EU-CHINA

Social Protection Reform Project

中国欧盟社会保护改革项目

1.4.1. - EUROPEAN BEST PRACTICES RELATED TO REGULATIONS FOR FUNDED PENSION INVESTMENT

Component 1

Relevant actuarial methodology shows that the most critical factor for the sustainability of a funded pension scheme Is yield on investment, more specifically the real rate of return. When China is willing to broaden the role of market and that of its funded components in the overall performance of its pension system, it was therefore useful to summarily describe the substance of rules and regulations established and adopted by European pension funds and related Government authorities to secure fairness and lasting efficiency in financial management of the respective pension systems. The following Note was compiled by Koen Vleminckx (Belgium) on the occasion of one of its collaborative missions conducted under the EU-China Social protection Reform project.

Critical points:

- Introduction of market competition operation mechanism and investment
- Strengthen supervision by central government
- Establishment of pension fund risk control system
- The development of investment targets, investment rules and procedures
- Portability strategy

European Experience:

1. **Clearing house model**

An interesting innovation is the organisation of administrative functions along the lines of the so-called 'clearing-house' model. In Sweden's 'clearing house'-model, individual contributions for the funded scheme are still collected by the state, and benefits are still paid by the State. Social insurance institutions collect information on each contribution record and provide annual compounds of both pension contributions and rights. However their investment in the financial markets is handled by private managers. The private funds selected by the insured thus use resources collected by public authorities. Fund managers do not know the identity of those who have sent their contributions.

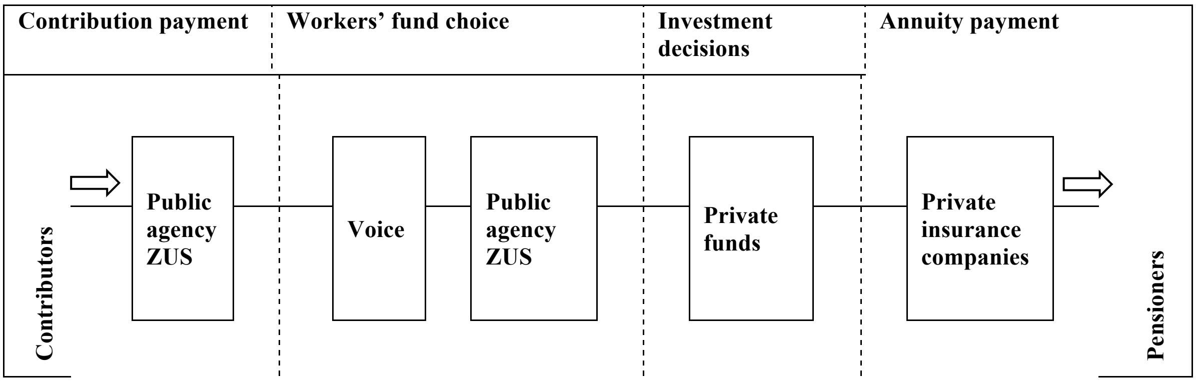
This is expected to provide protection against some of the risks and uncertainties related to financial markets. In the 'clearing house' model, contributions and fund choices are centrally managed by public agencies and this is expected to minimise administrative costs.

It is a particularly promising approach in terms of dealing with both problems of mis-management (of pension funds) and mis-selling (of savings products in the exclusive interest of the fund).

Poland also introduced a 'clearing house' model, but a slightly more reduced role for the central government. Each pension fund is managed by a separate legal entity: the private pension fund company. Yet private pension contributions are still collected by the public Social Insurance

Institution (ZUS). On retirement, savings in pension funds are used by insured persons to purchase an annuity provided by private companies

The ‘Clearing House’ Structure in Poland:



2. Legal framework

Pension Funds can be profit making commercial entities or non-profit entities. Both need regulation in the public’s interest, in particular their members, which are future pensioners.

Less developed financial markets and mandatory systems require more intensive supervision.

Thus, a legal framework is needed, particularly with regard to rules and regulations governing the structure and operation of pension funds.

The main elements of pension regulatory law are:

- Legal Status and Governance of Funds
- Definition and Holding of Assets
- Licensing and Entry Requirements
- Structure and Scope of Regulatory/SupervisoryAuthority
- Rule Making/Interpretive Procedures
- Funding Source for Regulator/Supervisor
- Relationship of Pension Law to Other Laws Controlling Financial Services
- Individual Rights and Dispute Adjudication
- Withdrawal Requirements and Access to Funds
- Liability Structure and Delegations
- Tax Treatment of Pensions
- Reporting, Data and Records
- Conflict of Interest Prohibitions
- Fees and Expenses
- Investment Requirements or Prohibitions
- Penalty and Enforcement Structure

The main aspects of pension fund regulation are:

1. **Structure and organization of pension funds**

- Licensing of Fund Operators
- Governance of Funds
- Capital and Reserves
- Segregation of Assets
- Custody of Assets

2. **Operation of pension funds**

- Investment Guidelines
- External Audit Requirement
- Reporting and Disclosure
- Limits on Fees and Expenses
- Guarantees

3. **Supervision, sanctions, and remedial action**

- Government Agency with Oversight and Regulatory Authority
- Legal Venue and Guidelines for Application of Sanctions
- Rights of Members and Venue for Resolution of Disputes

4. **Portability of funded pensions**

Another important issue for China is the portability of pension rights for citizens who work from one province to another.

The portability of pension rights requires:

• Improvement of the scope for transferring the capitalised value of pension rights between pension schemes;

• Coordination of, and increasing transparency in, actuarial calculation of the pension liability (claim)

Regulatory issues: Directive for a European Institution for Occupational Retirement Provision (IORP)

• Rules for transferring vested pension rights from one pension scheme to another

• Actuarial standards for calculating the capitalised value of pension claims

• Surveillance

Related best practices

Creation of Pension fund regulatory authority. Belgium, Italy, Czech Republic, …

- Licensing:
    - –Pension Companies
    - –Fund Managers and Trustees
    - –Custodians, Actuaries and other Service Providers

- Monitoring: Collection of information and monitoring of system to support review and analysis
    - Financial Reporting and Auditing
    - Actuarial Reviews
    - On-Site Reviews and Investigations
    - Receiving Complaints

Investment regulation of pension funds:

Two Basic Approaches:

- Quantitative Restrictions (results)
- Prudent Person (decision process)

Common elements in quantitative limits:

•Limits on specific asset classes

•Required diversification – limit on proportion of any single issue and share of portfolio

•Currency matching

•Required minimums and Maximums by asset class

•Consider defining concepts/categories in law

•Limits on Foreign Assets

Among the consortium member the Czech Republic, France, Italy and Poland have extensive quantitative limits on investment. They usually vary by type of scheme. Investments in equities, in particular in unlisted equities, are capped in most countries regulating pension funds' investments. Investment in real estate is not allowed in Italy. There are also floors on investments of pension funds in a few countries (e.g. government bonds). Sometimes the legislation on investment regulation also includes specific rules on investments abroad, usually with the exception of other EU and OECD member states (Italy).

Remark: The OECD publishes an Annual Survey of Investment Regulation of Pension Funds which describes the main quantitative investment regulations applied to pension funds in OECD and IOPS[1] countries - http://www.oecd.org/finance/private-pensions/annualsurveyofinvestmentregulationofpensionfunds.htm .

The OECD survey questionnaire covers all types of pension plans financed via pension funds. Where regulations vary depending on the type of plan (occupational, personal, mandatory, voluntary, DB, DC, etc), the tables identify the types of plan that the investment regulations apply to. The information collected concerns all forms of quantitative portfolio restrictions (minima and maxima) applied to pension funds at different legal levels (law, regulation, guidelines, etc.).

Finally, the third pillar consists of voluntary, supplementary pension schemes, which enjoy high tax subsidies in those cases when the combined value of the AOW and occupational schemes' benefits do not guarantee a final replacement rate of 70%.

Koen Vleminckx,

July 2015

[1] IOPS: International organisation of pension supervisors http://www.iopsweb.org/