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of Pension Supervisors

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ABSTRACT

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The pros and cons of the alternative structures for the agencies that supervise the financial system are of interest to policymakers. Whether to employ an integrated structure, with a single agency overseeing a range of financial intermediaries (including banks, insurance companies and securities firms) has been debated at length – mainly due to the rise of financial conglomerates providing a range of products. Another matter which has been less considered is whether the supervision of pension funds should also be included in such integrated authorities. This paper aims to add to that debate. After examining a range of arguments for and against such integration, the paper concludes that there is no simple reply, that the answer depends on the context and environment of the pension system, and that the benefits of both integrated and specialist pension supervision can probably be achieved within either structure.

Keywords: *supervision, pension, supervisory structures, integrated, specialist, intensive supervision, exceptional supervision.*

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1. Input to this paper was also provided by Fiona Stewart of the OECD

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I. Introduction

The pros and cons of modifying the structure of the agencies that supervise the financial system are of interest to policymakers. It is an issue that has been widely discussed in policy notes and academic papers in recent decades, and began to be discussed in the late eighties when Norway, Denmark and Sweden were establishing a single supervisory authority in their countries.[2] The discussion heated up in the late 1990s when the United Kingdom created the Financial Services Authority (FSA) and continued in the first half of this decade as many developed and developing countries moved towards more integrated structures.[3]

Today, the discussion seems to have reached a consensus regarding the need to supervise the regulated components of financial groups to take into account the different prudential requirements of each sector and the different risks to which each is exposed, but without losing sight of the group as a whole, including the parent. Indeed, it is partly this need to ensure that a group-wide assessment and management of risk is achieved that has led some countries to restructure their supervisory systems to deal with financial groups in an integrated fashion. However, no single model has been adopted and many countries continue to rely more or less on functional oversight regimes with separate rules and separate supervisors for the banking, insurance, and securities sectors. Regimes range from disaggregated structures to single regulators with statutory authority, with various mixtures in between. Given the wide range of regimes in practice, it is safe to conclude that there is no single model to organize supervision which can be considered "optimal" in all cases.

There is a pending, and most important, issue in the discussion of supervisory structure with respect to pensions. Pension funds are becoming major institutional players in financial markets around the world. Policymakers must have an educated opinion on the impact that the supervisory structure has on the efficacy and efficiency in achieving its objectives. Is it better to incorporate the pension supervisor within the integrated agency that supervises other financial intermediaries as Australia, Denmark, Iceland, Norway, and Sweden have done? Or, is it best to have a specialized agency to deal with pension funds?

This paper sheds some light on this issue. Section II provides a brief overview of the main issues raised in the literature on the pros and cons of integrating *banking* supervision with that of *insurance and securities*. With that framework in mind, we review, in section III, what has been written about incorporating *pension* supervision into an integrated supervisory agency. Section IV develops these arguments further, looking at how the broader socio-economic and pension environment may impact the optimal supervisory structure.

2. This paper centers on the issue of pension supervisory structures without touching on the related issue of regulatory and supervisory independence. See Quintyn and Taylor (2002) for arguments in favor of independence, its dimensions, and the way to achieve them, as well as the institutional arrangements needed to make independence work in practice.

3. In the past 30 years, Australia, Austria, Canada, Colombia, Denmark, Estonia, Finland, Germany, Hungary, Iceland, Ireland, Japan, Latvia, Malta, Netherlands, Nicaragua, Norway, Peru, Singapore, South Africa, South Korea, Sweden, Switzerland, and the United Kingdom among others have established integrated agencies, which oversee various combinations of the banking, insurance, pension and securities sectors.

The analysis in this paper does not provide a straight forward answer as to whether a specialist or integrated supervisory structure is optimal for pension funds, for several reasons:

- First, the debate as to whether pensions are similar enough to other financial products to be supervised in the same way has not been decided – particularly in relation to prudential supervision and whether the approach used to supervise financial institutions such as banks and insurance companies is applicable to pension funds;
- Second, there is no right or wrong answer as the supervisory system will depend on the pension system itself – and this in turn is informed by other economic and social factors. Some pension systems and environments may be *better suited* to an integrated rather than a specialist supervisory approach, but often the supervisory structure is more due to 'historical accident' than any strong view on the pros or cons of integration;
- Finally, in many ways the question is irrelevant. There may well be an argument as to why pension funds are unique enough for pension supervision to require a different approach to other financial institutions. However, it is possible that this specialist approach may be achieved as successfully by a separate division within an integrated supervisory authority as by an independent pension supervisor. Likewise, if an independent supervisor is set up, many of the gains of an integrated authority may still be achieved via strong communication between supervisory authorities.

II. Arguments for and against the integration of *banking* supervision with that of *insurance and securities*

Types of supervisory systems

Market imperfections and failures create the need for financial regulation and supervision in financial services. In the presence of externalities and information asymmetries, the competitive equilibrium fails to achieve Pareto efficiency without proper state intervention. Llewellyn (1999) points out seven components of the economic rationale for regulation and supervision in banking and financial services: (1) Potential systemic problems associated with externalities; (2) The correction of other market imperfections and failures; (3) The need for monitoring of financial firms and the economies of scale that exist in this activity; (4) The need for consumer confidence, which also has a positive externality; (5) The potential for grid lock, with associated adverse selection and moral hazard problems; (6) Moral hazard associated with the revealed preference of governments to create safety nets arrangements: lender of last resort, deposit insurance, and compensations schemes; and, (7) Consumer demand for regulation in order to gain a degree of assurance and lower transaction costs.

In this context, four core objectives of financial regulation and supervision have traditionally been identified: (1) Protection of consumers/investors against opportunistic and hazardous behavior on the part of financial institutions; (2) Maintenance of consumer confidence in the financial system and in the integrity of financial institutions; (3) Ensuring systemic stability; and (4) Safety and soundness of individual financial institutions. At issue is how to create an effective, transparent, and cost-efficient framework for achieving these objectives, both for individual sectors of the financial services industry and for the financial system as a whole.

Table 1. Countries with a Single Supervisor, Semi-integrated Supervisory Agencies and Multiple Supervisors

Multiple Supervisors (at least one for banks, one for securities firms and one for insurers)		Agency Supervising Two Types of Financial Intermediaries: Securities firms and insurers	Agency Supervising Two Types of Financial Intermediaries: Banks and Insurers	Agency Supervising Two Types of Financial Intermediaries: Banks and securities firms	Single Supervisor for banks, securities + insurers
Argentina	Jordan	Bolivia	Australia	Dominican Republic	Austria
Bahamas	Lithuania	Chile	Belgium	Finland	Bahrain
Barbados	New Zealand	Egypt	Canada	Luxembourg	Bermuda
Botswana	Panama	Mauritius	Columbia	Mexico	Cayman I.
Brazil	Philippines	Slovakia	Ecuador	Switzerland	Denmark
Bulgaria	Poland	South Africa	El Salvador	Uruguay	Estonia
China	Portugal	Ukraine	Guatemala		Germany
Cyprus	Russia	Netherlands	Kazakhstan		Gibraltar
Egypt	Slovenia		Malaysia		Hungary
France	Sri Lanka		Peru		Iceland
Greece	Spain		Venezuela		Ireland
Hong Kong	Thailand				Japan
India	Turkey				Latvia
Indonesia	USA				Maldives
Israel					Malta
Italy					Nicaragua
					Norway
					Singapore
					South Korea
					Sweden
					UAE
					UK
As percent of all countries in the sample					
38%		9%	13%	8%	29%

* Sample includes only countries that supervise all the three types of intermediaries (banks, securities firms and insurers)

Source: De Luna and Rose (2003). (It should be noted that some countries may have changed their supervisory structure since the publication of this report.)

In practice, no approach has been universally adopted. Rather, three broad models of regulatory and supervisory structure seem to be clearly identifiable: (1) A specialized sector-based model in which there are separate regulatory and supervisory agencies for banks, for insurance, and for securities; (2) a fully integrated model, where all regulatory and supervisory functions have been incorporated into a single agency; and (3) an intermediate model in which banking and some other financial services are regulated and supervised by one agency but some specialized regulators and supervisors still exist.

The case for integrated supervision

An oft-stated maxim in discussions about regulatory frameworks is that supervisory structures need to mirror the evolving structures of the sectors they cover. It was in this context that the debate over the formation of integrated supervisory agencies began to intensify back in the 1990s, when a trend toward conglomerate structures in financial services developed in some regions. There is fairly widespread agreement that the potential for intra-group exposures within integrated financial services groups complicates the task of supervision. The January 2001 Group of Ten report on consolidation in the financial sector (the Ferguson Report)[4] notes, for example, that the consolidation of a wide array of financial activities within large and complex organisations that include banking units not only blurs the traditional lines of demarcation among service providers but increases the potential for contagion effects from the non-bank to the commercial bank components of the same organisation. Conglomeration in financial services increases the need for information sharing, co-ordination and co-operation among supervisory authorities to ensure that a group-wide assessment and management of risk is achieved. Some observers contend that these activities are best achieved in integrated supervisory authorities.

The main arguments discussed in the literature in favor of integration of all supervisory activities are:

- that financial conglomerates can be more effectively supervised by an integrated agency, which enables economies of scale and scope in supervision to be better exploited;
- that there is less likelihood of regulatory arbitrage,
- that the probability of attaining a better defined set of objectives increases when they are all drafted for a single agency (avoiding the Christmas tree effect);
- that integrated authorities have a lower probability of suffering from "agency capture" by the industry;
- that there is an improvement in the quantity and quality of the information that flows between the various components of integrated authorities versus among the separate sector supervisors of distinct financial activities; and,
- that there will be more transparency and accountability in the case of a single regulatory and supervisory agency.

Some researchers argue that the net benefits of integration are greater than the net benefits of a specialized supervisory structure (Demaestri and Guerrero (2005)). Other authors acknowledge that there has been a global move towards more integrated structures over the past couple of decades (Goodhart et al (1998), Llewellyn (2004), De Luna and Rose (2003)) and concede that integration offers some advantages, but they stop short of claiming any clear superiority of one structure over another. In any case, most analysts agree that the shift towards regulatory and supervisory integration has its origins in the structural changes that have occurred in the financial system. The rise of

4. "Consolidation in the Financial Sector", Group of Ten, Bank for International Settlements (Basle, January 2001).

financial conglomerates, the speed of financial innovation, the growing complexity of financial activities, the increased demand for supervision of products which overlap several specialized supervisors, and the growing internationalization of financial services are all factors that have been cited as catalysts behind the formation of single financial services supervisors or at least behind the move towards integration and away from the specialized agency model.[5]

Nonetheless, it is widely recognized that there is no optimal financial supervisory structure. In fact, the most sensible advice seems to be that simply modifying the supervisory structure will not guarantee effectiveness.

The case against integrated supervision

Arguments against integration include the possibility of creating a single supervisor that is so big and powerful that it can potentially become divorced from the industry it oversees (Bureaucratic Leviathan). Furthermore, it has been argued that a moral hazard problem can arise if the public develops the false impression that every financial instrument has the same risk or is supported by the financial safety net, given that they are all supervised by the same agency.

Some authors, such as Llewellyn (2004), have made the point that the potential hazards of integrated agencies go beyond the risk of creating an extremely powerful regulator divorced from the financial industry and the moral hazard problem that can arise because of a misconception of the risk of different financial services. Rather, he argues that the main grounds for criticizing the mega regulatory and supervisory agency are that: (1) There remain major differences between the core businesses of banks, securities firms, and insurance companies which can blur the accountability for certain financial products within a single integrated agency; (2) A mega agency might lose focus on the objectives of regulation and supervision for each different product and business; and (3) There is no guarantee that supervisors within the same organization will communicate more efficiently and closely than if they were within different specialist regulatory agencies.

There also is a case that can be made against having a monopolist regulator.[6] There might be some merit to having a degree of diversity in regulation; namely, having some “competition” among specialized agencies allows them to learn from one another. Furthermore, a shadow of doubt on the argument of economies of scale and scope can be cast by pointing out that X-inefficiencies (derived from suboptimal resource allocation) may arise in a monopolist regulatory and supervisory agency.

Some of the arguments in favor of integration of the regulatory and supervisory structures seem to rely in part on an implicit assumption that a new integrated agency will begin with a valuable opportunity to redraft the objectives of the agency. Furthermore, this line of reasoning takes for granted that any such redrafting opportunity will be exempt from politicians’ interference, thereby leading to a better defined set of objectives for the new agency. One might also question the claim that integration leads to a reduction in the likelihood of regulatory capture. A single regulator could be easier to capture than a whole set of regulators. Finally, the contention that transparency and

5. See Goodhart *et al* (1998).

6. Llewellyn (2004).

accountability will be increased through a more integrated regulatory and supervisory structure is ultimately a matter of having the willingness and political backing to carry it out, without the need to modify the regulatory and supervisory structure.

A study by Carmichael et al. (2004) includes several countries' experiences with integration.[7] Specific case analyses of the possible effects of changing a given country's regulatory and supervisory structure for banks, insurance and securities have been done before (Taylor and Fleming (1999) for Northern Europe, Briault (1999) for the FSA in the United Kingdom, and Demaestri and Guerrero (2005) for Latin America and the Caribbean). However, in these studies the potential benefits of integration have not been fully weighted against the possible hazards.

III. Arguments for and against the integration of *pension* supervision with that of *other financial sectors*

Case for integrating pensions

In some countries private pension schemes are financed with vehicles that have characteristics in common with life insurance; that is, the liabilities of both life insurers and many pension funding vehicles have long time horizons, and both the life insurance and pensions business are often conducted via products employing mutual funds as investment instruments.[8] The so-called "unit linked" life policies and many types of personal pension products such as the 401(k) plans found in the United States are examples of such vehicles. Insurers are also major providers of personal pension products or act as managers of funds in some jurisdictions and, partly as a result, pension funds and insurers in a number of jurisdictions are overseen by the same supervisory body. Private pension schemes face a different ranking of financial risks, however, some of which are common for all pension systems while others are particular to private plans.[9] They include the risk of the fund becoming insolvent, the investment portfolio risk for the employer in defined benefit plans and for employees in defined contribution schemes, and more generally interest-rate and inflation risks in funded schemes.

In practice, the structure of oversight regimes for pension schemes is quite complex, reflecting the variety of schemes in practice, and the varied nature in which such schemes are financed and managed. The various distinctions in the types of pension schemes result in a number of basic institutional modalities that may call for different supervisory approaches. To date, however, only a single article has tried to actually assess the pros and cons of incorporating the supervisory and regulatory agency for pensions into a financial sector mega-agency. An empirical analysis of the net benefits of incorporating pension supervision with an integrated agency for Latin American countries was done by Demaestri and Ferro (2004). This study qualitatively measures the relative efficiency and efficacy of reaching the main goals of financial regulation (Consumer protection,

7. Australia, South Africa, Ireland, Sweden, Korea, El Salvador, Hungary, Estonia, and United Kingdom are all chapters in Carmichael et al (2004). Demaestri and Sourouille (2003) offer a comparative analyses of experiences of integrated supervision

8. See, for example, E Phillip Davis, "Portfolio Regulation of Life Insurance Companies and Private Pension Funds" (2001), *Financial Market Trends*, No. 80, October, pp. 133-189.

9. See André Laboul (1998) "The Financial Security of Private Pension Systems (Part II)", *Financial Market Trends*, No. 71, November, pp. 67-134.

Systemic stability, and Efficiency of the System and safety and soundness of financial institutions) under an integrated system of regulation and supervision and a specialized one.[10] The approach used indicates with a plus sign (+) the presumed advantage of a given approach in achieving a set objective. A (+/-) sign indicates ambiguity where neither approach seems to be better. Finally, a minus sign (-) indicates that the alternative approach would be better.

Table 2. Structure of Pension Supervision in Selected OECD + IOPS Member Countries

Specialized Pensions Supervisor	Semi-integrated Supervision	Integrated Supervision
	At least pensions + insurance	*Pensions, insurance, securities and possibly banks*
Chile	Belgium	Australia
Costa Rica	Finland	Austria
Hong Kong	France	Bulgaria
India	Jordan	Canada
Ireland	Luxembourg	Croatia
Italy	Portugal	Czech Republic
Japan	Spain	Denmark
Kenya	Turkey	Germany
Mexico	Zambia	Hungary
Nigeria		Iceland
United Kingdom		Israel
United States		Jamaica
		Kazakhstan
		Kosovo
		Korea
		Mauritius
		Namibia
		Netherlands
		Norway
		Pakistan
		Poland
		Slovak Republic
		South Africa
		Thailand
		Trinidad + Tobago

10. The three objectives of financial regulation and supervision are found in Llewellyn (1999).

Table 3. Efficiency and Efficacy of the Integrated and Specialized Approaches to Supervision in Meeting the Core Goals of Financial Regulation in Latin America

Issues	Objectives	Integrated Banking, Insurance and Securities		Integrated Banking, Insurance, Securities, and Pensions	
		Efficacy	Efficiency	Efficacy	Efficiency
Less Risk of Moral Hazard	Consumer Protection	+/–		+/–	
	Systemic Stability	+		+	
	Financial System Efficiency				
Less Chance of Regulatory Capture	Consumer Protection	+	+	+	+
	Systemic Stability				
	Financial System Efficiency				
Absence of 'Christmas Tree' Effect	Consumer Protection	+		+	
	Systemic Stability				
	Financial System Efficiency				
Less chance of a Bureaucratic Leviathan	Consumer Protection				
	Systemic Stability				
	Financial System Efficiency	+/–	+/–	–	–
Achieving Economies of Scale and Scope	Consumer Protection				
	Systemic Stability				
	Financial System Efficiency	+	+	+	+
Treatment of Financial Conglomerates	Consumer Protection	+	+	+	+
	Systemic Stability	+	+/–	+	+/–
	Financial System Efficiency	+	+	+	+
Greater Competitive Neutrality	Consumer Protection	+	+	+	+
	Systemic Stability	+/–	+	+/–	+
	Financial System Efficiency	+		+	
Greater Transparency and Accountability	Consumer Protection	+	+		
	Systemic Stability	+	+		
	Financial System Efficiency	+	+		

Source: Demaestri and Ferro (2004)

Based on this analysis, the only hazard of incorporating the pension agency into the integrated financial sector regulator and supervisor would be creating an agency that is so powerful that it becomes detached from the industry that it regulates (Bureaucratic Leviathan) with the associated loss of efficacy and efficiency in the pursuit of its objectives. The authors claim that the achievement of economies of scale, the treatment of financial conglomerates, the greater competitive neutrality, and greater transparency and accountability would all be enhanced by the incorporation of the pension regulator and supervisor into the integrated agency.[11] The analysis is qualitative, however, and does not allow the expected gains derived from the incorporation of the pension regulator and supervisor into the integrated agency to actually be weighed against the anticipated loss generated by an agency that is too big and powerful, and therefore detached from its regulated industry.

The study by Demaestri and Ferro (2004) extends this analysis of the advantages and disadvantages of integrated supervision in Latin America by attempting to take into account the peculiarities of pension funds. They attempt to qualitatively review the importance of the following: (1) the regulatory objectives; (2) the legal status of pension funds; (3) the taxonomy of pension funds; and (4) the way in which pension funds are regulated (the regulatory and supervisory model used). This additional analysis is apparently undertaken to see if some of these considerations could change their vote of confidence on integrated structures. The study concludes that the integrated approach to financial supervision is better than the specialized one even if one considers aspects specific to the pension supervisor.

The case against integrating pensions

There is no literature specifically outlining the case against integrating pension supervision with other financial sectors. The arguments in the following section are therefore the authors' own and are drawn from a variety of sources.

In the particular case of pension supervision, the potential benefits of maintaining a specialized agency are related to the expertise that a specialized agency can provide in an area with unique risks, tax treatment, public guarantees, and deeper welfare implications than many other financial services. The particular characteristics of this financial service naturally limit the benefits and augment the hazards of integrating pension supervision with the rest of the financial system.

The case against integrating the supervision of pension funds with that of other financial sectors stems from the unique nature of pensions themselves – though it should be noted that how distinctive pension products and pension fund managing companies are depends on the nature of the pension system examined (for example pensions and insurance products are very similar in the German pension system). These arguably distinct characteristics include:

- the long-term nature of the contract involved, and the subsequent requirement for incentives or even compulsion to overcome individuals' 'myopia' towards long-term savings;
- their coverage of a wider social and economic range of the population than other savings products (particularly where incentives or compulsion are applied),

11. Demaestri and Ferro (2004).

meaning that vulnerable consumers, those with low incomes and often limited education levels, are involved;

- the fact that investors in pension funds often have a low risk tolerance, especially where private pensions represent subsistence rather than discretionary savings;
- the complexity of these products, involving tax issues, assumptions over future salaries and longevity, difficulties in the valuation of assets and liabilities etc. – a complexity which is beyond the financial literacy of most investors and which gives rise to asymmetrical information between pension providers or financial intermediaries and consumers;
- the frequent involvement of employers and sometimes trade unions, and the possible relevance for supervisory purposes of some aspects of their agreements, such as the commitment to pay contributions to a certain pension fund;
- the large number of pension funds in some countries limits the extent of supervisory oversight, and means a greater dispersion of fiduciary talent and expertise in pension fund administration;
- the non-profit nature of pension funds in some countries, which may require different supervison to profit-making, commercial institutions;
- the 'social' as well as financial role of pensions, which is becoming more important as reforms in many countries have given an increasing role to private pensions – placing greater responsibility with individuals;
- the potential impact of pension assets on financial market and economic stability given their increasing size relative to financial markets and countries' GDP makes it important for the economy as a whole that saving is at a stable and adequate level and that pension assets are invested wisely.

Social welfare considerations and extensive government involvement in the pension system make pension funds fundamentally different from other financial services. The assets in pension funds represent a greater portion of household wealth of the average participant than other types of financial assets, and reach more deeply through socio-economic strata than other types of financial intermediaries.[12] Preferential tax treatment for pension savings and explicit compensation guarantees make the government a major stakeholder in the pension system.[13] Furthermore, a major financial crisis that reduces the value of assets in pension funds could ultimately lead to budgetary assistance to the elderly as there are implicit guarantees for pension funds given the social implications of ensuring an adequate living standard for the workers who will receive a pension.

Pension funds do not suffer from systemic runs and/or bankruptcies. Nevertheless, a systemic crisis may temporarily affect pension funds through a reduction in the value of their assets. If defined benefits are offered, this process may cause financial stress for the pension plan sponsor, a private corporation, or the government. If the system is based on defined contributions the effect of a reduction in the pension funds assets would be borne primarily by those workers that reach retirement age at that point in time.

12. Rocha et al (1999).

13. Ibid

The specific requirements that must be met to ensure adequate consumer protection depend in part on the particularities of the pension industry. Pension funds must be supervised to ensure that they will be able to fulfill their obligations to retirees and that they will treat customers in a satisfactory manner. Information considerations are very important in pensions; the complex and long-term nature of the products creates asymmetries whereby the customer is less informed than the service provider. Regulation and strict supervision can force pension funds to disclose more comparative information on private pensions' administrative charges and returns to compensate for this information problem. These functions should be well aligned to enhance competition and to make it more effective. Given the growing share of total financial sector assets managed by the pension fund sector, protection for pension savings and savers is taking on added importance within the broader financial system.

The goal of consumer protection is particularly important in mandatory defined contribution pension systems. The pension regulatory and supervisory agency needs to protect millions of small savers, most of whom have low levels of financial literacy, and whose old age income will depend crucially on their pension. A further complication with mandatory contributions is the tendency for workers to become somewhat inattentive. In mandatory savings systems workers tend to perceive the mandatory deposits into their individual retirement accounts as a type of tax and, thus, pay little or no attention to the conditions of their individual retirement accounts. Furthermore, when they are young individuals tend to heavily discount distant time events, such as old age. As a result, consumers' demand usually has a low elasticity with respect to prices (administrative fees) and returns. Low price-elasticity of demand creates the conditions for generous mark-ups, unless there is a regulator and supervisor looking for ways to make the system more competitive.

In this sense, there is some overlap between the objectives of consumer protection and the efficiency of the pension system. If consumer protection emphasizes information disclosure in order to create a more competitive industry it will generate efficiency and lower costs for the consumer. The importance of the cost efficiency of the pension industry can make a large difference in the replacement rates that will be obtained for millions of individuals.

Systemic considerations have to be taken into account if the rest of the financial sector can be affected by pension funds' manager decisions during a financial downturn, given the relative size and importance of the pension fund sector. As traditional long-term investors, pension funds, like other institutional forms of saving, can serve as providers of liquidity and stability to the financial system as a whole. However, the sheer size of the sector in some economies means that there can be adverse effects on broader asset prices associated with the portfolio rebalancing activities of pension fund managers. The possibility of spillovers of this form means that efforts to preserve systemic stability should take into account the possible reaction of pension fund managers operating under stress scenarios, taking into consideration those regulations which could promote herd behavior in portfolio choice.

The specific nature and circumstances of pensions – particularly the high level of consumer protection required - may therefore be used to argue for a specialized supervisory approach. Though, as noted previously, the exceptionality of pension products and pension fund managing companies may not be appropriate arguments for some systems depending on their particular structure.

IV. Integrated vs. specialized – the answers depend on the context

In looking at the choice between integrated versus non-integrated structures, a distinction should be drawn between the organisational structure of supervisory agencies and the actual conduct of supervision. For pensions, the latter depends on the type of pension system being supervised, as well as on the level of financial market development achieved in each country. A wide heterogeneity of pension fund systems exists in the world today. More than 20 countries adopted defined contribution mandatory systems with special-purpose fund managing companies when they abandoned their PAYG defined-benefit public pension systems. Many industrialized countries still have their traditional defined benefit pensions as well as voluntary/mandatory occupational pensions, in which the financial assets are either held in trust funds or directly managed by banks and brokerage firms. As a result, most countries have co-existing public/private, personal/occupational as well as mandatory/voluntary pension regimes, some of which are defined benefit and some of which are defined contribution.

In spite of the heterogeneity of pension systems, certain 'styles' of pension supervision have been identified by analysts.[14] Rather than being a choice between discrete alternatives, supervisory styles are considered to reflect a set of attributes that represent different positions along a spectrum. The two ends of the spectrum - represented by the Latin American approach at one end (where supervisors engage in intensive supervision, interacting with funds on a daily basis) and an Anglo-Saxon style at the other (where by supervisors interact with funds only on an exceptional basis, such as where problems are detected) – are discussed below. A third approach, part way along the spectrum, would be more usual in Continental Europe, for example.

Atrributes of Supervisory Systems

Restricted	←→	**Open**
Pro-Active	←→	**Reactive**
Intensive	←→	**Exception**
Directive	←→	**Negotiated**
Corrective	←→	**Deterrent**

Source: Hinz, Richard and Mataoanu, Anca, (May 2005)

14. Rocha R., Hinz R. and J. Gutierrez et al (1998), Hinz, R. and A. Mataoanu (2005).

'Exceptional' supervision is associated with countries that have more developed economies and capital markets, allowing supervisors to rely on market mechanisms for financial sector supervision and to enforce the integrity of financial intermediaries such as pension funds. The same logic applies where markets are open and many participants enter to provide advice, products or services to clients. In these markets, the intensity of the efforts of the supervisors typically face a capacity constraint and supervisors must rely on other methods to facilitate voluntary compliance with regulation. Economic development is also frequently linked to legal traditions which support this type of 'market-based' supervisory approach.

> *"Countries with higher levels of per capita income and financial market development are associated with stronger rule of law, governance institutions, voluntary pension systems and occupational sponsorship. These factors combine in a variety of ways that lead to supervisory systems that are more open, less pro-active and function in a less directive manner." (Hinz 2005)*

Given the reliance on market mechanisms and the oversight of many financial institutions, it could be argued that a more integrated supervisory structure is more appropriate for this type of supervisory approach and pension environment.

The opposite approach – involving more intensive supervision – is used in those countries that have reformed their public pension systems into mandatory defined contribution systems with open funds managed by a small number of specialized pension fund companies. This is the pension system that Chile created in 1982 and that ten Latin American countries currently have operating, albeit with some modifications. In this supervision model ex-ante licensing of pension managers and funds is extensive and sets the relationship for the on-going supervision that will be done. On-going monitoring and inspections are done both off-site, when asset composition is monitored in real time, taking pre-emptive action based on this information, and on-site, when verification of all records through general or special-purpose audits is carried out. There is usually a heavy emphasis on pre-emptive addressing of compliance issues (early intervention), which implies intensive and very frequent analysis.

> *"Mandated pension systems require a large number of typically unsophisticated members to engage in enforced savings through pension funds, usually with the underlying economic risk born by the participants. These types of arrangements can be expected to required higher levels of security and consequently a more pro-active, intense supervision." (Hinz 2005)*

Focusing on the Latin American pension systems, the following arguments have been mentioned in favor of a specialized regulatory and supervisory agency:[15] (1) Participation is mandatory and the responsibility of the government is more important; (2) There are complex interactions between capital markets, insurance and social security in this type of system; (3) The adoption of this type of system introduces new retirement products which might have been previously unregulated; (4) There is a need to ensure transparency and

15. Demarco, Rofman and Whitehouse (1998)

efficiency (in places where regulatory enforcement has been low and the reliability record of the financial sector is weak). Furthermore, the Latin American model creates a new industry of specialized fund managers with competition issues (industry concentration, price dispersion in an industry with a homogeneous product, and low sensitivity of demand to administrative fees and returns).

In such a system it may therefore make sense to operate a specialized supervisory agency dealing specifically with pension funds and their challenges.

However, there are other ways to categorize pension supervision, for example based on the work-based pension environment. Such a method is described in the models outlined below (which are meant to be illustrative of broad frameworks rather than sharply delineated methods, with approaches combining elements from the different models also possible):

- *Government and policy-driven model*: In these systems the government has motivated and specified the development of the pension scheme so as to achieve wider sociological or economic objectives, even though the ultimate provider is within the private sector. In such systems there is a relatively low tolerance of risk, especially to the achievement of government objectives. The supervisor is expected to be very interventionist within a directive regulatory framework. The provision of pensions may well be very distinct from that of other financial services. The benefits of supervisory integration are likely to muted while those of having a separate supervisor are prone to be strengthened.

- *Employer-driven model* – in these systems pension provision is sponsored by the employer to achieve its objectives. The directors (trustees) of the pension entity are not financial services specialists but are accountable to the employer and its current or former employees, and hence can usually be expected to share supervisory objectives. Government policy involvement is limited to general encouragement through tax breaks and the creation of a regulatory and supervisory regime that provides basic safeguards in a way that (as intended at least) not to discourage provision. Consequently, there is a tendency towards a relatively high risk tolerance. The directors/trustees are assumed to be acceptable unless proven otherwise. This could be characterised as leading to an 'exceptional' approach – though this would vary according to the individual pension fund's level of systematic risk (where this was seen to be above the risk tolerance level the supervisor may indeed by highly proactively). Because employers and lay trustees differ significantly from the types of people involved in other financial services, it is not straightforward to apply the supervisory approaches in other sectors to pensions and the merits of an integrated supervisory approach are somewhat muted. As with the intensive style of supervision, supervisors might be expected to be specialist.

- *Commercial-drive pension fund model* – in these systems the market drives the provision of work-based pensions by supplying employers with the ability to provide pensions, quite often with limited commitment by employers. The government may mandate that such provision is made available or leave the decision entirely to the market. In either case the pension product has many of the characteristics of a financial services product, subject to varying degrees of profit maximisation motivation and professional governance. These features are strongly consistent with the arguments in favour of integrated supervision, especially as there is much greater similarity within model between pensions and insurance.

When these three models are mapped onto the spectrum of styles, the government policy-drive and employer-driven model are at the two extremes, with the commercially-driven model midway. The arguments for specialised supervision are, therefore, strongest at the extremes and those for integrated supervision strongest in the middle. If there is indeed convergence towards a common ground characterised by commercial rather than agency relationships then a trend from specialised to integrated supervision may be expected (as has been the case in practice). For instance, as supervisors move from trusting in the motivation of the pension provider or directing their behaviour in detail, to a method focused more on enforceable standards of competence, governance and performance, the approaches used by supervisors of other financial services become more relevant and consistency of approach more important and efficient. It is, however, important to note that it is as much the supervisor's attitude and methodology as the form of pension delivery that matters. For example, if not for profit trusts or foundations are expected to have similar standards to those that would be expected of commercial concerns – such as in the Netherlands or Australia - then the supervisory system tends toward the commercial model end of the spectrum. Yet in Italy the structure of non-profit, stand-alone pension funds, with trade union and employer involvement, has been seen as an argument in favour of specialized supervision. Finally, it should be noted that these are stylised models and that the pros and cons of specialisation and integration are not clear cut and depend on a much wider range of circumstances.

V. Conclusion

Those in favour of the establishment of integrated supervisory agencies suggest that such entities have a greater potential for delivering a consistent approach across a range of institutional types, including the different components of financial groups, than a collection of separate sector-based agencies. In some jurisdictions, arguments of this sort provided support for the combination of once separate sector-specific agencies into integrated, prudential supervisory authorities. But many other jurisdictions have opted to continue with an established system of functional regulation comprising separate sectoral supervisory agencies. Supporters of sector-based structures of financial supervision argue that most financial services groups are not true conglomerates in the sense of having activities equally split between two or more sectors. Rather, most existing financial groups are characterised by a predominance of either the banking, or the insurance or the securities business, which is often reflected in the group's corporate culture, its governance and its risk management practices.[16] Thus, it is argued that the "best" approach to supervision is 'specialised supervision', which would enable supervisory personnel to take into better account the specific features of each kind of institution for prudential oversight and conduct of business purposes and perceived differences in the risk profiles of service providers for the prevention of systemic risk.

Many of the same arguments can be applied to supervision of the pension fund sector. The conclusion of this paper is that the initial question it tried to ask – whether the pros of integrating pension supervision with other financial sectors outweigh the cons – could be

16. "Regulatory and market differences: issues and observations", (May 2006), The Joint Forum.

argued to be irrelevant – or rather that there is no one single way to respond, as it depends on the context. In addition the benefits of specialization may be achieved via an integrated authority (through having a specialist pensions division within the agency). Indeed, in practice, while a supervisory agency may have an integrated structure, many have separate operational units which focus on particular types of institutions[17]. Likewise many of the benefits of integration may still be achieved by a specialist pension authority if strong communication links with other supervisory institutions are established. Some argue that an integrated structure makes the process of supervision easier in general and perhaps better in the case of smaller countries where it may be more difficult to find sufficient personnel with the necessary skill set to staff multiple agencies, but as noted before, integration alone is not a sufficient condition for effective and efficient supervision.

17. Examples of IOPS members with integrated financial authorities but where pensions and insurance are handled in separate departments include: Austria, Belgium, Bulgaria, Croatia, Hungary, Korea, Namibia, Poland, Portugal, South Africa, Thailand, Turkey.

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