OUTSOURCING RISK

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OUTSOURCING RISK for PENSION FUNDS

- Rapid growth of outsourcing activity in recent years.

- More activities are subject of outsourcing → more the risk of outsourcing has to be addressed by supervisors.
GENERAL APPROACH TO OUTSOURCING

- **core functions - cannot be outsourced**
  Generally agreed that “overall decision making” and “setting the overall asset management strategy” is the core function of a pension fund.

- **non-core functions - can be outsourced**
  Mainly administrative functions are viewed as non-core function and can be carried out by entities falling outside the category of supervised institutions.

- **functions – mandatory to be outsourced: custody**
  In many countries custody is mandatory to be outsourced, as part of risk management.
  In few countries investment management, auditing of processes, payment of annuities, valuation of assets and performance measurement are also mandatory to be outsourced as part of risk management.

- **when considering DB vs. DC pension plans**
  In DB pension plans the number of core functions tend to be almost 100% lower than in DC pension plans, resulting a higher number of functions that can/must be outsourced.
GENERAL APPROACH TO OUTSOURCING

CORE FUNCTION

Actuarial calculations 27.59%
Asset management 27.59%
Risk management 37.93%
Administration 19.54%
Payment of benefits 32.76%
OUTSOURCING CONDITIONS (1)

The pension fund (pension fund manager) has to ensure that:

- outsourced function is carried out at a proper standard;
- no prejudice on integrity to its own systems and controls;
- procedures are in place to assess the performance of the service provider on an on-going basis;
- the 3rd party service provider is competent and financially sound and has enough resources;
- confidentiality is protected;
- a contingency plan is in place.
Most countries require a legally enforceable document for any outsourced activity (*written contract*).

Some countries prescribe the minimum content of such a contract, special provisions, regarding:
- requirements on exit provisions;
- data protection requirements;
- confidentiality clause;
- cooperation of service provider with auditor and supervisor;
- possibility of the supervisor to carry out on-site inspection;
- governance rules;
- costs ceilings;
- applicable law and jurisdiction clause.
Outsourcing risk becomes more and more important to supervisors, due to:

Possibility to outsource almost all functions related to administration of a pension fund:

- Asset management;
- Administration;
- Payment of benefits;
- Risk management;
- Actuarial calculations;
OUTSOURCING ASSET MANAGEMENT

- setting asset management strategy;
- investment management;
- custody;
- valuation of assets and liabilities.

Most countries, require 3rd party service provider to be licensed and to be under prudential supervision.

Supervision is performed either through:
- reports submitted via pension fund;
- direct information from 3rd party service provider;
OUTSOURCING ADMINISTRATION

- Collection of contributions;
- Compliance & compliance reporting;
- Members’ contracts administration;
- Auditing process/reconciliation;
- Information to members and beneficiaries;
- Record keeping;
- IT;
- Transfer of pension rights;
- Claim administration;

- *In most countries these functions can be outsourced to institutions that are not under prudential supervision.*
- *Reports can be obtained via pension fund.*
- *Some supervisors have the authority to require 3rd party service provider itself to supply data/report.*
- *In most countries, supervisors are empowered to carry-out on-site inspections at the premises of the service provider.*
- *In few cases supervisors can impose sanctions as on the fund manager.*
OUTSOURCING PAYMENT OF BENEFITS

- Performed by specialized entities

- Most countries require 3rd party service provider to be licensed and to be under prudential supervision

- Data and reports can be obtained either via pension fund or directly from the 3rd party service provider
OUTSOURCING RISK MANAGEMENT

- In most countries this function cannot be outsourced
  *It is considered a core function and core functions shall not be outsourced.*

- In some countries this function can be outsourced
  *It is considered that risk assessment performed by an independent entity is more reliable.*
BENEFITS OF OUTSOURCING

- avoidance of conflict of interest;
- costs reduction;
- developing scale of economies;
- focusing on core activities;
- increase in objectivity in case of performance measurement, custody, external audit, actuarial report.
RISKS OF OUTSOURCING

- avoidance of responsibilities;
- hidden costs, that may be borne by the fund members;
- when outsourcing, legal liabilities have to be considered;
- failure of service provider leaves the fund without access to critical service;
- concentration risk;
- outsourcing arrangement may diminish the ability of the fund (pension fund manager) to fulfil its obligations to members/beneficiaries and supervisors;
- impede effective supervision.
SUPERVISORS’ APPROACH REGARDING OUTSOURCING

- Supervisors have different views to a majority of issues in the regulation of outsourcing.

- Still, all supervisors agree that:

  The pension fund (pension fund manager) retains the final responsibility for any outsourced function.
SUPERVISORY APPROACH IN CASE OF OUTSOURCING

Most of the supervisors have the power to:

- obtain data and reports from the service provider either directly or via pension fund;
- carry on-site inspections to the service provider;
- approve outsourcing or to request to be informed about outsourced functions;
- check whether outsourced activities are carried out in accordance with the regulations, as an integral part of their ongoing assessment of the supervised entity;
- check whether corporate governance is still preserved.
Thank you!

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