BRAZIL – REGULATION AND SUPERVISION OF CLOSED PENSION FUNDS

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I. INTRODUCTION

This short paper is focused on the regulatory and supervisory structures surrounding *closed* pension funds in Brazil; the use of the word "closed" in this context will be explained. Both the regulatory and the supervisory aspects will then be assessed against OECD[1] and IOPS[2] core principles in these areas.

Brazil can produce many interesting surprises for pension specialists from other parts of the world. "Think of South America, think of the Chilean model" would be a very bad starting point for understanding the social security and occupational pension systems in Brazil.

1. Social security.

The basic social security system (Regime Geral de Previdência Social, RGPS) is a conventional pay-as-you go system providing defined benefits. It covers private sector employed and self-employed workers and elected civil servants. In the current sense of the phrase, the first Bismarck-style social security system started in Brazil in 1923. Somewhat equivalent programmes can be traced back to 1793 and 1821. The system expanded rapidly in the 1930s and 1940s. The monthly salary ceiling for RGPS benefit calculations is R$3,218.90 (about €1,210 or US$1,760 per month). The replacement ratio is relatively high for individuals earning less than the salary ceiling, but there is a clear need for a complementary pension benefits for those with higher earnings. This group is currently estimated to constitute about 8% of the working population, but it is a percentage that should increase as wages grow faster than the indexation of the earnings ceiling.

2. Civil servants.

Government workers are covered by a plethora of systems (Regimes Próprios de Previdência Social, RPPS), which are managed by the federal government, states and municipalities. Most are pay-as-you-go, but some are prefunded. Parametric reform of these systems started in 2003 (Constitutional Amendment EC41/03), including possible imposition of a salary ceiling and other convergence with the RGPS system. Such plans are allowed to impose a salary ceiling equal to the RGPS salary ceiling <u>if</u> they establish complementary plans (probably defined contribution) for earnings above the ceiling. This has potentially important consequences for the closed pension fund system and the supervision thereof. Legislation was introduced in 2007 to create just such a complementary pension fund for all federal public servants (FUNPRESP), and similar legislation has been introduced and is pending approval in several states and some cities. These complementary plans would almost certainly be financed through closed pension funds, and regulated and supervised as such. Combined with the huge assets already held by state-owned companies in closed pension funds, this would create a dominant pool of closed pension fund assets supporting complementary pension plans sponsored by government (in its various forms and at various levels). Minimal political pressure on the regulation and supervision of pension funds is always an important objective; it would become even more important under these circumstances.

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3. Occupational pension plans.

Occupational plans have existed in Brazil for even longer than social security. For example, the PREVI plan for employees of the Bank of Brazil started in 1904. The plans are mature, and the funds are large. Brazil is placed seventh in the world in terms of aggregate assets held under occupational pension funds, a position it has held for several years[3].

4. Regulation v. Supervision.

The issues of "regulation" and "supervision" will be analysed separately. This is particularly important in Brazil, where there is a concerted effort to establish a new supervisory authority (PREVIC) and create a wider separation of supervision from policy development and regulation.

5. Occupational pension arrangements – two distinct financing arrangements

In broad terms, occupational and other complementary pension plans can be financed through either an open pension fund (Entidade Aberta de Previdência Complementar, EAPC) or a closed pension fund (Entidade Fechada de Previdência Complementar, EFPC).

6. Open pension funds.

These are commercial pension products offered on a retail basis by life insurance companies. They are somewhat equivalent to personal pension plans in other countries and, in a similar manner to some of these other countries, they can be grouped collectively to form a simplified occupational pension plan – a group personal pension plan or a "collective open plan" in Brazilian terminology. Open pension funds are supervised by Insurance Supervisory Authority (Superintendencia de Seguros Privados, SUSEP), a semi-autonomous body subordinated to the Finance Ministry. Open pension plans are not the subject of this paper.

7. Closed pension funds.

These most closely resemble the pension foundations found in the Netherlands, Switzerland and elsewhere. A closed pension fund was traditionally established by a single employer or a closed group of related employers, but much has changed in recent years. Such funds can now be established for professional associations and unions and on a collective basis for unrelated employers. All are non-profit organisations established solely for the purpose of financing retirement pension and related death and disability benefits. There are also some "special" closed funds that provide healthcare coverage. Both types are supervised by the Complementary Pensions Secretariat (Secretaria da Previdência Complementar, SPC), which is currently a department of the Ministry of Social Security. Efforts have been underway since 2003 to create a more independent supervisory authority, and these initiatives will be discussed in more detail later in this paper.

8. Closed pension funds – three distinct types of plan design.

The law recognizes three distinct types of plan design[4], namely:

- **Defined Benefit plans.** Traditional definition. Still dominant in terms of fund assets, but most are closed to new entrants.

- **Defined Contribution plans.** Plans where the retirement benefit accumulation is pure DC and where the retirement benefit payouts also continue to be a direct function of participant's account balance. Association plans are DC, and any new civil service complementary plans will be DC.

However, it is important to note that many employer-sponsored DC plans provide defined benefits in the event of pre-retirement death or disability. These "risk benefits" closely resemble those found under occupational DB plans in several countries and under separately insured group life insurance and group long term disability contracts. In other words, the benefits are often a direct function of salary or of the projected retirement benefit. The closed pension fund self-insures these benefits and thus is required to submit actuarial reports. As an alternative to self-insurance, there are no major legal impediments to either the plan sponsor or the pension fund purchasing group death and disability insurance contracts from insurance companies, but the insurance industry has shown little interest in offering such products. A new law on reinsurance was introduced in 2008, removing the state reinsurance monopoly and allowing foreign reinsurers. Whether this will have any positive impacts on closed pension plans and funds remains to be seen. [Note that some literature categorizes Brazilian DC plans with risk benefits as variable contribution plans – see next paragraph – but this is not the categorization used in the applicable regulation.]

- **Variable Contribution plans.** They are also sometimes called "mixed plans". These need to be understood, as they are an important characteristic of the Brazilian pension scene, and because they create special challenges for both pension funds and the regulator. Variable contribution plans are again pure DC during the retirement accumulation phase, but they retain the life annuity obligation (if any) after retirement. Under this scenario, the pure DC retirement accumulation is converted at retirement to a lifetime pension - always with indexing and often with a survivorship feature – and the fund retains the obligation. Again, actuarial valuations clearly are required for such benefits. The problems of increasing longevity have been masked in recent years by extremely favourable investment returns and by an ever-increasing focus on programmed withdrawals (with no mortality implications) and partial lump sums as the primary forms of retirement benefit payout. Again, the life insurance industry could play a much greater role, but this is not really happening for a variety of reasons. It should nevertheless be noted that insured life annuities are available under several forms of open pension funds, and one route to arms length annuitization on an individual basis would be to further encourage retirees to transfer their DC retirement capital to such open plans (as allowed under article 14 of Law 109).

9. Broad statistics (generally as at mid-2009)

For a general idea of the size of the closed pension fund system, there are:

- 372 closed pension funds,
- operating 1,037 pension plans (DB 35% + DC 35% + VC 30%),
- covering 2,491 plan sponsors (of which about 350 are trade associations),
- with 2,215,000 active plan members and 655,000 beneficiaries (DB 38% + DC 20% + VC 42%),
- aggregate assets of R$445 billion (DB 81% + DC 6% + VC13%), i.e. approximately €167 billion or US$243 billion and equivalent to 16%-17% of GDP.
- Aggregate contributions in 2008 were R$26.04 billion and aggregate benefit payments in the same period were R$32.51 billion.

In broad terms, plans for financial sector employees account for 51% of the total fund assets, but this includes the huge PREVI plan for Bank of Brazil employees (R$121.5 billion). The services and industrial sectors account for 25% and 24% respectively.

Table 1 – Fund Assets and Asset Allocations

	Assets	Bonds	Equities	Property	Loans	Other
Dec. 2002	R$168.5 billion	58.8%	27.7%	6.7%	3.9%	2.8%
Dec. 2003	216.2	60.2%	28.9%	5.4%	3.4%	2.1%
Dec. 2004	255.8	60.5%	30.1%	4.5%	3.1%	1.8%
Dec. 2005	295.2	60.9%	30.7%	4.0%	2.8%	1.6%
Dec. 2006	352.2	59.8%	32.8%	3.3%	2.5%	1.6%
Dec. 2007	435.8	57.0%	36.7%	2.6%	2.2%	1.5%
Dec. 2008	419.2	64.8%	28.0%	3.1%	2.6%	1.6%
Apr. 2009	444.5	62.8%	30.0%	3.0%	2.5%	1.8%

Source: the Brazilian pension fund association (ABRAPP), July 2009

Table 2 – Historical Returns (2003-2008)

	2003	2004	2005	2006	2007	2008	Cumulative
Nominal return (%)	27.05%	20.05	17.85	23.60	21.31	-1.27	**166.09%**
Inflation rate (INPC)	11.01%	6.50	5.35	2.98	5.67	6.86	44.83%
Real return	14.45%	12.72	11.87	20.02	14.80	-8.22%	**82.50%**
Minimum actuarial rate (INPC+6%)[5]	17.01%	12.50	11.35	8.98	11.67	12.86	100.96%
Excess return over actuarial	8.58%	6.71	5.84	13.42	8.83	-14.29	**29.74%**

Source: SPC 2008 annual report

10. A brief history of the regulation of closed pension plans.

The first comprehensive occupation pension legislation was issued in 1977 (Law n° 6.435), although less detailed precedents can be traced back to the beginning of the century. Pursuant to this law, Presidential Decree 81.240 of 1978 created the SPC as the supervisory body. The new federal Constitution came into effect in 1988, and article 202 thereof addressed private pension systems. The next major development came in 1998 when Constitution Amendment EC 20/98 reintroduced the concept of establishing pension plans complementary to social security and provided for a Complementary Law on pensions to be enacted. A complementary law project (PLC n° 9/99) was drafted in the following year, but it was never enacted.

The real breakthrough did not come until May 2001, when Complementary Laws n°108 and n°109 were enacted. Complimentary Law nº 108 applies specifically to (i) closed pension funds sponsored by state controlled enterprises and organisations and (ii) those complementary pension plans that are now being created for civil servants (employees of the federal, state and local governments). Complimentary Law n° 109 revokes all earlier pension laws and, together with Law n°108, forms the base of today's legislative framework. For extra clarity, it should be understood that public sector plans are covered by both Law n°108 and Law n°109, and private sector plans are covered by Law n°109.

11. The governance and management structure of closed pension funds.

The minimum management and governance structure consists of the following three bodies:

- **Conselho Deliberativo.** The maximum governing body. Approximately equivalent to an Anglo-Saxon board of trustees. For public sector (Law 108) plans, the membership is three plan sponsor representatives and three plan participant representatives, with one plan sponsor representative have an extra vote. For private sector plans, there is no set number of members and the plan participant representatives must be at least one-third.

- **Diretoria Executiva (or Conselho Executivo).** Responsible for the day-to-day management of the fund. These executives are appointed and dismissed by the Conselho Deliberativo. In Law 108 public sector plans, these executives cannot be employees of the pension plan sponsor.

- **Conselho Fiscal.** The Auditing Committee - below the Conselho Deliberativo but clearly off to one side. For Law 108 plans, there are two plan sponsor representatives and two plan participant representatives, with one of the latter having a casting vote. For private sector plans, there is no set number of members and again the plan participant representatives must be at least one-third. The function of the Audit Committee is to oversee the acts and decisions of the other two boards. However, it can only report its concerns to the Conselho Deliberativo and hope that action will be taken to remedy the perceived problem. It has no "whistle-blowing" powers that would enable it to report serious, unresolved problems to the regulator or another third party.

To avoid any ambiguity, the Portuguese names for these three bodies will be retained. Articles, papers and presentations in English tend to use such phrases as "board of directors" and "board of governors", or just "the board", "directors" and "governors", without any consistency in the use of such terminology.

In recent years, the larger funds have also created "committees", often with 50%:50% plan sponsor and plan participant representation. These committees are seen as moves to improve governance and to give plan participants a greater sense of involvement in the operation of the plan and fund.

II. REGULATION

1. "Regulation" of closed pension funds.

The bodies involved in the various aspects of the regulation of closed pension funds are:

- **Federal government.** It enacts high level "complementary pension laws", including the critically important Law n°108 and Law n°109 of 2001 to be described below. The only major pension "laws" issued since 2001 relate to the taxation of investment income – finally abolished after many years of confusion - and benefit payments (n°11.053 of 2004 and n°11.196 of 2005). However, there is an important draft law (Projeto de Lei 3962/2008) concerning the reorganisation of the SPC and the greater separation of its regulatory and supervisory activities. This will be discussed below. The federal government also issues a limited number of "presidential decrees" covering closed pension plans, e.g. Decreto n°4.678/2003 concerning the composition of the CGPC.

- **CGPC** (Conselho de Gestão da Previdência Complementar). It is chaired by the Minister of Social Security and is comprised of five members representing the government (including the head of the SPC) and three individuals representing pension fund entities, pension plan sponsors, and plan participants and beneficiaries. It is the dominant source of regulations covering a wide range of aspects of the operation of closed pension plans and funds. The SPC develops policies and prepares draft resolutions for consideration by the CGPC, but it is the CGPC (with it wider representation) that brings such regulations into effect. Several important CGPC resolutions will be discussed below. The CGPC has also introduced its first two "recommendations" – covering financial education and risk based supervision.

- **SPC** (Secretaria da Previdência Complementar). It issues lower level “instructions” to clarify various laws and regulations and generally to assist plan sponsors and pension fund entities. The SPC legislative department also initiates regulations for implementation by the CGPC and the CMN.

- **CMN** (Conselho Monetário Nacional). The National Monetary Council periodically issues “resolutions” concerning closed pension fund investments. The most important is CMN Resolution n°3.456 of June 2007. It is a comprehensive document that establishes quantitative investment limits for the assets of closed pension funds.

- **CVM** (Comissão de Valores Mobiliários). Roughly equivalent to the Securities and Exchange Commission, it issued Deliberation n°371 in December 2000 concerning pension plan accounting and expensing by publicly listed companies. In turn, it refers to NPC n°26 issued by the Institute of Independent Auditors, which is identical to the version of IAS 19 in effect at that time (2000). Subsequent changes and proposed changes to IAS19 are being carefully monitored. However, it is important to note that the “Preliminary Views” document issued by the IASB in 2008 and concerning proposed changes to IAS19 clearly indicates that Brazilian type variable contribution plans and DC plans with DB risk benefits were “outside the scope of the project” (see paragraph 5.60 of said document). Thus, there is no international guidance on one of the key accounting aspects concerning Brazilian plan sponsors.

- **CVM-SPC.** Acting together, they periodically issue “joint decisions” covering matters of mutual interest or overlapping responsibility.

The entire body of laws and regulations can be easily accessed on the SPC website[6]. The SPC periodically issues a single book that consolidates all such laws and regulations. A version of the latest consolidation is available in PDF format on the same website[7].

2. **Key laws and regulations (chronologically) since 2001.**

Note that, following a change in the formal name of the Ministry of Social Security, the numbering of CGPC resolutions started again at n°1 at the beginning of 2003.

- **Complementary Pension Law n°108** (29 May 2001). Covers (i) closed pension funds sponsored by state-controlled enterprises and (ii) closed pension funds that can now be introduced for public sector employees who have their separate social security systems (see earlier comments). This law prescribes the conventional three-tier governance structure described above, whilst re-emphasizing that these Law 108 plan participants have stronger representation on the Conselho Deliberativo and Conselho Fiscal than private sector funds. The law also requires that employer contributions do not exceed employee contributions, consistent with a 1998 Constitutional Amendment. In practical terms, it means a 1:1 ratio of employer to employee contributions.

- **Complementary Pension Law n°109** (29 May 2001). Applies to all closed pension plans, including Law 108 plans. It extends access to the closed pension fund system to members of professional associations and trade unions – for which clarifying regulations subsequently were issued in 2003. The law clarifies many actuarial and other matters not addressed in earlier legislation, and it forms the foundation for all subsequent regulations. Article 11 also opens up the possibility of (i) reinsurance being used by an active fund and (ii) an insolvency fund to protect against the plan sponsor’s insolvency. The former has been the subject of a subsequent CGPC resolution. The latter periodically has been discussed, but never really pursued – all in the hope that reinsurance would provide a softer and less dramatic solution.

- **Plan creation and pension entity licensing.** There are several resolutions on the two subjects, but the SPC seeks further improvements in the process of licensing – from the perspectives of both the regulator and the applicant. Online licensing is now available.

- **Vesting and portability.** CGPC Resolutions 09/2002, 13/2002, 06/2003 and 19/2006. Mandatory vesting after three years of plan participation (regardless of age), detailed provisions concerning deferred vested pensions and portability options, and related calculations.

- **Minimum funding requirements.** CGPC Resolutions 11/2002 and 18/2006. Minimum funding requirements are to be calculated using the unit credit actuarial costing method, the AT-83 or a more conservative mortality table and a maximum real interest rate (i.e. net of inflation) of 6%. Whilst a real interest rate of 6% would be considered as optimistic in other developed pension markets, very much higher yields were achievable in Brazil simply by purchasing government bonds. It is only recently that the 6% assumption is being critically re-assessed. The mortality table is a constant subject of discussion. Any resultant underfunding must be liquidated over a maximum period based on the average expected working lifetime of the current participants (similar to the old FAS 87 formula for pension plan expensing); the previous limit was 20 years.

- **Actuarial Commission.** CGPC Resolution 19/2004 authorises the SPC to establish an actuarial commission to provide the SPC with informed opinions on actuarial matters. The commission was finally created in 2009 and held its first meeting in May 2009. In attendance at this inaugural meeting (in addition to the author of this paper) were representatives from academia, the actuarial profession, government ministries and agencies, pension fund entities, plan sponsors and plan participants.

- **Risk benefit reinsurance.** CGPC Resolution 10/2004, pursuant to Article 11 of Law n°109, prescribes conditions under which closed pension funds can reinsure their death and disability benefits. In theory, this should be a particularly useful option for variable contribution plans. In practice, the issue is rarely discussed. Pension funds do not seem interested, and the insurance industry is not showing any appetite for this type of business.

- **Pension fund governance.** CGPC Resolution 13/2004. The fund must implement systems to identify, evaluate, monitor and control all risks that might impact on the fund's objectives. It must comply with prescribed communications requirements, set up internal audit controls and publish findings at least every six months. Recommended best practices include the development of governance guidelines and codes of ethics. Also not mandatory, but identified as being within management discretion, include seeking second opinions from third party specialists and hiring independent external auditors to assist in the evaluation of the pension fund's internal controls.

- **Disclosure of information to plan participants.** Well covered in CGPC Resolution 23/2006.

- **Investment restrictions.** CMN Resolution 3.456 (2007). A long and detailed document that prescribes quantitative investment restrictions on the assets of closed pension funds and sets other standards in related areas. Although issued relatively recently, it is already up for re-evaluation.

- **Overfunded plans.** CGPC Resolution 26/2008 regarding overfunded defined benefit plans. If the plan is overfunded, but the fund assets are still less than 125% of the liabilities, then the overfunding must be retained in the plan as a "contingency reserve". For this purpose, and only for this purpose, the liabilities must be (re)calculated on a basis no less conservative than the AT-2000 mortality table with a 5% real interest rate. When the assets exceed 125% of these liabilities, the excess becomes a "special reserve" and ***can*** be used to reduce or suspend employee and employer contributions, improve plan benefits and/or be withdrawn from the fund. If the special reserve exists for three or more years, then the special reserve ***must*** be used for these purposes. The 100% minimum funding requirement, based on a less conservative interest rate and an older mortality table, remains unchanged. This Resolution is focused on encouraging the creation of explicit contingency reserves for those plans that are overfunded and discouraging attempts to "spend" or withdraw large portions of such overfunding.

- **Pension fund accounting.** CGPC Resolution 28/2009. More demanding and more prescriptive than its international equivalent, IAS 26. Recognizes that, whilst pension fund accounting at many large pension funds is of very high quality, something needed to be done to improve standards and practices by funds at the other end of the spectrum.

- **Administration expenses.** Since 1978 for private sector plans and since 1992 for public sector plans, the overall administration expenses of a closed pension fund entity have been restricted to a maximum of 15% of employee and employer contributions; administrative expenses in this context excludes investment management expenses. The limit was meaningless at the time and was not really expected to be a practical constraint in the future. But many plans are now so mature that they are dominated by pensioners and other beneficiaries for whom contributions should not normally be required. Some of these same plans are also so overfunded that contributions have been suspended for the plan sponsor and active employees. 15% x zero = zero! To address this problem, a new set of limits for public sector (Law 108) plans was announced by the CGPC on 31 August 2009. The new limit will be 1% of the actuarial reserves or, at the option of the entity, 9% of the sum of the incoming contributions and outgoing benefit payments. The new rules come into effect on 1 January 2010. Any fund not in compliance on that date will have five years to bring itself in line with the new limits. Private sector plans will no longer be subject to any limits in this regard, but all plans will need to set objectives regarding expenses (to be proposed by the Diretoria Executiva, approved by the Conselho Deliberativo and monitored by the Conselho Fiscal).

3. SPC's list of priority issues and new regulations

The main priorities are the creation of PREVIC as a separate and independent supervisory authority, and the implementation of risk based supervision, but these issues will be addressed in the next section. The following is a list of priorities relating to "regulation".

- **Variable contribution plans.** As the IASB does not really know how to expense the cost of such plans, it is hardly surprising that the SPC continues to be concerned about their funding. An alternative to overcoming the concerns about some variable contribution plans is to encourage the reinsurance of the death and disability benefits and life annuities provided under such plans. This debate, already mentioned above, needs to receive wider attention.

- **Actuarial funding requirements.** Maximum funding - CGPC Resolution 26/2008 was effective in addressing various short term concerns about surplus withdrawals from defined benefit plans, and the subsequent financial crisis proved the wisdom of being allowed (or even required) to establish contingency reserves in good times. However, the latest resolution made little mention of underfunding, and there is a general desire to provide greater precision and clarification regarding earlier resolutions. As already mentioned, the funding requirements for variable contribution plans are of particular concern. The SPC is aware of international developments regarding funding standards and the active debate around different approaches such as the Dutch model and the UK more principles-based approach. Discussions are also taking place in Brazil concerning the possibility of moving funding standards very close to IAS19 expensing standards – a development that many actuaries and other experts consider to be impractical and generally undesirable.

- **Pension fund investments.** A new resolution is being developed that would significantly relax the quantitative asset mix restrictions in CMN Resolution 3.456, but there is no question of moving at this time to complete removal of all quantitative restrictions or of abolishing all the restrictions on foreign investments. At the moment, only the largest and most sophisticated funds even push against the current limits or understand that such limits can impede the development of "efficient" portfolios.

- **Asset liability management.** Bringing together the two previous bullets.

- **One pension "fund" administering several pension "plans".** The traditional Brazilian closed pension fund supported a single pension plan, but life has become far more complicated in recent years. At the most basic level, this could be the commingling of the assets of the DB, DC and VC plans of the same employer. At the next level, the commingling of the assets (and liabilities?) of DB plans of a closed group of employers – a common result of mergers and acquisitions. At even more complicated levels, the commingling of assets (and liabilities?) of DB and VC plans of unrelated employers. Consequently, there has been a movement to increased supervision of each individual plan, rather than supervision being concentrated on the pension fund entity, but many questions and concerns remain unresolved.

- **DB/DC conversions, plan mergers, fund mergers and plan terminations.** There are widely varying practices among the actuarial profession regarding such "events", all of which require approval by the SPC. Although not highlighted by the SPC in various discussions with the author of this paper, some outsiders expect further regulations in this regard. [Note that CPC Resolution n°6 of 1998 does not allow a plan sponsor to absolve itself of responsibilities regarding a plan it decides to freezes – very progressive legislation at that time!]

- **Certification of corporate directors.** Brazil understands that certification of individual trustees or senior management is rarely found in other countries, but it is anxious to pursue the idea, to address its concerns about the poor operation of some of the weaker pension entities and generally improve the operation of all funds and plans. Members of all three basic bodies could be affected, namely the Conselho Deliberativo, the Conselho Fiscal and the Diretoria Executiva. One approach under discussion would involve separate institutions running courses and setting exams, especially as the SPC well understands that these are roles that should be outsourced. Such institutions already exist – IBGC (the Institute for Corporate Governance) and ANBID for certification.

- **Financial education.** As can be appreciated by reading research papers and official documents from earlier in the decade, the development of financial literacy among consumers in general and pension plan members in particular has been a priority objective in Brazil – partially in recognition of the low general level of understanding at that time. With financial education now being such a high profile subject around the world, Brazil is trying to be at the forefront of the movement. In 2006, a presidential decree established COREMEC, being comprised of four supervisory agencies - the SPC, SUSEP, the CVM and the Federal Reserve Bank. In May 2009, this group finalized a "national strategy for financial education" (ENEF). One of its goals is to establish a private foundation to coordinate and control financial education in Brazil. Previously, in April 2008, the CGPC issued Recommendation n°1, which instructs the SPC to elaborate a financial education programme, recommends that closed pension funds implement such programmes, etc… Current SPC initiatives include an online training programme (in conjunction with ABRAPP, the pension fund association) and two easy-to-read brochures (one for potential sponsors of association plans and the other for plan participants). The incentive for pension funds to create and maintain good financial education programmes is that they could then be released of such obligations as sending hard copies of annual reports to participants.

- **Reinsurance.** At least for a few months, there was renewed interest in this subject. It was almost certainly a consequence of recent legislation that ended the 69-year monopoly of the government-related reinsurance monopoly (the IRB) and opened up the wider reinsurance market to more local companies and to foreign reinsurers[8]. These reinsurers are being licensed and supervised by SUSEP, the insurance regulator. If the insurance industry and the closed pension entities were interested, this could present important opportunities for transferring biometric risk, but it is far from certain that anything truly useful will develop in the near future.

4. Overall assessment of the "regulatory" environment.

For ease of reading, this brief assessment of the regulatory regime in Brazil will follow the first six principles in the June 2009 document entitled "OECD Recommendation on Core Principles of Occupational Pension Regulation". The seventh and final section of these core principles addresses "supervision", which is treated as a separate subject for the purposes of this paper – see Section III. Building on the foundations set by Laws 108 and 109, enormous progress has been made in the last six years (since 2003) in the development of regulations covering closed pension plans. At each stage, the SPC and the CGPC have made comparisons with evolving international best practices and OECD core principles in force at that time.

[However, in certain areas of regulation, it is important to note the fairly prescriptive requirements of Laws 108 and 109. Many of the early regulations were clarifications of the practical implications of various provisions of these two laws. Today, the greater challenge is to develop state-of-the-art regulations that still comply with and support these original provisions – as changing Law 109 is not an option! One example is minimum and maximum funding requirements, where such details as 25% overfunding, three consecutive years of such overfunding, employee and employer sharing of underfunding and overfunding corrections, etc… are all described in general terms in Law 109.]

Given that the "implementing guidelines" of the OECD Core Principles of regulation are numerous and comprehensive, and given the high level of compliance in Brazil with most of these principles and implementing guidelines, the following commentary will concentrate on the areas of weakness. The numbers in brackets are references to specific implementing guidelines in the OECD document.

- **Principle n°1 -** *Conditions for effective regulation and supervision*.

  - "There is a body of ethical, professional and trained lawyers and judges, and a court system, whose decisions are enforceable." (1.4). Some people in the pension industry have expressed concerns about a shortage of judges experienced in the complexities of pension matters.

- **Principle n°2** - *Establishment of pension plans, funds, and fund managing companies*.

  - Requirements for pension entities managing more than one plan to maintain separate accounts, funding policies and investment policies (2.5, 2.7 and 2.9). Already identified by the SPC as an important and urgent project.

  - Requirement for a business plans (2.14). Some of the important sub-requirements (e.g. adequate risk control reporting and auditing mechanisms) are already regulated, but a comprehensive business plan of the type envisaged here is not mandatory.

  - Licensing process (2.20 - 2.28). Full compliance on several of these aspects, but the SPC recognizes that there are still some concerns that need to be addressed.

- **Principle n°3 -** *Pension plan liabilities, funding rules, winding up, and insurance*.

    - Close to full compliance with the principle and the assessment criteria. However, there are concerns about the funding requirements for variable contribution plans, and there is a constant desire for further clarifications on minimum funding for all plan types.

- **Principle n° 4 -** *Asset Management*.

    - Investment policy (4.7). There is no regulation to mandate the level of detail described in this assessment criterion n°4.7 - although the most professionally managed funds would address these issues and more in their investment policies.

    - Portfolio limits (4.13, 4.17 and 4.19). The CMN (National Monetary Council) sets complex limits on asset classes, and also investments outside of the country are severely restricted. The SPC is a great believer in asset liability management, and it intends to continue its efforts to encourage or even mandate ALM. However, removing some of the obstacles to the development of efficient portfolios – such as little understanding of the concept, the CMN quantitative limits and a generally entrenched appetite for bonds - will not be easy.

- **Principle n°5 -** *Rights of members and beneficiaries and adequacy of benefits*.

    - Protection of employees against retaliatory actions and threats (5.4). Although there is some level of protection within labor law, the issue is not sufficiently addressed in pension law. It is too early to say whether the ombudsman envisaged in the PREVIC legislation will do anything to address concerns in this regard.

    - Portability rights and unreasonable charges (5.14). There does not appear to be any legislation addressing these concerns. Otherwise, the portability requirements are substantially compliant.

    - Disclosure of information to plan participants (5.18). The regulations on communications are quite comprehensive, but there are some areas of non-compliance, e.g. the requirement to notify plan participants of non-payment of contributions into the fund.

    - Member directed DC funds (5.24 - 5.30). There is some confusion concerning the legality of a DC plan being able to access multiple funds. Such arrangements are certainly offered by some pension entities, but others have taken explicit decisions to operate just a single DC fund (in the absence of additional legal clarification). By extension, the issue of member choice is somewhat confused, and compliance with OECD principles in this regard is not guaranteed.

- **Principle n°6 -** *Governance*.

    - The major assessment criteria requirements of a governing body comprised of suitable persons and accountable to the plan members and competent authorities, and the appointment of an independent auditor, an actuary and a custodian are fully compliant. The same is true for risk-based internal controls.

    - The governance requirements stem primarily from CGPC Resolution 13/2004, which was a major step forward at that time. Much has been learned and much has been enhanced around the world during the last five years, and it is probably time to consider changing some of the *recommended* approaches in the Resolution into *mandatory* practices. Ideally, such changes should be in effect before the implementation of civil servant complementary pension plans.

III. SUPERVISION

1. "Supervision" of closed pension funds.

The SPC is the supervisor of closed pension funds. It was created in 1978, pursuant to Law n° 6.435/1977 and Presidential Decree 81.240/1978. In the watershed year of 2001, Article 74 of Law 109 continued the regulatory and supervisory roles of the SPC and the CGPC - under the auspices of the Ministry of Social Security - *until a law is passed that creates new regulatory and supervisory agencies*. Thus, the seeds for restructuring the regulatory and supervisory agencies were sown eight years ago. Key references to the supervisory *powers* also can be found in Law 109: Chapter V regarding documentation requirements and information requests; Chapter VI on intervention and possible liquidation; and Chapter VII on disciplinary powers. Presidential Decree n°4.942/2003 established implementing regulations for Law 109, especially as regards sanctions. It clarified that fines cannot be paid by the fund, but must instead be paid by the individuals concerned. There are rumours that this decree is under review.

The SPC is currently funded, at a very low level, by the Ministry of Social Security (of which it is a department). A major restructuring of the SPC was undertaken in 2003 - subsequent to the election of President Lula who had included private pension issues as a priority during his election campaign. Technical departments were established to replace the general coordination approach. A technical analysis department was created, and there was a reallocation of actuaries and other specialists into the areas responsible for handling different authorization requests. Auditors were hired into the SPC. Later, more auditors were hired, and routine supervisory activities were decentralized into regional offices – with the supervisory professionals in Brasilia retaining responsibilities for the coordination and unification of procedures. The CGPC (the primary source of regulations) was formally restructured by a 2003 presidential decree. However, further comprehensive restructuring of the SPC at that time was conditioned on the creation of PREVIC.

As already indicated, the basis for the establishment of PREVIC can be traced back to Law 109 and thus predates the Lula administration. With the active support of the new government, a Provisional Measure (Medida Provisoriá n°233) was introduced in 2004 that would have created PREVIC as a separate and more autonomous supervisory authority. However, in a generalized protest against what it perceived to be the excessive use of Provisional Measures, the senate refused to vote on the legislation and thus allowed it to die. It was only in 2008 that a new draft law (Projeto de Lei n° 3962/2008) was introduced. This new draft law has already been approved by the House of Representatives (24 June 2009), and it is now been debated in the Senate under the title PLC 136/2008. Progress in the Senate is relatively slow, and the chances of it becoming effective on 1 January 2010 are diminishing. Highlights of Draft Law 3962/2008 are provided below.

2. Current internal structure and headcounts.

The current internal structure of the SPC is dictated by Decree 6.417/2008. There are five technical departments, as follows:

- Technical analysis (DETEC).
- Legislative (DELEG). Staffed by lawyers from the office of the attorney general. Also assists the CGPC in the drafting of new regulations and serves as the defence attorney for complaints brought against the SPC and its Secretary.
- Supervision (DEFIS). Note that "supervision" in Portuguese is "fiscalização", which – given its resemblance to unrelated English, French and other words - can cause confusion to the foreigner.

- Information Technology (DERIN). Among its other responsibilities, it controls the establishment and maintenance of an integrated data base that will underpin risk based supervision. The data base has “gateways” – various levels of access by the general public, pension fund entities (that can only see their own information), and three different levels of access within the SPC.

- Monitoring and Control (DEMOC) formerly known as the Economics Department.

The following table provides a breakdown of the employees by department as at the end of 2008. This is important to our understanding of the relatively low numbers and the heavy reliance on personnel seconded (assigned) from other ministries and from the outside. The top role of SPC Secretary is clearly not a career position, but this is perhaps also the perception of other senior positions. Draft Law 3.962/2008 on the creation of the new PREVIC is seen as an attempt to address concerns about staffing, continuity and related challenges.

	Cabinet	DETEC	DELEG	DEFIS	DERIN	DEMOC	**Total**
Full time employees	7	10	2	5	20	4	**48**
Seconded employees	7	4	3	99	5	6	**124**
Trainees, part time, …	4	4	2	5	22	1	**38**

3. The new PREVIC.

Draft Law n°3.962/2008 prescribes a major overhaul of the regulatory and supervisory structure for closed pension funds. Highlights include:

- The “formulation of policies” will remain with the **SPC**.

- The supervisory functions of the SPC will move to the National Supervisory Authority for Complementary Pensions (Superintendência Nacional de Previdência Complementar, **PREVIC**).

- The regulatory powers of the CGPC will move to the new National Regulatory Board for Complementary Pensions (Conselho Nacional de Previdência Complementar, **CNPC**).

- The judgement and recourse responsibilities of the CGPC will move to the new Appeals Chamber for Complementary Pensions (Camara de Recursos da Previdência Complementar, **CRPC**) **-** with the goal of streamlining the appeals processes and avoiding everything going to court.

- An ombudsman (*ouvidoria*) will be appointed.

- A *corregedoria* also would be appointed – to be charged with policing compliance with internal processes.

Similar to the current CGPC, both the CNPC and the CRPC will include representatives of pension fund entities, plan sponsors, plan participants and the government. PREVIC itself will be “an independent unit associated with the Ministry of Social Security”. Its structure and level of autonomy would then be similar to the Bank of Brazil and SUSEP, the insurance supervisory authority.

The basic source of funding for PREVIC will be levies (Tafic) on the pension plans. These levies are to be calculated on a sliding scale, based on the size of the actuarial reserves of each such plan. Other financing would come from fines, grants and donations and from other ministries, and the general budget will cover any remaining shortfall. The number of personnel employed by PREVIC would increase by the order of several hundred percent, according to one very senior source.

PREVIC would be administered by a collegiate board consisting of the superintendent and four other directors. According to the draft law, all five would be chosen amongst people of high reputation and recognized competencies, identified by the Minister of State for Social Security and approved by the President of the Republic. However, the senate would prefer that it appoints the directors, placing further emphasis on professional over political qualifications. It would also prefer that directors are appointed for five-year terms (eventually on a staggered basis). Directors would be forbidden from participating in any professional or political activity that would conflict with their responsibilities.

One of the major overall objectives of the legislation and the creation of PREVIC is to align the Brazilian closed pension fund supervisory functions with IOPS Principles of Private Pension Supervision. Examples include: financial independence, greater operational independence and adequate powers and resources to perform its functions. PREVIC will absorb almost all of the employees of the current SPC and further expand its workforce. It will accelerate the SPC's shift away from "a rule-based and remedial approach to one that emphasizes prevention and efficient risk-management." Thus, it is hoped that a real move to risk based supervision – actively debated for many years – will finally become a reality.

If the current attempts to form PREVIC are not successful, an alternative plan seems to be the eventual fusion of the central bank, the SPC and SUSEP.

4. Summary assessment of the Supervisory Regime.

For ease of reading, this assessment of the supervisory regime in Brazil will follow the 10 principles in the IOPS Principles of Private Pension Supervision (December 2006).

- **Principle n°1 -** *National laws should assign clear and explicit objectives to pension supervisory authorities*. [Fully compliant]. Here, the Brazilian regime would seem to be in full compliance. Evolving pension legislation since 1978, and Law 109 itself, clearly provide for a supervisor and sets objectives, responsibilities and duties for such a supervisor. In turn, the supervisor publicly and explicitly states such duties and responsibilities.

- **Principle n°2 -** *Pension supervisory authorities should have operational independence.* [Mixed levels of compliance]. Under the current structure, the SPC does not have operational independence and is not totally free from political influence. However, in day-to-day practice, the SPC has been free from undue external influence on operational matters. The budgeting process is far from being transparent. Although some would say that a change of government would not force senior directors to resign or be replaced, this has not been tested for many years. President Lula has been in power the entire period of recent change and strengthening of the regulatory and supervisory regimes. On the positive side, acts of the supervisor can only be over-ruled through due process. In any event, it is hoped and expected that the creation of PREVIC would go some way towards rectifying the current concerns and satisfying the basic principle of independence.

- **Principle n°3 -** *Pension supervisory authorities require adequate financial, human and other resources*. [Not in compliance]. The SPC is inadequately funded, does not have enough staff and relies heavily on personnel assigned from elsewhere who are not expected to stay with the SPC. It should also be noted that the SPC does not have the power to outsource supervisory functions. The creation of PREVIC, its improved and more transparent funding through levies on pension funds and the anticipated increase in staff numbers should be major steps towards resolving these concerns. Significant progress continues to be made regarding other resources such as improved IT systems.

- **Principle n°4** - *Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives.* [Full compliance in the majority of areas]. Returning to a more positive note, Brazil would be in compliance with many aspects of this principle. However, there are some clear exceptions, such as the lack of regulations (and thus the lack of power to enforce regulations) on reserves to be held by DC funds. Inability to enforce other actuarially related requirements is also a potential problem. Governance requirements for the supervised entities, and the ability to enforce such requirements, could also benefit from further strengthening.

- **Principle n°5** - *Pension supervision should seek to mitigate the greatest potential risks to the pension system.* [Partly implemented]. Although risk based supervision and related matters have been identified as a major priority for at least five years, actions to fully implement RBS require financing and resourcing that - many would argue - will only come with the creation of a financially and operationally independent PREVIC. Currently, decisions to intervene are not being made on the basis of assessed risk. In any event, with the legislation still pending, the SPC has solicited assistance from the World Bank to move ahead. Staffing, training and related aspects should not be underestimated.

- **Principle n°6** - *Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent.* [Partly implemented]. Poor scores on several of these aspects. The creation of PREVIC will not directly address these concerns, but implementation of risk based supervision and compliance with Principle n°5 would certainly help. Fully or broadly compliant ratings can be given in respect of actions being taken on the basis of unbiased evidence and choosing interventions that are proportionate to the problems and risks encountered – whilst recognizing that greater consistency of approach and full quantification of these risks is still work-in-progress.

- **Principle n°7** - *Pension supervisory authorities should consult with the bodies they are overseeing and cooperate with other supervisory authorities.* [Fully compliant in some areas; not compliant in others]. Whilst the SPC (and the CGPC) would score high regarding consultation on *regulatory* issues - and multiple forums do exist for two-way communication with supervised entities and other interested parties – there is no real consultation on strategic *supervisory* matters. On the positive side, there are legal requirements and efficient systems for exchanges of information and other cooperation between national authorities within Brazil. As a specific example, in 2006, Presidential Decree n°5.685 created a Committee on the Regulation and Supervision of Financial Markets (Coremic). SPC and SUSEP are members of this organisation, together with Federal Reserve Bank and the CVM (Securities and Exchange Commission). Exchanges of information between these bodies are now well organized. In contrast, it does not appear that the SPC is empowered to exchange this type of information with supervisory authorities in other countries.

- **Principle n°8** - *Pension supervisory authorities should treat confidential information appropriately.* [Fully compliant]. There are strong and unambiguous regulations on this subject (e.g. Presidential Decree 4.522/2002), and it is also a matter that is treated seriously by the supervisor. Actual compliance is more difficult to assess. The SPC does not outsource supervisory functions to third parties, so this issue does not arise.

- **Principle n°9** - *Pension supervisory authorities should conduct their operations in a transparent manner*. [Fully compliant on several issues; broadly compliant on others; weak on one aspect]. The SPC would score highly on the publication of its rules and procedures and publication of an annual report, and fairly high on the publication of supervisory decisions and related explications. Its website could be more helpful in assisting pension entities to understand what is expected of them, with some Anglo-Saxon countries providing examples of good practice in this regard. The issue of "assessing risks in the sector" is tied to earlier principles, and to challenges that the SPC already knows it needs to address. Finally, the SPC could be criticized for not publishing adequate information describing its strategic plans and decisions, and related cost-benefit analyses.

- **Principle n°10** - *The supervisory authority should adhere to its own governance code and should be accountable*. [Broadly compliant]. High marks for the existence of an appeals process that can be followed by a pension entity against decisions of the supervisor – the CGPC is currently the adjudicator, and the PREVIC legislation will reinforce these rights under a replacement body. Good marks for independence of authorizing sanctions without executive interference. In contrast, the SPC does not seem to have sufficiently documented internal control and risk management processes.

5. Further comments and recommendations.

The following recommendations are made with the objective of improving compliance with the IOPS Principles. In this context, it should be positively acknowledged that the SPC is itself the source of many of these ideas. For various reasons, implementation has proved to be difficult, and it would be naïve to think that the creation of PREVIC will be the overnight solution to all of these implementation challenges.

Principle 1: objectives

- No further comments or recommendations.

Principle 2: independence

- The passage of the legislation to establish PREVIC will go a long way to addressing most of the concerns in this area. However, there is no room for complacency. One example is the budgetary process, and whether there is "sufficient transparency in the process for setting the supervisor's budget to enable it to challenge any settlement aimed at compromising its operational independence". The current process is completely non-compliant, and (rather obviously) it has yet to be tested under the new structure.

- Other challenges which require monitoring are (i) removal of government interference in licensing decisions and (ii) the whole issue of senior management and staff be protected in some manner against civil actions taken against them, or against the supervisor as an entity.

Principle 3: adequate resources

- More than any of the other nine IOPS principles, this will be the greatest beneficiary of the PREVIC legislation. Article 51 of the legislation prescribes specific numbers of specialists, analysts and technical administrators for permanent positions at PREVIC. Whilst this is very good news, the hiring and training of all the new hires will be a major challenge.

- Both existing staff and new hires will need clear career paths and professional opportunities. Training will be a major issue. The FIRST programme to implement risk-based supervision, or an associated project, needs to address both this training and the cultural re-orientation needs associated with the move to risk based supervision.

- Actuarial careers need to be better defined within the permanent supervisory structure, such that actuaries cannot be fired for political reasons or if they find a problem with a major and influential pension entity. Individuals employed for actuarial work are currently hired as technical analysts, so an actuarial degree is not required. It appears the PREVIC legislation will not address these issues.

- Concerns have also been expressed about inadequate knowledge and experience regarding the supervision of association and union plans, where the individual plan member has a somewhat different status from employee members of more traditional closed pension funds.

- The supervisor needs to be in total charge of this hiring programme. Whilst no judgement is being made in this regard, if there is a risk of staff being imposed on the supervisor by the government under the present structure, it should be eliminated in the future. The excessive reliance on seconded employees – some holding senior positions - should be substantially reduced, so that regular employees can see a clear career path within the organisation.

- The outsourcing of supervisory and support functions is mentioned in the IOPS assessment criteria. It is not currently allowed in Brazil, so it remains a subject for future discussion.

Principle 4: adequate powers

- One area of concern – and one area for improvement - relates to enforcing legislation on the capital adequacy of pension funds. Both regulatory and enforcement issues still need to be addressed in this regard.

- Another concern relates to the probable needs for clearer *regulation* and stronger and faster powers of *intervention* regarding termination of seriously underfunded plans, e.g. Varig.

Principle 5: risk orientation

- At each stage of the move to a comprehensive system of risk based supervision, progress should be assessed against the IOPS principle and the assessment criteria. As is the case in many other countries, everyone is supportive of the move, but successful implementation is the real test.

Principle 6: proportionality and consistency

- Each pension entity must submit daily and detailed monthly (formerly quarterly) investment reports. These are checked against custodial reports and verified for general compliance. The adoption of risk based supervision should provide an opportunity to review which information is still really necessary and, in turn, should cause the productive reallocation of some of the supervisor's internal resources.

- Whilst internal *processes* will become more consistent and effective, it needs to be verified whether PREVIC will have the necessary *powers* to enable it "to vary its supervisory actions according to the magnitude of risks being addressed".

Principle 7: consultation and co-operation

- No further comments or recommendations.

Principle 8: confidentiality

- *No further comments or recommendations.*

Principle 9: transparency

- The SPC's current website is particularly user-friendly concerning access to all applicable laws and regulations, but it could be improved regarding practical advice to pension fund entities – and their senior representatives - concerning compliance and best practices. The SPC's annual report has evolved into a useful and very readable document, and further improvements are always possible in this and other key communications.

Principle 10: governance

- PREVIC needs to develop and communicate clearly documented internal control and risk management processes. This is perhaps implicit in the new legislation that envisages the appointment of a *corregedoria* to be charged with policing compliance with such processes.

6. Final comments concerning self-regulation and self-supervision by independent professionals.

This is a similar concern to that expressed in Principle n°9 of the OECD's original 15 Core Principles, and it is an issue that the SPC identified when completing its own assessment against past versions of OECD core principles and guidelines. The SPC places excessive compliance checking responsibilities on itself, rather than delegating some such tasks - and the associated accountability - to qualified third parties such as actuaries and accountants. How can these third party professionals be held more directly accountable? How can the SPC have greater discretionary power, and even veto power, over their actions? Can these professionals be summoned to a formal review? What are the disciplinary powers within each professional association? It appears that these questions still need answers.

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[1] OECD Recommendations on Core Principles of Occupational Pension Regulation (June2009)

[2] IOPS Principles of Private Pension Supervision (December 2006)

[3] OECD 2008.

[4] Complementary Law n°109 of 29 May 2001 and CGPC Resolution n°16 of 22 November 2005.

[5] Many DC plans guarantee a minimum real return of 6% per year. Most DB plans use an actuarial assumption of a real return of 6% per year (although there is a trend towards more conservative assumptions).

[6] http://www.previdenciasocial.gov.br/conteudoDinamico.php?id=269

[7] Coletânea de Normas dos Fundos de Pensão http://www.previdenciasocial.gov.br/arquivos/compressed/3_090729-174211-400.zip

[8] Complementary Law n°126 (January 2007) and CNPC Resolution 168 (December 2007)