
  - Entails regulator assessing validity of approach to investment
  - Requires transparency
  - Different means of applying prudent person

Evolving regulation of DB funds

- Given investment rules, traditional focus funding of benefits and ownership of surpluses
- Issue of how fund is conceptualised, division of responsibility, risk sharing
  - Anglo Saxon focus on sponsor backup and guarantee fund
  - Continental focus on fund as guarantor, sponsor is reinsurer
- "Pension storms" and increased risk management focus

The shift to risk based regulation and the link to solvency regulation

- Definition of risk management
- Risks borne by DB funds
- Traditional focus on assets, but large funds began to use Asset-Liability management
- Reasons for risk based regulation
  - Financial market shocks
  - Use of complex markets
  - Supervisory resources
  - Integration of supervision
- Focus on corporate governance and management

Components of risk based regulation

- Use of ALM in regulation
- Value at risk and time horizons
- Stress testing
- Risk scoring
- Tightening of solvency regulation
- Contrasts in national approaches

Development of guarantees

- UK Pension Protection Fund 2004
  - Scheme based and risk based levies
  - New regulator
  - Risk of default….
  - ….and of regulatory overlap

Role of accounting standards

- Form of regulation as market discipline
- Mark to market/fair value accounting shifts focus from longevity and inflation risk to interest rate risk
- May shorten time horizon and limit investment in illiquid assets
- Inconsistency with actuarial approaches
- Focus on liability driven investment…
- …and regulators' market based calculation of liabilities

The evolving regulation of DC funds

- Regulation of DB has furthered shift to DC
- DC were vulnerable to market turbulence
- Focus on investment risks but also costs, annuitisation and education

Regulation of costs

- Variety of costs for DC plans and impact on outcomes
- Regulatory options
  - Direct regulation of costs
  - Creating market structure generating low fees
  - Competition
  - Transparency

Regulation of risks and outcomes

- Role of portfolio regulations in DC
- Minimum return regulations
- Risk based regulation
  - Stress tests
  - VaR
  - Risk scoring
  - Link to easing of portfolio regulations
- Is risk based regulation appropriate for DC?
- Regulation of default options –lifestyle basis?

Regulation of annuitisation

- Contrasting regulations for annuity provision in mandatory DC countries
- Prudential regulation of insurance providers
- Pricing of annuities
- Regulation of annuity options
- Marketing of annuities
- Impact of annuity regulation on DB/DC when voluntary

Transparency and education

- Transparency's role as a market discipline when can change providers
- Role of auditors
- Pension risk simulation for consumers
- Poor knowledge nonetheless
- Need for wider pension education

Evolution of portfolios

- Decline in equity holdings for DB and DC in some countries
- Role of accounting rules and risk based supervision
- Albeit also shift to unconventional instruments

Weaknesses – longevity risk

- Ongoing rise in longevity a challenge for private pensions as well as social security
- Key determinant of liabilities (DB) and outcome (DC)
- Use of outdated mortality tables
- Low interest rate magnifies impact
- Risk sharing as possible solution

Weaknesses - procyclicality

- Risk based regulation and fair value accounting may lead to procyclical behaviour
  - Inadequate surplus build-up in upturn
  - Fire sales in downturn
  - Heavy funding needs after downturn
- Measures of regulatory forbearance
- Possible longer term solutions
  - Lesser reliance of contributions on current market values
  - Smoothed discount and solvency rates
  - Flexible tax ceilings

Conclusions

- Widespread innovation in pensions regulation
- Greater focus on risk transparency and governance
- Further progress needed in longevity, procyclicality and education
- Issue of short term investment

Do pensions need a Basel III?

- Global agreements not needed – national rules and no cross border competition
- Issue of solvency regulation remains core, design possibly counter-productive
- Liquidity regulation less important
- Offsetting procyclicality
- Macroprudential regulation