

# **PROACTIVE VERSUS REACTIVE SUPERVISION AND THE ORGANIZATION OF PRIVATE PENSIONS**

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# **OBJECTIVE**

- **INCREASE LONG-TERM SECURITY.**
- **ENSURE HIGH EFFICIENCY.**
- **PROVIDE CONSIDERABLE FREEDOM OF CHOICE.**

# **NATURE OF PENSION CONTRACTS**

- **VERY LONG TERM: 60 YEARS OR MORE.**
- **LIKE ALL FINANCIAL CONTRACTS, STRONG RELIANCE ON TRUST.**
- **BUT TRUST IS, AND SHOULD BE, IN LIMITED SUPPLY OVER SUCH LONG PERIODS.**
- **NEED FOR EFFECTIVE SUPERVISION IRRESPECTIVE OF TYPE OF PROVIDER (GOVERNMENT, EMPLOYER OR INDEPENDENT FUNDS).**

# **CONSTRAINTS OF GOVERNMENT PLANS**

- **ON PAPER, POTENTIAL FOR HIGH EFFICIENCY AND LONG-TERM SECURITY.**
- **ECONOMIES OF SCALE, NO MARKETING COSTS, NO ADVERSE SELECTION, RISK DIVERSIFICATION.**
- **IN PRACTICE, POLITICAL PRESSURES TO INCREASE BENEFITS, LOWER CONTRIBUTIONS, SELECT ASSETS, HIDE PROBLEMS.**
- **RECENT INSULATING INITIATIVES BUT CONTINUING NEED FOR EFFECTIVE SUPERVISION.**

# SHORTCOMINGS OF EMPLOYER PLANS

- **GROUP CONTRACTS, LOW COSTS, PROFESSIONAL ASSET MANAGEMENT AND HIGH RETURNS, AVOIDANCE OF SELECTION ISSUES.**
- **DEPENDENCE ON SOLVENCY AND INTEGRITY OF SPONSORS.**
- **GRADUAL MOVE AWAY FROM DB PLANS BECAUSE OF DEMANDING RULES ON FUNDING, VESTING AND PORTABILITY.**
- **POTENTIAL CONFLICTS OF INTEREST. NO PRIMACY OF PENSION PROVISION.**

# **LIMITATIONS OF INDEPENDENT FUNDS**

- **POTENTIAL FOR PROFESSIONAL ASSET MANAGEMENT AND HIGH RETURNS.**
- **NO FUNDING, VESTING OR PORTABILITY ISSUES.**
- **BUT HIGH MARKETING AND OPERATING COSTS.**
- **STRONG RELIANCE ON SOLVENCY AND INTEGRITY OF MANAGERS.**
- **NEED FOR HIGH TRANSPARENCY AND STRONG CONDUCT RULES.**

# **FOCUS OF REACTIVE SUPERVISION**

- **RELIANCE ON BASIC LICENSING AND REPORTING RULES.**
- **LIMITED OFF-SITE ANALYSIS.**
- **EVEN MORE LIMITED AND INFREQUENT ON-SITE INSPECTIONS.**
- **REACTION TO CRISES, LITTLE ATTEMPT TO PREVENT CRISES BY IDENTIFYING AND ACTING ON WEAKNESSES.**
- **LACK OF TRANSPARENCY.**

# **ENRON COLLAPSE**

- **LARGE BENEFITS FOR MANY WORKERS.**
- **BUT MAJOR CONFLICTS OF INTEREST AND RISK CONCENTRATION.**
- **SOME WORKERS LOST EVERYTHING.**
- **MORAL HAZARD IN EX-POST SUPPORT.**
- **IMPORTANCE OF RISK DIVERSIFICATION AND TRANSPARENCY.**

# EQUITABLE LIFE FIASCO

- LONG OFFER OF GUARANTEED ANNUITY CONVERSION FACTORS.
- NO PROBLEMS AS LONG AS MARKET RATES WERE HIGHER THAN IMPLICIT GUARANTEED RATES.
- INADEQUATE RESERVING.
- POOR UNDERSTANDING OF FINANCIAL MARKETS.
- WEAK SUPERVISION.
- CROSS SUBSIDIES FROM YOUNG TO OLD.

# **NEED FOR PRUDENTIAL AND PROTECTIVE RULES**

- **“FIT AND PROPER” TEST.**
- **ASSET SEGREGATION, DIVERSIFICATION AND VALUATION.**
- **CHECKS AND BALANCES (FUND GOVERNANCE, CUSTODIANS, ACTUARIES, AUDITORS).**
- **EXTENSIVE DISCLOSURE AND HIGH TRANSPARENCY.**
- **NEED TO ENSURE FINANCIAL SOUNDNESS AND PROTECTION FROM MISCONDUCT.**

# **FOCUS OF PROACTIVE SUPERVISION**

- **CLEAR RULES ON FINANCIAL SOUNDNESS AND GOOD CONDUCT.**
- **REGULAR REPORTING, ON QUARTERLY BASIS, PREFERABLY IN ELECTRONIC FORM.**
- **STRONG CAPABILITY FOR FINANCIAL ANALYSIS AND FREQUENT INSPECTIONS.**
- **CLEAR POWERS OF INTERVENTION.**
- **NEED FOR EARLY ACTION TO CONTAIN LOSSES AND PROTECT MEMBERS.**

# **FEASIBILITY OF PROACTIVE SUPERVISION**

- **PROACTIVE SUPERVISION IS LESS FEASIBLE WITH VERY LARGE NUMBER OF EMPLOYER PLANS.**
- **IMPLICATION FOR ORGANIZATION OF PRIVATE PENSION PLANS: FAVOR SMALL NUMBER OF INDEPENDENT PLANS, USING GROUP CONTRACTS, BUT WITH WORKER OPTION TO SELECT PLAN.**
- **DIVERSIFIED PORTFOLIOS, CONSTRAINED CHOICE OF FUNDS, PROBABLY INVOLVING AGE-LINKED LIMITS.**

# **POLITICAL FEASIBILITY**

- **THIS APPROACH WOULD BE POLITICALLY FEASIBLE IN MOST COUNTRIES OF THE WORLD.**
- **BUT IN AMERICA THERE WOULD BE LITTLE POLITICAL SUPPORT FOR MANDATING EMPLOYERS TO PROVIDE ACCESS TO SMALL NUMBER OF APPROVED, EFFECTIVELY SUPERVISED, NATIONAL PLANS AND REQUIRING WORKERS TO SELECT FROM AMONG THESE FUNDS .**

# **AMERICAN VARIATION: INCREASE CHOICE**

- **TURN ARGUMENT ON ITS HEAD.**
- **ALLOW EMPLOYER-BASED 401K PLANS WITH HIGH LIMITS ON HOLDINGS OF COMPANY STOCK.**
- **AUTHORIZE 20 OR 30 HIGHLY DIVERSIFIED AND EFFECTIVELY SUPERVISED NATIONAL PLANS, SIMILAR TO TSP FOR FEDERAL EMPLOYEES.**
- **ALLOW FREE SWITCHING BY WORKERS TO ONE OF THESE NATIONAL PLANS.**

# **IMPLICATIONS FOR ANNUITY MARKETS**

- **AUTHORIZE SMALL NUMBER OF SPECIALIZED ANNUITY COMPANIES, SUBJECT TO HIGH TRANSPARENCY.**
- **ALLOW PHASED WITHDRAWALS AND OFFER COMBINATION OF FIXED AND VARIABLE ANNUITIES.**
- **ENSURE EFFECTIVE PROACTIVE SUPERVISION, PROPER ASSET/LIABILITY MATCHING, FULL DISCLOSURE OF LONGEVITY PROJECTIONS, CALCULATION OF VARIABLE ANNUITIES, DISTRIBUTION OF BONUSES.**

# RECAPITULATION

- **ORGANIZE PRIVATE PENSION SYSTEM TO MINIMIZE CONFLICTS AND FACILITATE SUPERVISION.**
- **INCREASE CHOICE BY ALLOWING SWITCHING TO SMALL NUMBER OF AUTHORIZED PENSION PLANS AND ANNUITY PROVIDERS.**
- **EMPHASIZE PROACTIVE SUPERVISION WITH REGULAR REPORTING AND FREQUENT INSPECTIONS, AND EARLY INTERVENTION..**