Strategy, Risk Based Supervision and Outcomes

6th Global Pension and Saving Conference
Washington, DC
4 April 2014

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Note that this presentation draws together the experience from the Toronto Centre and the results of a joint project with Will Price of the World Bank and John Ashcroft, Senior Independent Consultant

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There can be a lot of confusion over the terminology and scope of Risk Based Supervision

- Now that RBS is seen as desirable, some supervisors say they are risk based even when not dealing with many of the major risks in the system
- There can be too much focus on Risk Based Capital – often the least important part of RBS for pensions – particularly for Defined Contribution systems
- Risk Based Supervision ≠ Light Touch
- RBS systems can still have tough requirements to comply with key rules, such as use of a custodian and external audit
- BUT – judgment and an increased focus on the governance of the supervised entities should always be a critical feature of RBS

RBS must be comprehensive to achieve meaningful long-term objectives in the most effective way

RBS programs will be more effective if they start with a clear articulation of the key long-term outcomes – but the scope of supervisors will vary

Efficiency	•World leading pensions cost under 0.5% or 50bps of assets under management a year, second tier 0.5% to 1%, third tier 1% to 2% and the most expensive systems cost over 2%. •Returns on average in the worst funds can be negative or zero, while the best give 4% real pa •By 2050 a 0.5% point difference in annual growth achieved through good policy would be worth $85bn a year.
Sustainability	•Achieving sustainable public finances and politics requires tackling the challenges from longevity and low interest rates and returns. Target would be to reduce the combined total of explicit and implicit debt (unfunded pension obligations on government balance sheet. As a reference, implicit debt in key EU countries ranges from 163% to 293% of GDP.
Coverage	•Increasing coverage from 20% to even 50% globally would cover hundreds of millions of workers. Specific target for increase in coverage would be country specific and linked to the type of intervention – for example if only a voluntary private pension introduced coverage target would have to be modest – around an extra 10% point. Mandatory/auto-enrolment reforms can target much higher percentages – depending on degree of labor market informality – from 30% to 80%.
Adequacy	•Core adequacy – increase in % of people with income above the poverty line. •Broad adequacy – increase in incomes of bottom 40% of population (to align with new World Bank global targets on eradicating poverty and boosting shared prosperity). •In both cases target broken down by gender (and other relevant groups, e.g., region) to focus on improving equity.
Security	•Annuities and other retirement products can protect against falling back into poverty and impact of volatility – so outcome would be increased % of individuals with secure retirement income. •Automatic adjustments to risks can be built into the system – with retirement ages rising with longevity and investment allocations changing with age to reduce the impact of instability and encourage long-term investment players in the capital market.

Features of the pension system affect the outcomes. Supervisors need a broad and long-term view – to supervise for today and develop the system for tomorrow.

The 4 main elements of a pension system

Economic and political Environment

Overall Framework – other pillars and key rules

Market Structure, Entities and Governance

Supervision

The ability of supervisors to impact legislation and regulation may vary – but the most effective solutions to a risk may well lie outside their control. Best practice would be to engage proactively with those who do control new regulation and legislation. But a central focus should always be on governance in the industry

Rigorous assessment of risks to the outcomes is at the core of RBS

- Risk-based supervision (RBS) is a structured approach that focuses on the identification of potential risks faced by pension plans or funds…
- …and the assessment of the financial and operational factors in place to minimise and mitigate those risks.
- This process then allows the supervisory authority to direct its resources towards the issues and entities that pose the greatest threat.

Source: *IOPS Toolkit for Risk-based pensions supervision Module 1*

Focus on the key risks and sources of risk to the delivery of a good pension

The ultimate level of the final pension will depend on:

- Contributions (too low or missing)
- Investment returns
- Costs
- Avoiding fraud or compensating for it
- Operational risks, e.g., IT failures

Operational risks often get too much attention

Note: Investment risks, guarantees and the role of benchmarks will be dealt with in Session 2 of the Roundtable

Choosing the most effective solutions – and starting with a greater focus on governance – are central to RBS

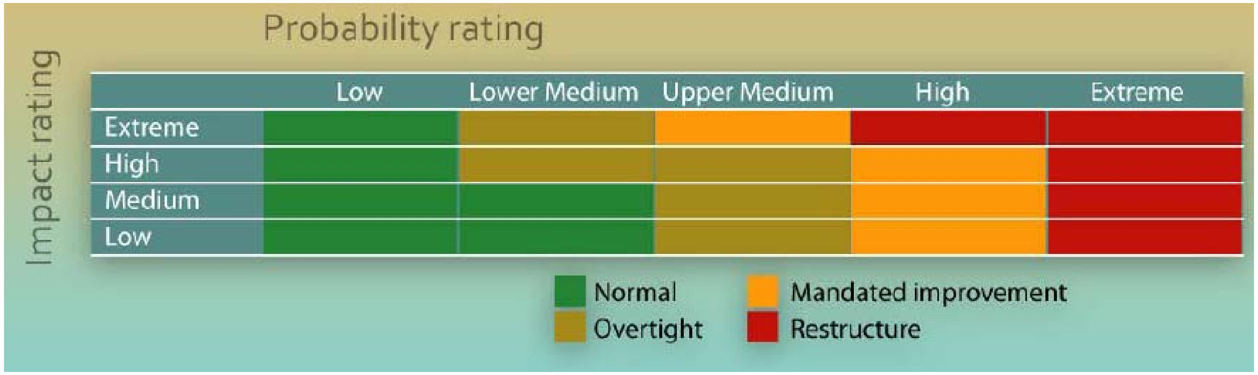
- RBS systems do not mean 'no compliance'
  - Rules (through laws and regulations) are still critical
  - But focusing on detailed compliance against rules that have little impact on the biggest risks leaves the supervisor – and more importantly the pensioner – exposed
- Improving the governance of pension entities is central
  - Many process failures can be best avoided by better governance and internal controls – not detailed transaction checks
- RBS is NOT light touch – it should still be intrusive and challenging

There are a number of approaches to making Risk Based Supervision happen in practice

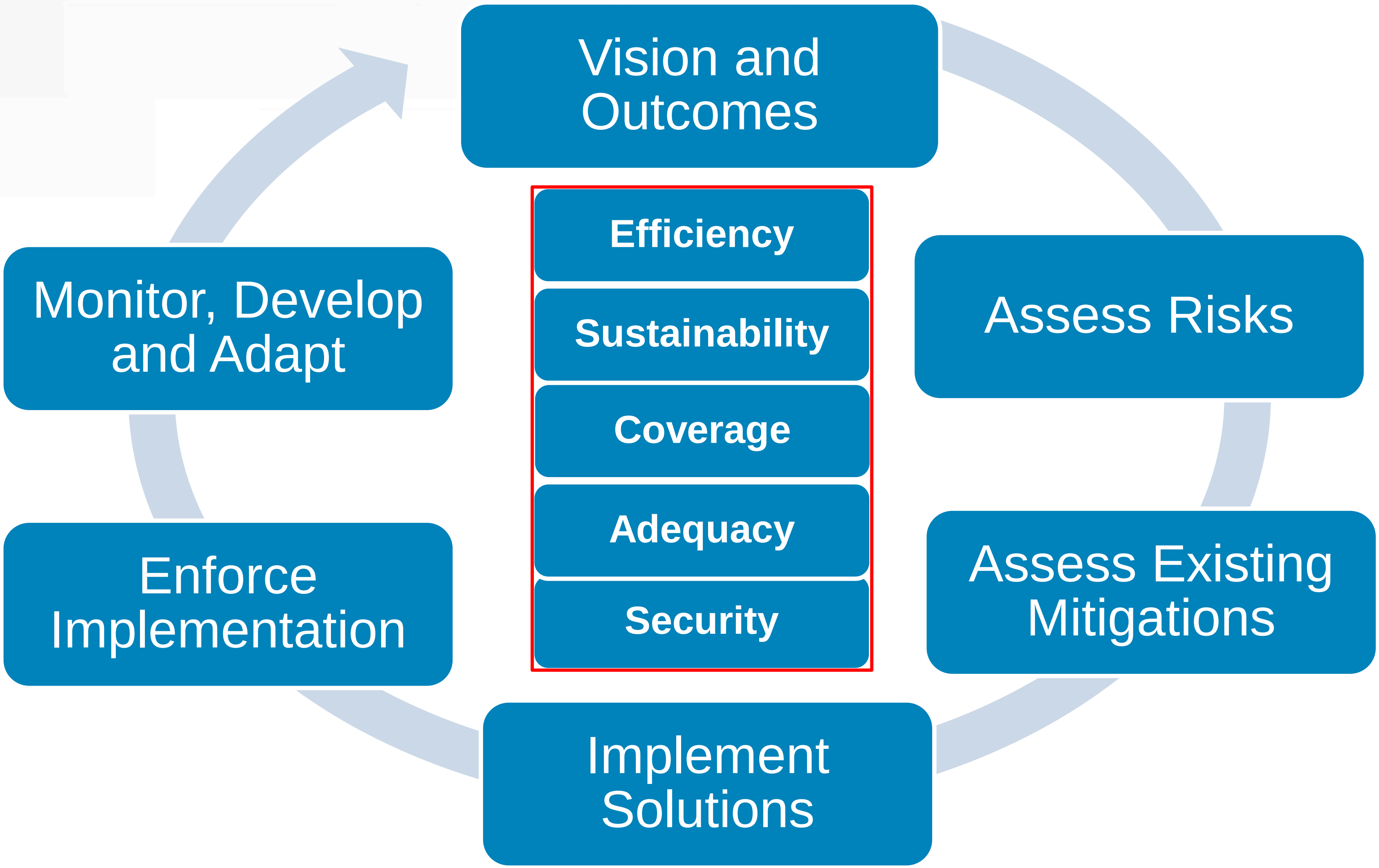
Significant Activities	Inherent Risks					Quality of Risk Management		Net Risk
	Investment	Pension / Valuation	Operational	Legal and Regulatory	Strategic	Controls	Oversight	
Actuarial								
Administration								
Asset Management								
Communication to Members								
							Overall Net Risk	

Solvency		Ongoing Performance		Funding	

CRR:	
Direction:	



Successful RBS is a long-term, continually evolving, journey – with the ultimate prize of better pensions



Toronto Centre programs for pensions supervisors can help to make your journey a success

- Increase your capacity to drive change
  - Action planning
  - Plan implementation
  - Stakeholder communication
- Strengthen your ability to deal with the challenges
  - RBS concepts and implementation case studies
  - Crisis simulations and problem cases
  - Supervisory tools, such as quantitative assessment of risk
  - Vignettes on issues that drive the outcomes, such as governance, investment performance, and outsourcing
- Leverage off the knowledge of others
  - Program Leaders with experience in RBS and understanding of the World Bank's OBA Framework
  - Participants from other countries in the region and worldwide