

ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 6

Risks and Challenges – Identification of Gaps

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SUMMARY PAPER

Confidence

Economies prosper when millions of people, unknown to each other, conduct business in their own self-interest. Collectively, this generates wealth for the good of the economy overall. However, economies cannot function unless the people are confident that their property rights will be respected and protected. People must have faith that everybody else will play by the same rules.

Private pensions are generated through a series of market transactions over very long timeframes. To generate an adequate time retirement income usually requires savings be set aside through out the full course of a working life time. So savings may be accumulated over a 40 year period and then drawn upon over a subsequent 20-30 year period. The network of people and institutions involved over this very long time frame is complex. The possibility that the participants lose confidence is real.

In private pensions and funds management, a key role of a regulator must be to engender confidence.

This does not mean that the regulators are expected to prevent all possible failures in pension funds in all cases; that's not a realistic expectation. But it does mean that participants in a private pension market have confidence that should failures occur there will be consequences. There will be adverse consequences for those people found to have deliberately or negligently contributed to a failure. The market participants must have confidence that the regulator has a sufficient power to enforce the law.

So, if this is the main objective of a regulator, what are the challenges? Where are the gaps in regulation through which confidence can disappear?

Challenges for Regulators

Real-time

The first main challenge is the inability of any regulator to operate in real time. By this I mean regulators cannot be involved in the day to day operations in any financial institution to any material extent. Too often regulators find out about problems when it is

too late to do anything about them. The speed of the market, the speed of transactions, the rapid rate at which circumstances change make life difficult for regulators.

Consequently, regulators, and I will use the Australian APRA regulator as an example, recognise that the maintenance of confidence and consumer protection is a significant responsibility of the parties actually involved in the governance of the pension scheme. In Australian terms it is the Australian Trustee who has the day to day responsibility for the operation of a fund and it is up to the Australian Trustee to devise its own risk management plans and put into place risk mitigation strategies. It is essential that those risk mitigation strategies are devised by the parties actively involved in the management of the scheme. They are the ones who will know the specific risks and will be able or certain more able than a regulator to effectively manage those risks. They are the best placed parties to monitor risks and the effectiveness of the mitigation strategies. As a result, APRA places requirements on the trustees to meet 'fit and proper' standards.

Consumers themselves play a role. Effective disclosures to consumers for information and education not only serves as an element of risk management for the trustee but gives the participants themselves the opportunity to self check and identify potential problems. The counterparties to each financial transaction are the best parties to monitor that those transactions happen fairly.

The Weakest Link

The next challenge relates to the legal framework that the regulator must operate under. Regulators do not make the law. Parliaments make laws and regulators enforce them. If there are weakness in the law the regulator has no power to change that. As an example, consider foreign investment. Certain countries have more restrictions on currency movements in and out of the country than others. If such restrictions prevent adequate diversification of investments, then the effectiveness of the wealth creation object of pensions weakened. If the legal framework is weak on consumer disclosure requirements, the regulator cannot enforce a higher standard. If the legal framework is not sympathetic to adequate funding, the regulator is exposed.

Fraud & External Shocks

The next challenges I highlight are fraud and external shocks. Markets are increasingly sophisticated and opportunities for fraud are always emerging. The massive growth in the rate of e-commerce is one example. Pension and institutional funds will always be at risk of attracting fraudsters. The role of the regulator is to make life as difficult as possible for fraud to be committed. The challenge for the regulator is how to do that.

External shocks include terrorism and pandemics. A flu pandemic or an avian flu pandemic would create serious difficulties for a whole economy including the pension fund sector. What can a regulator do to ensure that if that pandemic happens, the pension fund sector of the economy will be, to the maximum extent possible, protected and able to function with limited disruption?

Resources

The final challenge I would refer to is that of resources. There is a skills shortage in many countries, including Australia. One of the consequences is a high demand for skilled people to operate in this industry, boosting rates of pay and putting pressure on regulators in their ability to attract and retain suitably qualified and experienced staff. It is difficult for publicly funded regulators to keep pace with paying conditions that are paid in the private sector and this must generate some restrictions on the abilities of regulators to be effective in their role.

How well are we doing?

The study report commissioned by Melbourne APEC Finance Centre has highlighted that there is wide variety in the state of regulation in APEC economies. The regulation infrastructure and quality of data in Australia is reported as strong, relative to some other countries in the study. Yet that hasn't meant that Australia has avoided problems. However, it is to be expected that a market as large as Australia's, in an economy where average annual GDP per head is over US\$37,000 will be more advanced in regulation than younger economies such as Vietnam's where GDP per head is less than US\$1,000pa.

Clearly there is much to be gained by the sharing of experiences among industry participants and regulators at forums such as this.