

**Workshop on Public Pension Supervision
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Public Pensions Supervision:

**Is the risk based approach
applicable?**

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Pension supervision as an area of concern

- ✦ Pension Supervision developed as a major area of concern in the 80s and 90s, associated with the processes of privatization of mandatory pension plans
- ✦ Principles of supervision can also apply to public pension schemes. These have poor standards of supervision around the world, and are usually subject to internal audits only

Conceptual Framework to risk based supervision

- ✦ Approach designed to minimize the exposure to mismanagement in pensions administration
- ✦ Alternative to rigid supervision plans and instrument of resource allocation for supervision agencies
- ✦ Demands some degree of regulatory flexibility

Concept of risk

Possibility of prejudice to members of a pension plan as a consequence of:

- a) Financial loss of funds
- b) inefficiencies that affect the returns of the savings scheme or the quality of services
- c) Poor quality of service to members and beneficiaries
- d) Non compliance with laws and regulation (that protect the interest of members)

Who is responsible of assessing risks?

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- ✦ Administrator --- Internal and external audits, actual audits, controls
 - ✦ Supervisor --- in turn this function may be exerted by:
 - ✦ a) a specialized autonomous public agency (Costa Rica, Colombia, Kenya)
 - ✦ b) a multinational specialized organization (CIPRES -West Africa)
 - ✦ c) An agency that reports to other levels of the government
 - ✦ d) an agency that reports to other powers of the government (e.g. Parliament)

Exposure to risk in pensions

- ✦ Investments: Misallocation of funds is a major source of risk, but not the only one
- ✦ Benefits/annuities: Miscalculation of benefits, poor investment of actuarial reserves
- ✦ Membership: Risk of fraud in the affiliation process; poor attention to customers
- ✦ => **NEED OF AN INTEGRATED APPROACH TO RISKS IN PENSION SUPERVISION**

Sources of risk in pensions

- ✦ **Capital**
- ✦ **Assets of Pension Funds**
- ✦ **Governance and Management**
- ✦ **Earnings**
- ✦ **Liquidity**
- ✦ **Interferences in the process of decision making**

Are public pension administrations exposed?

- ✦ Capital risk is not an issue
- ✦ Asset management : very relevant in provident funds or similar schemes
- ✦ Governance and Management : Increasing awareness of the impact on the efficiency of public schemes
- ✦ Earnings : Relevant for private management only
- ✦ Liquidity : Relevant mainly for private management
- ✦ Interference: High exposure

Assessing Management risk - Steps

✦ Plan

✦ Implementation of Controls

✦ Corrective measures

✦ Preventive programs

Assessing management risk - tasks

- ✦ 1. Identifying of potential sources of risk
- ✦ 2. Measuring risks
- ✦ 3. Allocating resources to audits and controls
- ✦ 4. Auditing / supervising
- ✦ 5. Measures and plans to correct
- ✦ 6. Measures and plans to prevent

Measuring risks

✦ Associate a risk indicator to each process “j”

✦ Management risk indicators $r(j)$ associated with:

a) previous experiences of pension administration

b) Internal and external controls of the administration

Uses of risk matrices

- ✦ Determine frequency of controls
- ✦ Determine size of statistical samples
- ✦ Allocate resources (given the level of budget constraints)
- ✦ Support disciplinary policy

Minimizing risks through interactive supervision

- ✦ Both Supervision Authority and administrators have supervision plans
- ✦ There may be synergies between both levels of supervision
- ✦ Supervision Authority may use internal controls of administrator as ‘first stage supervision’, and concentrate efforts in ‘second level’ of controls

Internal Control Plans

- ✦ ICP provide useful information to evaluate operational risks
- ✦ Risk evaluation provides information to define the structure of ICP

Conclusions

- ✦ Risk based approach permits more flexible supervision plans
 - ✦ There is need of a clear definition of the role of supervised and supervisor in minimizing exposure to financial risk
- Interaction between internal controls and supervision may be an useful tool, but...
- ✦ Minimum guidelines for the first stage supervision plan should be provided by the supervisor
 - ✦ Flexible Supervision plans demand more flexible regulations.