EVOLVING ROLES FOR PENSION REGULATIONS – TOWARDS BETTER RISK CONTROL?

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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