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SUPERVISION OF PENSION INTERMEDIARIES

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SUPERVISION OF PENSION INTERMEDIARIES

ABSTRACT

The goal of the paper is first to establish how private pensions are distributed in different IOPS member countries, and how pension intermediaries involved in the advice and sales process are regulated and supervised. The paper identifies common approaches and challenges encountered by IOPS members in their jurisdictions, and looks at different regulatory mechanisms and supervisory tools which have been used to overcome these issues.

The paper is structured as follows, after an *Introductory Section* discussing the importance and unique features of pension intermediation, and how pension intermediation is structured in different types of pension system. *Section II* moves onto looking at the challenges encountered with selling pensions in mandatory and voluntary systems, and discusses the various tools and approach which can be used to overcome these challenges. *Section III* provides conclusions of the topics analysed.

Keywords: pension, supervision, supervisory authorities, pension intermediaries

JEL codes: G23 G32

SUPERVISION OF PENSION INTERMEDIARIES

Introduction

The goal of the paper is first to establish how private pensions are distributed in different IOPS member countries, and how pension intermediaries involved in the advice and sales process are regulated and supervised. The paper identifies common approaches and challenges encountered by IOPS members in their jurisdictions, and looks at different regulatory mechanisms and supervisory tools which have been used to overcome these issues.

By '*pension intermediaries'* this working paper means individuals and institutions selling or advising on pension products to individual members of pension plans – including staff directly employed by pension providers themselves, 'tied agents' selling the products of only one provider as well as 'independent financial advisors' and sales agents who can sell a range of pension products. Other service providers (such as auditors, custodians etc.) will not be covered in this project.[1]

Intermediation between providers and pension plan sponsors / employers / trustees (i.e. parties who make decisions on behalf of individuals) – though an important topic - will be mentioned but will not be considered in-depth. This issue may be taken up by the IOPS as a separate report in the future. Consequently occupational pension plans will only be considered in this paper where individual plan members can exercise individual choice (e.g. of investment options).

This paper will focus on selling and advice given during the pension accumulation phase. Intermediation related to the decumulation phase - and particularly relating to annuities – is an interesting issue which has been partly covered by the IOPS in Working Paper No.7 (IOPS 2008a). Readers are directed to this Working Paper for more detailed work on the topic.

The paper is structured as follows, after an ***Introductory Section*** discussing the importance and unique features of pension intermediation, and how pension intermediation is structured in different types of pension system. ***Section II*** moves onto looking at the challenges encountered with selling pensions in mandatory and voluntary systems, and discusses the various tools and approach which can be used to overcome these challenges. ***Section III*** provides conclusions of the topics analysed.[2]

[1] Other service providers – notably pension fund asset managers – are covered in previous projects by the IOPS and other international organisations (e.g. *OECD (2006) Guidelines on Pension Fund Asset Management, IOPS/ OECD (2011) Guidelines on Pension Fund Risk-management*).

[2] Information for this version of the paper was drawn from questionnaire responses and other inputs received from IOPS Members: Albania, Australia, Austria, Belgium, Brazil, Bulgaria, Chile, Colombia, Costa Rica, Czech Republic, Ghana, Hong Kong, Hungary, India, Israel, Italy, Jamaica, Korea, Lithuania, Macedonia, Mexico, Namibia, Netherlands, Nigeria, Pakistan, Poland, Romania, Serbia, Slovakia, South Africa, Spain, Tanzania, Thailand, Turkey, UK, Ukraine and Zambia. It should be noted that some IOPS members operate under a 'twin peaks' supervisory structure where the IOPS member authority is the prudential supervisor and market conduct issues are handled by a separate consumer protection agency. In such cases, likewise, in other jurisdictions there may also be more than one authority involved in the oversight of intermediaries. IOPS delegates have liaised with the relevant counterparts in their jurisdictions.

I. Structure of Pension Intermediation

1. Why is pension intermediation important?

As the *IOPS Principles of Private Pension Supervision* note,[3] the provision of pensions is of fundamental economic and social importance, ensuring the successful delivery of adequate retirement income. The effective supervision of pensions, and of the institutions that provide pension products and services, is required to ensure the protection of consumers – a necessary task with any financial product being sold to non-professionals. Pension supervision is required to achieve the degree of protection needed to support privately managed savings and is a means to help pensions adapt to market risks.

Such risks can be particularly problematic with regard to pensions due to the characteristics of these financial products, such as the complexity of the products, involving tax issues, assumptions over future salaries, longevity, difficulty 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..[4]

Due to the imbalance of technical knowledge between individuals and financial professionals, consumers are highly dependent on intermediaries for help in making decisions relating to pensions and other financial products. In situations in which consumers are illiterate, such dependence on intermediaries is all but total. In many situations, there is ample opportunity for intermediaries to take advantage of consumers by selling products that do not fit their needs, or are even fraudulent.

The Joint Forum of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) produced a review of '*Customer Suitability in the Retail Sale of Financial Services*' in 2008 (Joint Forum 2008). The report considers how supervisors and regulated firms across the banking, securities and insurance sectors deal with the risks posed by mis-selling of retail financial products (specifically with a significant investment component), including related regulatory requirements, both with regard to disclosure of information to retail investors and requirements on firms to determine whether recommended investment products are suitable for such investors. The report considers factors which have increased the potential for mis-selling financial products and services in recent years – which also apply to pensions – including:

- *Social and economic imperatives*: including individuals taking on more financial responsibility as reliance on the state and employers for pension benefits declines;
- *Changing market conditions*: including low interest rates driving the search for yield through more complex products; financial innovation; increased competition etc.

In addition to these longer-term trends, the financial and economic crisis of recent years served to highlight ever more strongly the importance of good sales and advice within the financial markets and the importance of regulating market conduct to support prudential supervision. As pointed out by the former European Commissioner for Internal Market and Services, Charlie McCreevy:

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[3] See http://www.iopsweb.org/dataoecd/59/7/40329249.pdf?contentId=40329250

[4] Impavido et al (2009) argue that the limited capacity of individuals to choose what is best for them stems from "*a combination of lack of financial education, bounded rationality and use of simplistic 'rules of thumb' in the decision-making process*." Further information available via the OECD's project on financial education www.financial-education.org

"*The financial crisis has underlined once again how important it is that retail investors are able to make informed investment decisions. It is vital that investors receive information they can trust and understand about the investments they make and that those selling investments always treat investors fairly and focus on their needs.*"[5]

Likewise, the review of the financial sector in South Africa by the Treasury notes that:

"*As was demonstrated by the subprime crisis, inappropriate selling of financial products can have systemic effects, and a lack of confidence in the financial system due to poor market conduct practices causes losses to consumers and inhibits economic growth*." (South African Treasury 2011).

Hence, major reviews of how financial products are sold and how financial advice is given have been launched in several countries - including Australia, South Africa, and the UK, as well as at the European level and by the G20 – which have implications for pensions selling and advice.[6] Responses to the IOPS questionnaire on Intermediaries (which gathered information for this paper) also revealed that controls on pension intermediaries are being introduced in a number of member jurisdictions (such as Bulgaria, Hong Kong, and the Netherlands by way of example).

2. What is unique about pension intermediation?

Private pensions are provided in different ways and through different structures across jurisdictions. The most important distinction in terms of intermediation is whether pensions are provided on an *occupational basis* (i.e. through employers) or a *personal basis* (where individuals interact directly with pension providers and make personal choices).

Occupational Plans

In *occupational plans*, members are not strictly speaking 'consumers' as very often they do not make decisions directly themselves or on an individual basis - though member choice (e.g. of investment products) is allowed in some occupational systems. Decisions (such as which provider to use, how to invest the pension plan's assets) are usually taken by employers and plan sponsors, and 'protection' is provided by statutory safeguards and the actions of trustees and other fiduciaries.[7]

In such cases (for example in countries such as the Netherlands and Austria) intermediaries deal with these parties rather than with individuals themselves. It could therefore be argued that occupational pension products are not technically 'sold' but rather are workplace benefits and the member is therefore a beneficiary not a consumer (they often have no real choice in products so do not purchase them in the same way as other financial products).

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[5] Europa Press Release 29/4/2009 '*Commission proposes better investor protection measures for packaged retail investment products'* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/666

[6] See (Australian Government 2011 and 2010), (South Africa Treasury 2011), (FSA 2011), (FSB 2010)

European Union reviews http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm http://ec.europa.eu/internal_market/insurance/docs/mediation/imd_final_en.pdf - the latter review of the insurance mediation directive includes proposals for enhanced disclosure on the nature and source of remuneration and an enhanced conflicts of interest regime.

[7] See OECD (2003) *' Guidelines for the Protection of Rights of Members and Beneficiaries in Occupation Pension Plans'* These guidelines cover issues such as access and equal treatment, accrual and vesting rights and portability.

Though trustees and sponsors may be expected - or indeed required - to have some greater knowledge of pension issues than individual plan members, the complexity of pensions means that they too are often lacking in knowledge and understanding.[8] Problems with intermediation can therefore also arise in such cases, with trustees etc. being 'captured' by experts and not being able to properly evaluate the advice they are given. How they interact with financial intermediaries (such as consultants, advisors and fund managers) is an important issue (focusing on governance structures and internal control,[9] due diligence, trustee knowledge and training, fiduciary duty and conflicts of interest etc.) – but outside the scope of this report. Only occupational plans where individuals do have choices and therefore may interact directly with intermediaries will be mentioned (e.g. in Australia and Israel where plan members can opt out their employer's default options and choose a different pension provider or investment product).

Voluntary Personal Pension Plans

In the case of *personal pensions,* the distribution is organized more like other financial products, and therefore the general consumer protection measures and controls on market practice and intermediaries used in other financial sectors generally apply. Members of these plans do deal directly with intermediaries, and therefore the goal is to ensure: a) they receive information to allow them to make informed decisions; b) they are not subject to unfair or deceptive practices; and c) they have access to recourse mechanisms to resolve disputes.

Indeed, in voluntary personal pension systems intermediaries can play an important role in helping individuals choose their provider and investment product. Marketing and selling naturally plays a large part in these systems as they are voluntary and individuals therefore need to be persuaded to purchase a pension product (like all financial products pensions are 'sold' rather than 'bought'). As reported in Antolin et al (2009), no OECD country with a voluntary DC system has established specific investment options that providers must offer and only a few regulate default options.

In the absence of auto-enrolment mechanisms and default investment options, specific protection for consumers is required to prevent them from locking in suboptimal options (whose impact can last for several decades). Targeted advice and information (including on alternative providers to the one used in the accumulation stage) when choosing a retirement product may be required, and specific oversight of how such assistance is provided and incentivized may be needed.[10]

However, there are some particular issues which arise in relation to personal pensions over and above other financial products which makes the relationship between individual plan members and intermediaries even more complex and important to oversee carefully. For example:

- Unlike other financial products (which individuals simply 'buy' - i.e. make a one off purchase), with pensions individuals often have to make a series of choices which can involve aspects of intermediation and advise through the entire pension product cycle, not just at the point of sale– *i.e*. the start up point when a member joins a pension (which provider to use), but also decisions

[8] Professor Gordon Clark of Oxford University, for example, has written extensively on the topic of pension fund governance, board knowledge and the reliance on external experts. See, for example, (Clark 2007), (Clark and Urwin 2008a 2008b).

[9] See OECD (2009), *Guidelines on Pension Fund Governance*

[10] As with intermediation relating to the occupational pensions, intermediation relating to the decumulation stage can be seen as a separate issue – and one which has already been developed to some extent by the IOPS in Working Paper No.7 (IOPS 2008a), which examines how intermediation and selling problems have been tackled in Chile and the UK through the use of centralized quotation systems. This paper therefore focuses mainly on the accumulation phase... For a further discussion on the topic see also (Antolin et al 2008)

taken during the accumulation phase (such as whether to switch provider, how much to contribute, investment decisions) and at the point of retirement (whether to take a lump sum, programmed withdrawal or various types of annuity).How intermediaries interact with pension plan members at all these points therefore needs to be considered.

- Many financial products usually cover individuals for a limited period of time and are renewed regularly (e.g. car or house insurance), allowing markets to function as individuals are more likely to shop around and change provider or product if they realise they are getting a bad deal. Pensions, however, are purchased rarely, decisions taken may lock-in individuals for a long-time and the 'quality' or appropriateness of the product may not be determined until a long-time into the future (or when problems occur). Evidence from systems around the world increasingly shows that pensions do not function like other consumer markets due to their complexity and the lack of engagement on the part of the majority of individuals.[11] The role and influence of intermediaries may therefore need to be considered differently.

- Ensuring that charges are reasonable is also a particularly important issue for pensions (given that an annual charge of 1% over 40 years can reduce eventually pension income by around 20%).[12] The fees intermediaries charge are therefore of critical importance for pensions.

- The concept of '*suitability*' may be different for pensions vs. other products. With most financial products the concept rests on the notion that if an individual does not understand a product they should not buy it (or be sold it). This works for other financial products as there are usually less complex products with limited risks and other alternatives available. The issue is more multifaceted with pensions as more than one decision has to be made, which also blurs the line between sales and advice. The problem with pensions is that people may have to buy one, and are therefore often at a minimum enrolled into a default option or are at least heavily encouraged and incentivized to join a pension plan. Control over intermediaries may have to come in different ways – i.e. with pension regulators / supervisors deciding what is suitable and only allowing such products on the market. Auto enrolment and default options can be one way around suitability and appropriateness issues.

- Tax issue may also be different with pensions vs. other financial products – i.e. other financial products are purchased from post tax income, where as pensions (in some countries at least) are purchased from pre-tax income. An aspect of tax advice is therefore involved in their selling, again impacting the concept of suitability.

- Finally, pensions notably involve not only a savings or accumulation phase, but also a payout or decumulation aspect. Problems with decision making in the decumulation phase include the following:

  - Individuals often have a choice between retirement income products (e.g. between lump sum, programmed withdrawals and annuities). Incentives for intermediaries to sell these products may differ, which can lead to individuals making inappropriate choices.

  - In some systems the purchase of an annuity is compulsory. Yet these are complex products and individuals therefore may well require the help of intermediaries in deciding what type of

[11] For example, in a UK survey conducted in 2009 comparing 45 markets private pension plans were joint bottom with the gas and electricity market. See (Consumer Focus 2009).

[12] See (IOPS 2010).

annuity product to choose (e.g. do individuals have an impaired life or could they qualify for some kind of enhanced rate? Do they need cover for their spouse or dependents?). As discussed in Antolin et al (2008), when it comes to the pay-out phase, there are concerns that retirees do not always have the necessary information or expertise to select the best retirement product.

– In addition, individuals often do not realize that they can purchase an annuity from someone other than the provider who managed the accumulation stage of their pension (or even if they do realize they cannot be bothered to 'shop around). Therefore, individuals should be encouraged to compare products, despite such comparisons often being difficult and time consuming.

– As well as locking in to a suboptimal provider or product, individuals also risk locking into an annuity at the inappropriate time, when annuity rates are low (meaning that two individuals with the same accumulation balance could potentially face the prospects of living on very different retirement incomes).[13]

Mandatory Individual Pension Accounts

In contrast to voluntary personal pension plans, where pension intermediaries are largely regulated in a similar fashion to other financial products, a different approach to pension intermediation usually applies particularly in countries where *mandatory, individual pension saving accounts* replace social security benefits (as in the case in much of Latin American and Central and Eastern Europe).

In these systems it is not just selling or market conduct practices and consequently intermediaries which are regulated - pension authorities also regulate choice. Given the pension savings in these systems are mandatory rather than voluntary and provide subsistence rather than additional income in retirement, individual members are protected through regulation limiting their interaction with intermediaries and the range of decisions which they have to make. Individuals are effectively 'fish in a barrel' having no choice but to sign up to a pension plan. In such systems members are usually allowed to choose their pension provider, though the number of providers is normally severely restricted (through strict licensing) to just a handful. Such regulation may include restricting (and heavily regulating/ intensively supervising) the number of providers offering pension products and severely restricting the scope of pension investments and the choices which individuals can make.

When it comes to choosing a provider, in these individual account systems, people are meant to decide for themselves and little advice is provided. Intermediaries are sales agents – their job is to sign individuals up to a particularly provider, not to help people chose between products. Indeed in many countries with mandatory systems a high percentage of new entrants do not make an active choice of provider and end up with the provider which is designated the default for the system.[14]

[13] See, for example, (Antolin et al 2009)

[14] For example in Poland in January 2011 37% of new entrants were allocated according to the default provider in the system, whilst in Bulgaria 68% and in Macedonia 35% of new entrants in 2010 were allocated by default, and in Slovakia it is estimated that 80% of members ended up with the default provider. Supervisory authorities have different ways of selecting the default provider for new entrants who do not wish to make an active choice. For example, in Mexico the choice of default provider was previously based on cost – as is the case in Hungary - but is now based on the net return of the providers. In Bulgaria, Macedonia and Poland new members are allocated across providers (based on a formula) whilst the default provider is stipulated by law in Costa Rica. In Chile a bidding process (based on the most inexpensive commission)

In some countries with mandatory pension systems, in addition to choosing their provider, individuals also have the option to choose a particular investment option. Exceptions to this include Bulgaria, Costa Rica, Colombia, Macedonia, Poland and Romania where providers can only offer one type of pension fund.

However, in order to ensure strict control over these mandatory system, the types of investment option offered in many countries are often highly restricted (e.g. to a growth, balanced and conservative fund). In addition to controlling the type of funds on offer, individuals may also be restricted in the range of these funds they can invest in according to their age (as is the case in the multifonds systems in Chile and Mexico, for example).

Again the role for intermediaries in making choice of fund decisions in mandatory systems may be limited as many members simply sign up to the default fund and do not make an active choice - though this does vary by country.[15] Mexico is an extreme example, where only 0.0032% of individuals opted out of the default in 2010. The level of involvement of intermediaries in the system may be one reason why more individuals take active decisions in some countries than in others – though this could also be explained by the structure of the system (e.g. where there are more younger workers they are more likely to opt out of the conservative default option and to choose funds with more equity exposure) and other external reasons. Tapia and Yermo (2007) discuss how behavioural economics could also be the main driver of active choice rather than any role played by intermediaries. (e.g. US research found that the greater the number of choices the more likely individuals are to choose the default option).

Box 1. Mandatory Systems in Australia and Hong Kong

The mandatory systems in Australia and Hong Kong are somewhat different to the Latin American/ Central and Eastern European model in that the ***choice of providers*** is far less restricted.

In Australia employers choose a default provider for the occupational based superannuation plan, but individuals can choose to join a different plan if they wish, thereby creating a greater role for intermediaries - around 1 in 5 Australians currently receive financial advice.

In Hong Kong since the inception of the Mandatory Provident Fund (MPF) System in 2000 up to October 2012, it was mainly the employer who selected the provider – individual employees have no choice. Since 1 November 2012, the "Employee Choice Arrangement" has been introduced to the MPF System whereby employees are allowed to transfer their MPF accrued benefits relating to their own mandatory contributions to a scheme of their own choice once per calendar year.

When it comes ***to choice of investment fund***, the mandatory systems in Hong Kong and Australia are again exceptions.

Under the MPF System in Hong Kong, employees can choose among the investment choices (called 'constituent funds') offered by the MPF scheme(s) chosen by their employer. As at 30 September2012, there were 19 approved trustees (i.e. providers) which provided a total of 41 schemes with 464 constituent funds. On average, each scheme offers 11 fund choices. These fund choices may fall into one of the following fund types: *MPF Conservative Fund, guaranteed fund, bond fund, mixed assets fund, equity fund and money market fund and others*. The law requires that at least one of the constituent funds of a scheme must be a MPF Conservative Fund. The number of constituent funds

takes place in Chile every 2 years to allocate new entrants. Thus, all new entrants become members of the cheapest provider for this period, after which they can change to another provider.

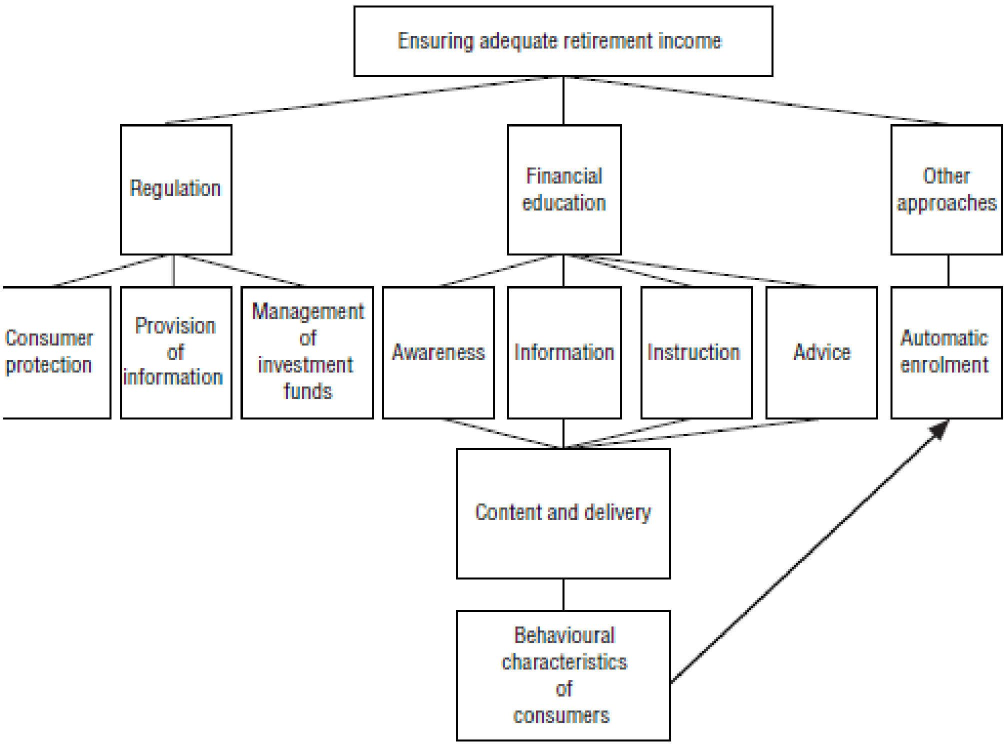
[15] The default fund in these systems is either the most conservative fund, irrespective of age (as is the case in Estonia and Slovak Republic) or differs according to age (e.g. the default fund for younger workers in Chile, Peru and Mexico is one with higher equity exposure than the default fund for older workers). For further details see (Antolin et al 2008).

in a scheme ranges from three to 26.

Meanwhile, in Australia most individuals have had the ability to choose their own fund since 2004, whilst the employer will nominate a default fund This is not currently defined or controlled by regulation but is typically a balanced fund (typical allocations are around 50% in equities, 10% in property and 15-20% in fixed income – see (APRA 2012)). Between about 50% and two-thirds of the assets of corporate and industry funds are held in the default option, but this is only the case for 20% of retail funds. By June 2011, around 50% of corporate funds, three-quarters of retail funds and almost all industry superannuation funds offer participants to make investment decisions about where to allocate their contributions. On average, participants face less than 10 different investment alternatives for corporate and industry funds, but over 250 choices for retail funds (see APRA 2012).

The discussion above shows how the structure of the pension system will determine how much oversight or indeed restrictions are placed on intermediaries and how much market competition is relied upon vs. other more restrictive regulatory practices.[16] One could argue that in such mandatory, individual account systems intermediaries are not required at all – and indeed they have been removed from the pension system in some countries (for example they are not allowed to advise on switching between funds in Romania and may be removed from the system altogether in Poland).[17] How regulation interacts with market protection measures to help protect pension members and beneficiaries is outlined in the OECD's work on financial education and pensions (see Figure 1 below).

Figure 1: Tools for Achieving Adequate Retirement Income



Source: (OECD 2008)

[16] See (IOPS 2010) Working Paper No.12, '*Managing and Supervising Risks in DC Pension Plans'*

[17] Ibid footnote 15

3. Structure of Pension Intermediation in IOPS Member Jurisdictions

Financial products are distributed by both their originators (i.e. pension providers themselves) and by a variety of intermediaries. These can be either 'tied agents', selling the products of only one provider, or 'independent financial advisors' who sell products from a range of different providers, without commission paid for by the providers .

As outlined by the European Commission in the review of Packaged Retail Investment Products (PRIPs) (EC 2009a), the predominant model of retail distribution differs by country. The 'bancassurance' model is predominant in many European Member States (i.e. banks and insurance companies are the main financial intermediaries), whilst Independent Financial Advisors (IFAs) dominate in the UK – particularly so when it comes to pensions.

Traditionally financial institutions distributed only products from within their own group (i.e. they effectively acted as 'tied' agents), but the European Commission notes that a more open model (or 'open architecture') of distribution has developed within Europe, with third-party products offered alongside own-brand products. Distribution channels have become even wider for financial products in recent years, with sales now often done by telephone, on-line or in non-financial related outlets, such as supermarkets. However, it is interesting to note that in the UK, to give one example, 80% of Individual Personal Pensions are still purchased through Independent Financial Advisors, which is in stark contrast to other financial products where the role of advisors has shrunk and sales have increasingly moved on-line, often facilitated by price comparison sites.[18]

Intermediation by Pension Fund Employees

In relation to pensions, in some countries the pension fund providers themselves generally handle the distribution of pension products (i.e. those 'selling' and advising on their products are staff of and employed directly by the pension provider). This is the case for example, in Brazil, Hong Kong, Pakistan, Spain, Tanzania and Turkey.

Selling agents are also generally the staff of the pension fund administrators (AFPs) in Chile and other Latin American systems, such as Costa Rica. Advice on which fund to sign up to is usually provided by the pension provider directly.[19] Intermediaries are employees of the pension provider and their job is to 'sell' a particularly pension provider. Advice on fund choice is also provided by the AFPs themselves (once an individual is a member of a fund they can then go to their AFP for advice on which of the different investment options they should choose).

External Intermediaries

By way of contrast, there are a few countries (Korea, Jamaica and Romania) where only agents are involved (i.e. the pension providers do not handle distribution directly). In most countries both the pension providers themselves and sales agents are involved.

In some countries only tied agents sell pension products (as is the case in Albania, Bulgaria, Costa Rica, Jamaica, Macedonia, and Ukraine), whilst in a few cases (Korea, for example) only independent agents operate (also in Serbia where only banks can act as intermediaries). In the other countries

[18] See (Vaze and Roker 2011).

[19] As noted previously, Chile is an interesting exception where a system of independent advisors has been established, though their main role is to assist in the choice of pension product at retirement.

responding to the survey (Australia, Chile, Hong Kong, India, Israel, Italy, Poland, Romania, and South Africa) both tied and independent agents can operate.

In most of the IOPS members surveyed, sales and advice are provided by the same intermediary – Australia, Ghana, Israel and South Africa being the exceptions where sales and advice are separated.

It is important to highlight what type of intermediary structure exists in different jurisdictions – whether by internal staff or external intermediaries - as each has its own unique challenges – which will be discussed in Section II of the paper. However, whatever the pension system in place, IOPS members have found that the mis-selling of products can have a profound impact on the pension system as a whole, undermining people's trust which is vital for such long-term products. Relevant supervisory authorities therefore have an important role to play in the oversight of pension intermediaries which are providing advice to individuals and / or selling them pension products.

4. Structure of Supervision of Intermediaries in IOPS Member Countries

When it comes to supervising pension intermediaries, the authority which has responsibility for their oversight differs across IOPS Member jurisdiction. Supervision of intermediaries is normally undertaken by the pension supervisory and regulatory authority. However, in several IOPS members (including Australia and the Netherlands) a 'twin peaks' model is applied, with a separate conduct of business regulator having responsibility for intermediaries sales conduct. In other jurisdictions - such as in Hong Kong for example[20] – responsibility is shared between the authorities overseeing the different financial sectors.

[20] Prior to 1 November 2012, an institution-based approach was adopted under an administrative regime for the regulation of MPF intermediaries, whereby the Mandatory Provident Fund Schemes Authority ("MPFA") and the other three financial regulators in Hong Kong (the Hong Kong Monetary Authority, Insurance Authority and Securities and Futures Commission) jointly regulated the MPF intermediaries. Starting from 1 November 2012, a statutory regime for regulating MPF intermediaries has been introduced and the statutory regime continues to adopt the institution-based regulatory approach in the regulation of MPF intermediaries. The MPFA acts as the authority to register MPF intermediaries and impose disciplinary sanctions against non-compliant intermediaries, whilst the other three financial regulators are responsible for the supervision and investigation of registered intermediaries whose core business is in banking, insurance or securities. In Costa Rica there is coordination between Superintendencia de Pensiones and the consumer protection office related with monopolistic practices.

Table 1: Supervisory Responsibility

Intermediaries supervised by pension supervisory authority	Intermediaries supervised by the conduct of business authority	Others (coordination with other agencies)
Albania Jamaica Bulgaria Korea Chile[21] Macedonia Costa Rica Romania Czech Republic South Africa Ghana Spain Israel Zambia	Australia Italy Netherlands Poland South Africa UK	Austria Hong Kong Ukraine

Source: IOPS

Pension supervisory authorities also differ in their approach to investigating intermediaries. For example, both a sampling and a targeting approach is used in Australia, where ASIC (the conduct of business supervisor) monitors intermediaries' conduct via "surveillances". An intermediary may be subject to surveillance in response to complaints or as part of a project focusing on particular conduct, in which ASIC chooses a sample of intermediaries. Such intermediaries tend to be chosen ('targeted') on a risk basis (where risk is a function of many variables such as intermediary size, market impact of any poor conduct, intelligence concerning non-compliance, including complaint levels etc). A surveillance may involve only examining documents (desk based surveillance) or also involve a visit to the intermediary's business. Checks conducted during the surveillance are sample checks designed to test the intermediary's compliance systems and training procedures.

Chile is an interesting example, where the oversight is highly intensive, with data collected from the 550 independent intermediaries operating in the country and analysed jointly by the pension supervisory authority and the securities and insurance supervisory authority- including on the type of advice given, outcomes and how people make decisions. Meanwhile MAPAS in Macedonia checks the costs of the agents of pension companies via on-site inspections.

The authority in Lithuania (LSC) has an interesting approach. They have performed 'mystery shopping' for investment products – where a person is tasked with asking questions and purchasing a product and then provides a detailed report and feedback about her experience - and are thinking of doing the same for pension funds.

The supervisory authority in Turkey uses a combination of these tools. For example, ad hoc suitability and misguidance check calls are made by the supervisor's call centre. In addition, analysis of sales and pension contract transfer data regarding intermediaries is also undertaken. Regular supervisory interviews are also held with selected intermediaries regarding switching and on-site inspections with pension funds investigate commissions paid to intermediaries and the 'selling' policy of the pension company.

[21] In Chile sales agents of AFPs are regulated by the pension supervisory authority. However, pension advisors are regulated jointly by the pension and securities and insurance supervisor authorities.

II. Main Challenges with Pension Intermediation

1. Challenges

Table 2: Main Challenges Related to Pension Intermediation

Challenges + Countries where challenges noted	Solutions
High charges: Australia, Chile, Costa Rica, Czech Republic, Israel, Italy, Poland, South Africa, UK, Zambia	*Enhance disclosure* *Limit the role of or ban intermediariesBan Inducement Commissions* *Auto-enrolment Arrangements, Bidding Procedures*
Conflicts of interest: Australia, Bulgaria, Chile, Costa Rica, Czech Republic, Israel, Jamaica, Poland, South Africa, Spain, UK, Zambia	Enhance Disclosure Limit the role or ban intermediariesControl Fees Ban inducement Commissions *Auto-enrolment Arrangements*
Inappropriate advice: Australia, Austria, Brazil, Bulgaria, Chile, Costa Rica, Czech Republic, Israel, Macedonia, Poland, South Africa, Spain	*Improve Quality of Intermediaries* *Use of Default Funds / Impose Product Restrictions*
Lack of knowledge on part of advisers: Australia, Brazil, Bulgaria, Chile, Costa Rica, Czech Republic, Hong Kong, India, Macedonia, Romania, South Africa, Spain, UK	*Improve Quality of Intermediaries*
Overly complex information provided: Australia, Brazil, Chile, Costa Rica Israel, India, South Africa, UK	*Enhance, simplify Disclosure*
Others (such as poor service, insufficient information): Hong Kong, Jamaica, Korea, Poland	Auto-enrolment Arrangements, Use of Default Funds

As discussed above, intermediaries play different roles in different types of pension systems and, as we have seen, are structured in different ways. This leads to different problems arising. For example, in the mandatory individual account systems, where the role of the intermediary is to sign up new entrants to system to a particular provider, problems have centred on high marketing costs (as once the individual is signed up they are likely to remain with the provider for life). In voluntary systems which involve more individual choice issues can arise around poor advice and mis-selling of products by poorly trained intermediaries.

Where intermediaries are paid on commission, conflicts of interest abound, as the intermediary is incentivized to sell the product which is more lucrative for them, rather than the one which is most appropriate for the client. However, there are fewer such conflicts of interest inherent when employees of the pension fund effectively sell their own products as in this system as the individual has already signed up to the pension provider, which are stand alone entities which generally cannot provide any other services (and therefore cannot cross sell products) and the fees are the same for whichever investment option they sign up to (for example the AFP's in Latin America cannot charge higher fees for an equity fund so there is no incentive to push individuals into higher risk options).

a. High Fees

i. Marketing Costs

One of the main problems with pension intermediation in mandatory systems relates to the marketing costs involved in signing up compulsory membership. Despite the limitations on the range of choices which individuals can make within many mandatory pension systems, intermediaries play an important role in getting individuals to choose a particular pension provider when they first join the system through selling that provider's products (intermediaries in mandatory systems - such as in Latin America – are normally employees of the pension provider).

Unsurprisingly, the problems with intermediation which have therefore been encountered in these mandatory individual account systems are mainly around the cost of marketing to new entrants to the system. Given that most individuals a) must contribute to the system and b) elect to stay with their initial choice of provider, signing up new members is of key importance, which has meant that marketing costs within some mandatory systems have been high. This burden on providers can feed through to higher cost for members.

Problems relating to high charges are also an issue within voluntary systems – indeed potentially even more so than within mandatory, as when pensions are voluntary they have to be 'sold' with marketing cost therefore potentially even higher than when just battling for a (captive) market share. For example, a recent study in the UK by the consumer group Consumer Focus (Vaze and Roker 2011) looking at Individual Personal Pensions (IPPs) mostly purchased through Independent Financial Advisors (IFAs) found excessively high charges eroding accumulated pension balances as a key problem.

ii. Switching Providers

The other main problem within mandatory systems is with intermediaries persuading individuals to switch pension provider during the accumulation phase, with no benefit and potential cost to them but in order to raise commission for the intermediary. Though the flexibility to move from an under-performing provider is important for introducing competition and raising standards within mandatory pension systems, concerns have been raised in some countries that undue incentives were being used to encourage unnecessary and costly switching between providers.[22]

[22] It should be noted that, though an important issue, switching does not always involve a large number of participants. For example in Bulgaria only 5% of insured persons changed their pension fund during 2010 (though it should be noted that there was marked increase from 2008 and 2009), less than 10% in Mexico and in Costa Rica around 12% switch during an average year. In Peru the number has varied in the last few

Similar problems exist within voluntary systems. The Consumer Focus report on the UK pension market (Vaze and Roker 2011) points out that, unlike switching home insurance, the costs of switching and marketing in pensions are borne directly by the individual consumer and not externalised onto other customers. When customers switch home insurance old and new prices and benefits are known. Not so with pensions – as costs are unclear and past performance does not guarantee future returns. There can be good reasons for switching (a new employer may offer a good pension, more flexible product - e.g. contribution holidays/ fund choice - lower cost fund, quality service etc.). However, investigations found that these are not always in place – with both FSA and Consumer Focus research suggesting this is not just a problem with a small number of IFAs but in a sizeable part of the market.[23] Lord Turner in his 2005 review of the pension system in the UK (Pensions Commission 2005) also identified persistency (i.e. frequent changes of provider) as one of the factors pushing up the costs of personal pensions.[24]

iii. Commissions

A further important and related issue is how intermediaries are paid. This is particularly important within voluntary systems where more intermediaries are independent and can therefore sell the products of several different providers. Structuring and disclosing fees and charges properly is important for preventing mis-selling.

Intermediaries can either be paid a flat fee by individuals for receiving their advice, or they can be paid commission by pension companies when the intermediary sells their product – or indeed a mixture of the two and the distinction is not always clear to individuals.[25]

In around half the IOPS Members surveyed, intermediaries are paid by both flat charges and commissions. In some countries only commissions are charged and in a few countries (India, Nigeria and Pakistan) only flat fees are allowed. Other types of charging, such as 'soft commission' are rare.

It should be noted that regulation controlling the setting of fees does not exist in all jurisdictions (for example there is no regulation on the issue in Mexico, Poland, Slovakia, Spain, and Thailand). Where the intermediary is an employee of the pension fund, a separate intermediary fee is usually not charged and 'marketing costs' are rolled into and covered by the annual fee charged to members.

The European Commission identified misaligned incentives as a problem within the selling process as part of their review of Packaged Retail Investment Products (PRIPs).[26] Likewise, the review of the

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years, from less than 1% to around 17%. In Macedonia the number was a tiny 0.06% - but there is only a choice of 2 funds.

[23] See (FSA 2008) and (Pension Commission 2005) The Financial Ombudsman Service (FSO) also identified pension swithcing as an area of consumer detriment in their 2009/2010 review of complaints data http://www.financial-ombudsman.org.uk/publications/ar10/about.html

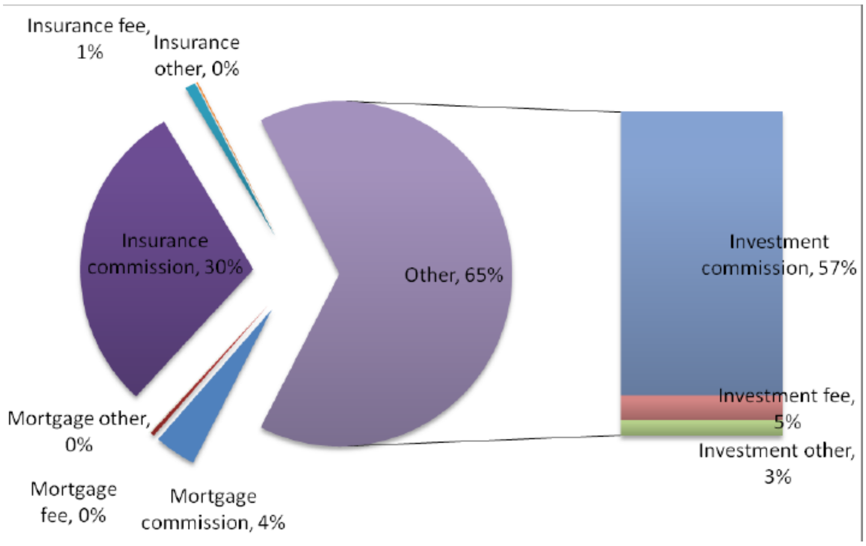
[24] In Australia the *Corporations Act of 2001* sets out additional information that must be provided when recommending replacement of one product with another (see s.947D), whilst also outlines representations about future matters taken to be misleading if made without reasonable grounds (s.769C).

[25] The Financial Services Authority (FSA) in the UK requires all Independent Financial Advisors (IFAs) to provide consumers with the option to pay for advice by fees. Other 'advisers' who are tied to one or more product provider such as a life company do not have to offer a fee option.

[26] See EU consultation on Package Retail Investment Products (PRIPs) http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm and revision of Undertakings for Collective Investment in Transferable Securities (UCITs) Directive http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm

Treasury in South Africa (South Africa Treasury 2011) noted that the financial services industry in the country is characterised by high and opaque fees, and the provision of inappropriate services driven only by commissions. This has also been an issue in the UK. Two reviews over the past 20 years have criticized how commission is paid for biasing advice and exposing pension savers to mis-selling (Sandler Review 2002[27] Gower Report 1980s). In 2009 financial advisors that filed returns to the FSA showed 57% of their revenue coming from commission paid from selling investment products (See (Vaze and Roker 2011)).

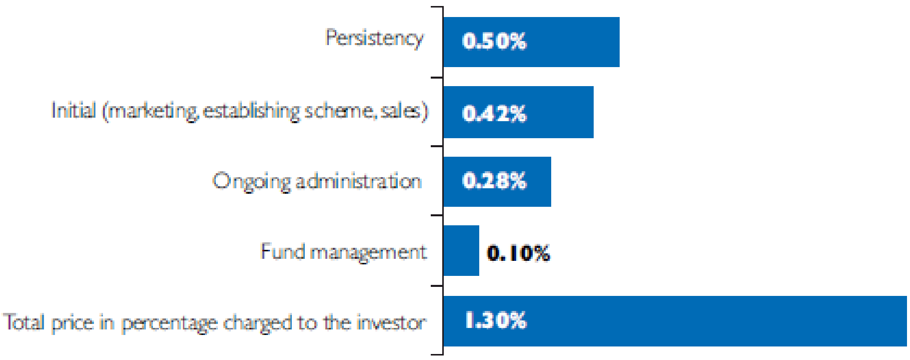
Figure 2: Gross Revenues Earned by Financial Advisers 2009



Source: Consumer Focus Analysis of Section B of FSA Retail Mediation Activities Returns (RMAR)[28]

As outlined in Vaze and Roker (2011), two distinct forms of bias are created: the first incentivizes advisers to recommend products that pay the highest rate of commission (*product bias*). As Pitt-Watson's report for the Royal Society of the Arts (Pitts-Watson 2009) in the UK points out, marketing costs can form a large percentage of overall pension charges.

Figure 3: Pension Cost Breakdown



[27] See (H.M. Treasury 2002)

[28] See (Vaze and Roker 2011)

Source: Pitts-Watson (2009)

The second incentivizes advisors to create unnecessary actions by their clients, such as switching provider (as noted above) - i.e. there is an incentive to churn savings to earn transfer commissions (*transactions bias*). Where a pension is transferred or a new pension taken out the advisor receives an up-front payment.[29]

The Consumer Focus report in the UK (Vaze and Roker 2011) also criticised the trend for products to pay on-going fees, also known as trail commission, to advisors (which it was estimated amounts to 25% of the total commission pension companies pay each year, and which is deducted from investments) even if they had not reviewed a customer's investments. Disclosure of costs and charges was also found to be complex and opaque, making it difficult for individuals to shop around.

b. Conflicts of interest

Conflicts of interest are closely tied to the issue of fees, arising when intermediaries are incentivised to act in their own financial interest or in the interest of providers whose products or other services they are selling rather than in the interest of individual pension plan members. The inherent agency structure of intermediaries gives rise to conflicts of interest, and many cases have arisen where intermediaries are not acting in the best interests of their clients. As pointed out in IOSCO's '*Guidelines for Regulation of Conflicts of Interest Facing Market Intermediaries'* (ISOCO 2010), imperfections in the financial market and asymmetry of information are the prime reasons which can lead to the exploitation of conflicts of interest by market intermediaries.

This is more of an issue in voluntary systems where independent agents and advisors are more common. For example, Israel and South Africa noted conflicts as a particular problem within their jurisdictions. Within mandatory systems it is generally the employees of the pension provider who sell their products, and advice is normally provided by the pension providers themselves. As pension providers are stand alone entities which can only undertake pension activities (and therefore are not able to cross sell other products etc.) conflicts of interest are not really an issue.

c. Inappropriate Advice

In addition to the issues around charging and switching (which are also problems in mandatory systems), within voluntary systems intermediation problems could be argued to be more widespread, as pensions have to be 'sold' within these systems, arguable giving intermediaries a broader role. The choices which individuals have within these systems are also less restricted, giving intermediaries a broader and more complex role. Additional problems relating to intermediaries within voluntary systems therefore include inappropriate advice on the part of advisors – an issue which also occurs in other financial sectors, but could be argued to be more acute when it comes to pensions due to their complexity and the disengagement of most individuals.

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[29] Initial commission in the UK is usually between 3-6% of sum invested, or between 20-50% of the regular contributions into a pension during the initial period (usually for around 2 years). Charles River Associates (CRA) analysis based on the provider survey. *Study of intermediary remuneration: A CRA report for the ABI*, February 2005. Note: Commission expressed as percentage of initial period (first few years of premiums). Vaze and Roker (2011) note that the average fees for a transfer in the UK is 4.6% of the value of the fund and that for 20% of IFAs transfers and consolidation make up half of the deals they do on behalf of their clients.

Pensions' mis-selling has been an issue in several IOPS member countries. In addition to the misincentives to sell inappropriate products (discussed), such problems also occur when intermediaries selling and advising individuals do not understand their clients' retirement income needs. This is a particular problem with pensions which are amongst the most complicated financial product which individuals purchase.[30]

d. Lack of Knowledge of the part of Intermediaries

As well as mis-selling arising from inappropriate products, mis-selling can also occur due to intermediaries not having full understanding of the products they are advising on – particularly in markets where new, complex products are constantly being introduced, and where the qualifications or training required of intermediaries is vague. Intermediaries may therefore lack the knowledge and experience to advise their clients appropriately.

e. Overly Complex Information

Decisions over pensions are also hindered by the provision of overly complex information. As discussed, these are complex products which require careful description and explanation so that the risks which are involved for individuals are understood and not hidden. As Vaze and Roker (2011) point out, mis-selling can arise from lack of clear data on pension products. Savers face multiple impediments in the pension savings market: consumers purchase pensions infrequently; the 'quality' of the product, in terms of yield, is only evident in the future; many customers have savings in legacy pensions; the terms and conditions which apply to these products are often hard to find or understand so it is far from straightforward to see whether it is in the consumer's best interest to switch or to stay with the scheme.

However, the information provided on pension products still remains overly complex and difficult for even more sophisticated consumers to understand.[31] Sometimes this may be deliberate on the part of intermediaries as a way of hiding hidden costs or selling products which are more of benefit to the provider or intermediary in terms of fees and commissions earned.

2. Solutions

As noted in the discussion above, different pension systems encounter different problems relating to intermediation. The types of solution outlined below will therefore not all apply to all pension systems. The mechanisms used to overcome intermediation challenges will need to be adapted to individual country circumstance. Most countries will use a combination of tools (for example the supervisory authority in Turkey uses ad hoc suitability and misguidance check calls via the supervisor's call centres, as well as analysing sales and pension contract transfer data regarding intermediaries. In addition, regular supervisory interviews with randomly selected intermediaries are planned). However, not all methods will be appropriate for all countries – indeed some may actually be contradictory or may well be counterproductive and result in unnecessary regulation thereby stultifying rather than protecting or improving the pension system,

When it comes to tackling the challenges around pension intermediation outlined above, several methods can be used, including:

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[30] In Australia the *Corporations Act of 2001* sets out additional information that must be provided when recommending replacement of one product with another (see s.947D), whilst also outlines representations about future matters taken to be misleading if made without reasonable grounds (s.769C).

[31] See OECD work on financial education and pensions – www.financial-education.org

- Enhance information disclosure;
- Improve quality of intermediaries;
- Regulate structure of distribution;
- Control fees and switching frequency;
- Other sales controls:
- Ban inducement commissions;
- Use of default funds/ Impose product restrictions.

Most supervisory authorities use a combination of these – as discussed below. What mix is appropriate will depend on the nature of the pension system which is being overseen.

a. Enhance Disclosure

i. Information Disclosure[32]

The first way many supervisory authorities try to overcome intermediation and market conduct problems is through increased transparency and disclosure. If individuals have timely and appropriate information on the products they are buying, issues around high fees, conflicts of interest and inappropriate advice can begin to be addressed through individuals protecting their own position.

Disclosing information is an important part of establishing whether a pension product is appropriate for an individual client. The report of the Joint Forum (Joint Forum 2004) examined the disclosure practices relating to the sales of financial products in the banking, insurance and securities sectors. The report notes that disclosure helps customers to make better informed decisions and reduces the risk of mis-selling, and that in many jurisdictions, firms generally appear to provide useful information to the customer prior to a sale.

As would be expected, virtually all IOPS members require intermediaries to disclose information on product characteristics, costs and investment risk. Around two-thirds require the expected duration of the product to be disclosed, and around half whether guarantees are involved and/or expected performance. Interestingly, only around half require information on conflicts of interest or remuneration policies. This corresponds with the Joint Forum's findings for the other financial sectors.

The information is generally made available when the intermediary first makes contact with the client and /or at the point of sale and on the request of the customer. It is generally provided via a contract or disclosure document (in around half the cases a summary of the information is also provided) in combination with an oral explanation for the client (in line with the Joint Forum's findings).

In around two-thirds of IOPS members the pension supervisory authority provides guidelines on advertising

[32] For further details on information disclosure see also (IOPS 2010), (IOPS 2008b) and (OECD 2003) *Guidelines for the Protection of Rights of Members and Beneficiaries in Occupational Pension Plans*

Disclosure requirements may be more effective if consumers are involved in helping to design and test disclosure material. Disclosure also needs to be backed up with financial education, awareness and advice.[33]

Where intermediaries perform a range of functions, such services and remuneration usually have to be disclosed to the relevant funds. Where the intermediary acts as a 'one stop shop', providing various administration and investment services to a pension fund, additional disclosure is usually also required. This is more likely to be the case in pension systems which are dominated by occupational, group pensions and where intermediaries are generally tied agents from large financial groups. Again, this raises supervisory issues and can extend the scope of supervisory oversight. However, in some jurisdictions intermediaries are prohibited from engaging in other activities (such as the collection of contributions).

ii. Imposing Suitability Requirements

In order to prevent mis-selling and individuals buying financial products which are not appropriate for their financial situation and needs, an obligation to only sell the product where it is 'suitable' for the client is applied in other financial sectors.[34] Such an approach effectively reverses the usual 'buyer beware' approach applicable to most consumer situations. Suitability requirements apply in most of the responding IOPS Member jurisdictions – with Austria, Bulgaria, Israel, Lithuania, Macedonia, Serbia and Poland (where all responsibility lies with the pension funds themselves) proving exceptions.

Different approaches can be taken as to when suitability requirements apply. As the Joint Forum Report (Joint Forum 2004) found, in most countries, suitability requirements only arise when a firm makes a recommendation or provides advice to a client to purchase a product. For IOPS Member jurisdictions, the suitability requirements generally apply when the client is sold the pension product and /or is choosing or switching between investment alternatives (exceptions being in Costa Rica and India).

In terms of what client information is required to be collected in order to establish suitability of product or advice, age is standard in virtually all countries which have such suitability requirements – and indeed is the only information required in Nigeria and Mexico (where a multifonds system organised by age exists). Risk appetite and income are requested in around three-quarters of case, investment experience, family situation and tax position in around half with only net worth being requested in less than half the responding IOPS member jurisdictions. More detailed requirements are currently being drafted in Israel and studies are being undertaken in Spain**.** The information collected is slightly less comprehensive than the results of the Joint Forum's survey for the other (banking, insurance and securities) financial sectors (Joint Forum 2004).[35]

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[33] See OECD project on financial education – www.financial-education.org

[34] The Joint Forum's report (Joint Forum 2004) looks in detail at the suitability requirements relating to financial products sold in the banking, insurance and securities sectors. Suitability requirements are defined as: "*any requirement that a financial firm, when advising a retail client to purchase a particular financial instrument, make a determination of whether that investment is 'suitable' or appropriate for that particular client. Suitability or appropriateness are given a broad meaning: 'the degree to which the product or service offered by the intermediary matches the client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience.'*"

[35] The report found that when a recommendation is made more than 95% of respondents collect information about age, investment experience, risk appetite of the customer and purposes of the investment. More than 80% also collect information about family situation, net worth and income, the types of assets held, level of knowledge of financial products and time horizon. The tax status and the diversity of the portfolio are less collected (78%), as well as whether there is a need for a guarantee (68%) and whether there is a gearing strategy (44%) or whether the investment is financed by credit (56%).

Some countries do have particular requirements. For example, in the UK, since the introduction of stakeholder pensions, there has been a Financial Services Authority (FSA) rule - commonly known as RU64 – which requires advisers, when recommending a pension that is not a stakeholder pension (i.e. a specific type of simple, low-cost pension), to explain in writing why the recommended policy is 'at least as suitable as a stakeholder pension' (with the adviser required to provide a 'suitability letter'). .[36]

The information has to be kept up to date in the majority of IOPS member jurisdictions(either by the intermediary which must seek updates or the clients volunteer updated information) – including in Europe under the MiFid Directive. For example, in Australia, if giving further personal advice, the intermediary must make reasonable enquiries about whether already held information is up-to-date and complete, whilst in Costa Rica this must be done annually or every time the employee changes provider. This corresponds to the Joint Forum's findings on the other financial sectors. For the pension sector, the information was ascertained by the client filling out a form in around three-quarters of the jurisdictions, and supplemented in with an interview in around half (the Joint Forum report noting a similar proportion by form but a higher percentage of interviews).

If sufficient information is not received to allow proper suitability assessments a warning must be given to the client in Australia, Colombia, Costa Rica, Israel, Mexico, Netherlands, Slovak Republic and Thailand. Alternatively, a lack of such information can mean that no sale can go ahead in Costa Rica, Hong Kong, India, Mexico, Netherlands, Pakistan, Slovak Republic and Turkey.

In terms of documenting suitability checks, provisions for an 'acknowledgement information provided' and /or an 'acknowledgement information received' are in place in around half the IOPS members imposing suitability requirements (in line with the Joint Forum's findings for the other sectors). Mexico is interesting in that when switching the affiliate must dial a call centre and listen to a recording with information that aims to ensure the consent of the affiliate holds. In Hong Kong intermediaries are required to put in writing the advice given to clients and state the rationale for the advice. Australian financial services licences require licensees to document the following and retain those documents for 7 years: the client's relevant circumstances; consideration and investigation conducted in relation to the subject matter of the advice; and the advice (including reasons the advice is considered appropriate).

Pension supervisors generally keep an eye on whether these suitability checks are being met via analysis of consumer complaints and compliance testing, with a 'second review' process being used in Colombia, Israel, and the Slovak Republic (with the Joint Forum report noting slightly higher usage of all these techniques in the other financial sectors they covered).

A problem of suitability requirements is that in general they do not take into account costs and charges. Therefore, products may pass the suitability test even if they are much more costly than others. In the field of pensions, granting a "suitability" label to expensive pension plans may be very misleading, as high costs charged for many years along the life of a pension plan will cut retirement benefits substantially. For this reason, in the pension field the approach to suitability that is applied in other sectors may not be appropriate.

b. Improve Quality of Intermediaries

One way to ensure that intermediaries provide the right advice and sell the right products is to ensure that they are suitably qualified and trained. For example, the International Organisation for Standardization (ISO) has developed a standard (ISO 22222) on Personal Financial Planning, which gives requirements for competence performance and competence assessment methods, and obliges financial planners to demonstrate continued competency by following the necessary training programmes and maintaining records of these.[37]

Requiring suitable knowledge and training on the part of intermediaries is usually part of the licensing process. [38] Requiring pension intermediaries to apply for a license is one of the main ways in which supervisors exercise oversight. Financial intermediaries in most countries are licensed as a consumer protection measure. Specific licenses or requirements for those handling pension products may also be in place. For example, the Standard on Intermediaries in the IAIS Insurance Core Principles (IAIS 2011) states that *'the supervisory ensures that insurance intermediaries are required to be licensed." (18.1)* and "*the supervisor requires insurance intermediaries to possess appropriate levels of professional knowledge and experience, integrity and competence."* (18.3)

In some countries pension intermediaries are licensed directly by the pension supervisory authority, whilst in others it is the consumer protection agency that provides the license.

Table 3: Licensing Responsibility

Intermediaries licensed by pension regulatory authority	Albania Bulgaria Chile Costa Rica Czech Rep Ghana Hong Kong India Israel	Jamaica Korea Macedonia Poland Romania Spain Ukraine Zambia
Intermediaries licensed by the conduct of business authority	Australia Ghana Jamaica	Netherlands South Africa UK Italy

Source: IOPS

Where licensing applies to individuals, requirements normally breakdown into 2 parts:

i. Fit and Proper Requirements

These would involve precluding conditions, such as no criminal record and not having been declared bankrupt etc., and positive criteria, such as financial capacity, commercial and professional honesty etc.. Indeed these standard criteria apply to pension intermediaries in most IOPS member jurisdictions**.** Requirements are currently being outlined in Bulgaria and Namibia and are being strengthened under the FOFA reforms in Australia.[39] In some countries (such as Colombia, Lithuania, Mexico) it is up to the

[37] http://www.iso.org/iso/iso_cafe_personal_financial_planning.htm

[38] See (*OECD/IOPS 2008) 'Guidelines for the Licensing of Pension Entities'* and supporting background paper (IOPS/OECD 2007)

[39] Media release of the Hon. Bill Shorten, Minister for Financial Services and Superannuation No. 127 *Future of Financial Advice Reforms – Draft Legislation*, 29 August 2011

pension fund manager to impose any requirements on the sales agents as these are not set by law. In almost all cases these criteria apply to those both selling products and giving advice. Most supervisory authorities check that these requirements are met when licenses are granted, but some also make ex post checks (as is the case in Poland), including during on/off-site inspections (e.g. in Spain). In Hong Kong, the MPFA will not specifically assess the fitness and properness of persons applying to be registered during registration process since registration as MPF intermediaries is premised on the persons being regulated by one of the other three financial regulators who had made the relevant fit and proper assessments during their licensing/registration processes. MPF intermediaries basically meet the general fit and proper criteria.

As the IAIS outline in their previous Core Curriculum, which relates to the previous set of Insurance Core Principles (IAIS 2003), objectively evaluating professional competence is not easy, but notes that monitoring systems based on achieving pre-established objectives can provide an indirect indicator of professional competence. The IAIS stress that the supervisory authority is not expected to produce an exhaustive, detailed evaluation of the professional competence of intermediaries. What it can do, for instance, is to react to and directly assess breaches of legal provisions or complaints it receives directly.

The Australian Government's proposed reforms to financial advice, including for superannuation, include establishing an expert advisory panel to review professional standards for advisers (including representatives from industry, professional associations, academia, consumer representatives and ASIC officers).[40]

ii. Qualifications

In addition to fit and proper requirements, licensing may also involve achieving specific qualifications. These would likely involve general education requirements, relevant experience and sometimes the passing of specific exams. In some cases these hurdles can be surprisingly low. For example, the 'Retail Distribution Review' in the UK found that education levels for IFAs were below a first year university level.

The requirement to have some knowledge of finance and economics is applied in around half the responding IOPS Member jurisdictions, with a similar number also requiring experience of financial products more specifically. 8 Members (Colombia, Costa Rica, Hong Kong, Netherlands, Serbia, Slovakia, Thailand and Turkey) responded as requiring academic qualifications, whilst industry qualifications are required in Austria, Hong Kong, Mexico, Netherlands, Serbia and Thailand. In other countries, such as Australia, the requirements are more principles based rather than rigidly set out in law (though they are being tightened under the currently reform proposals) [41]**.**

In terms of where intermediaries get their training, this is provided (and exams are set) by the pension supervisory authority itself in Hong Kong[42], India, Israel, Macedonia, Slovakia and Turkey. In Chile, tied agents from AFPs have to pass an exam set by the Superintendence of Pensions. Moreover, the Superintence of Pensions can randomly test them in order to evaluate their knowledge on the pension system and it has also the power to impose fines on these agents. On the other hand, pension advisors have to pass an exam set by both the Superintendence of Pensions and the Superintendence of Securities and

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[40] See '*Future of Financial Advice Package'* http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=reforms.htm (Australian Government 2011 and 2010)

[41] Media release of the Hon. Bill Shorten, Minister for Financial Services and Superannuation No. 127 *Future of Financial Advice Reforms – Draft Legislation*, 29 August 2011

[42] The supervisory authority in Hong Kong only provides training to the trainers of core continuing professional development courses and not the intermediaries themselves.

Insurance. The pension advisor certificate must be renewed every 5 years. Currently there are 550 certified pension advisors operating in the country.[43]

The pension supervisory authority approves courses provided by other institutions in Albania, Colombia, Costa Rica, Hong Kong Israel and Thailand. Continuous / on-going training requirements are applied in Costa Rica, Hong Kong, India, Mexico, Nigeria, Slovakia and Turkey**.**

One example of an authority approving courses is ASIC in Australia, which provides regulatory guidance about the minimum competency standards for individual financial products (ASIC 2009b). Advisors can demonstrate that they meet these standards by satisfactorily completing training courses listed on the ASIC Training Register. ASIC is proposing to improve current advisor requirements by: requiring all financial advisors to sit a national certification exam before they can provide advice on Tier 1 products (which include superannuation); having an experienced financial advisor check all advice a new financial advisor gives in the first 12 months; and each financial advisor to study a nationally provided knowledge update every 3 years and pass an associated test.

By way of contrast to the pensions sector, the Joint Forum's report on sales practices in the banking, insurance and securities found that almost all firms provide training to sales agents and advisors. Almost all firms include compliance training as part of the overall training programme. Many firms appear to test their employees' understanding of regulatory and firm policy requirements.

The IAIS Core Curriculum, which relates to the previous set of Insurance Core Principles (IAIS 2003), outlines training requirements for insurance intermediaries, and also discusses how supervisors can evaluate whether the training has been adequate in scope and mastered by an intermediary. Supervisory authorities can use aptitude exams to gauge the adequacy of training. Passing the exam would certify that intermediaries possess enough basic knowledge to exercise the profession. For most intermediaries this mandatory evaluation would be conducted directly or through training centers or institutions approved by the supervisory authority.

In the insurance sector, the IAIS note that insurers that tied intermediaries work for would have primary accountability for the adequacy of training, although the supervisory authority can follow up by inspecting the insurer's training plans and programs for intermediaries and verifying compliance with them, ascertaining the dates on which training was given, and examining progress reports, the results of tests, and the number of aptitude diplomas or certificates issued. In addition to checking the contents of the training courses, the supervisory authority can evaluate the apprenticeship program for newly appointed intermediaries, for example, by examining and verifying progress reports and activity logs (though it is said that industry participants are often no supportive of these due to the time and costs involved in keeping them vs. what they feel is their limited use).

c. Limit the role of intermediaries

In addition to these more standard regulations on intermediaries, other more innovative restrictions are being imposed in some IOPS Member jurisdictions to try to get to the heart of these intermediation problems.

One, rather radical, solution to high marketing costs which has been introduced in some countries where pensions are mandatory is to remove intermediaries from the system. Chile is an interesting case

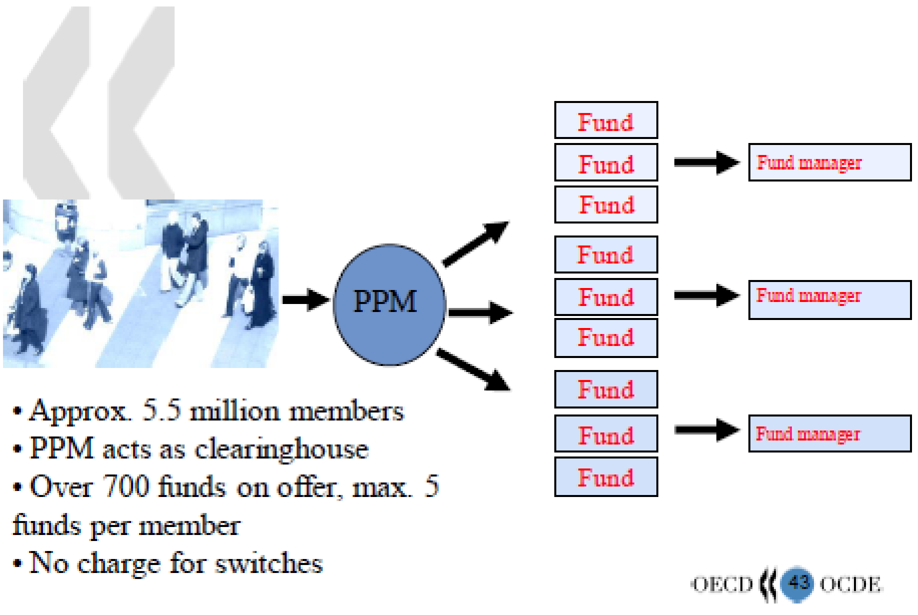
[43] More details regarding the functions, prohibitions and requisites for pension advisors can be found on Book V, Title VIII, Chapter II in the Compendium of Norms from the Superintendence of Pensions (available at http://www.spensiones.cl/compendio/577/w3-channel.html).

where intermediaries and selling has been removed from the initial enrolment into the mandatory pension system. From 2011, new entrants to the system are now automatically enrolled to a provider by the supervisor authority for their first 2 years – i.e. there is initially no choice of provider and no role for intermediaries or selling. The supervisory authority chooses the default provider via a bidding process based on cost.

There are likewise interesting reforms in Poland. Although there is a choice of provider in the Polish system, there are currently proposals to remove the sales force (currently tied sales agents of the pension providers) from the system. [44] From the start of 2012 individuals will have to choose their pension fund and will have the right to change fund, but pension funds and managing companies will be banned from active selling and their role in acquiring new members will be entirely passive. It is likely that all intermediaries will be banned from 2012 as it will not be possible for pension funds and managing companies to pay for their services. The reform has been introduced due to the heavy financial burden which marketing activities were placing on managing companies.

Sweden also provides an interesting example. The pension system includes a premium pension component (PPM) which allocates 2.5% of payroll tax for pension contributions (out of a total of 18.5%) to an individual investment fund that operates on a DC basis. Individuals can chose between a wide range of funds (over 600), but for those who do not make a choice, they are assigned a government run default fund – known as the AP7 fund. The system is run through a centralized administrative platform, so that individuals make their choice of fund within the PPM. Individual pension provides do not contact them directly as the PPM aggregates the choices for individual funds in order to negotiate lower, bulk discount rates on costs with providers.

Figure 4: Swedish Clearing House Model



Again, some countries have restricted switching practices and have gone so far as to ban intermediaries from advising on this practice. For example in Romania, in the case of both mandatory and

[44] Other pension products in Poland may also be sold by independent agents selling products from a range of providers.

voluntary pension funds, intermediaries are forbidden to provide assistance regarding transfer to another fund (following investigations by the supervisory authority which found a significant number of group transfers were taking place which were not initiated by members but rather from intermediaries drumming up fees).

d. Control Fees and Switching Frequency

Unlike in mandatory systems, where intermediaries have in some cases been banned outright in order to reduce marketing costs, the problem of high charges introduced into the pension system by intermediaries within voluntary systems has sometimes been solved by capping or controlling the fees they can charge. Given these systems are voluntary and pensions need to be 'sold' in order to improve coverage in the system, there is still a role for them - as recognized by the Australian Minister for Superannuation, for one: "*Longer term challenges such as the ageing of the population, as well as recent events such as the global financial crisis, underscore the need for quality advice.*"[45]

Though some countries have some sort of control on fees which intermediaries can charge (Albania, Bulgaria, Colombia, Costa Rica, India, Macedonia, Nigeria, the Netherlands and Pakistan), not that many IOPS members which responded to the survey impose a direct cap on intermediaries' fees. One exception is India with the New Pension System (NPS) - where the so called 'Points of Presence' (i.e. the selling intermediaries) can charge INR 20 (around US 35 cents) for opening accounts and INR 20 for subsequent transactions. Meanwhile in Israel the Ministry which supervises pensions is in the process of limiting the ratio between selling commissions and service commissions.

It should be noted that where the selling intermediaries are employees of the pension fund, a separate commission is generally not charged. There are no separate controls on their costs, but rather these selling or marketing fees would be part of the overall cap on charges which can be imposed on members (e.g. 3% of net asset value in Albania). Similarly in Hong Kong, although there are no direct controls on the types or levels of fees which intermediaries can charge, there are restrictions on what types of expenses could be deducted from the member/fund account relating to sales processes.

The Czech Republic is another example where problems with pension distribution related to the high turnover of clients (up to one-third each year) were addressed through changes in the incentive structure. These included inducements for potential clients being limited to c€15 per person per year, financial penalties for clients who switched funds during first 5 years of participation being set at c€30 and new rules of conduct for intermediaries and funds. New reforms will introduce fee caps for intermediaries for Pillar III and the new Pillar II pensions (initial fees limited to 3.5% of average national wage – i.e. €35.3 – per contract, with a limit on the average annual total cost for the new Pillar II pension of €20.4 (500kc)).

Fee controls have also been introduced in some mandatory systems, notably to reduce incentives and costs around switching providers. For example, problems with switching also occurred in the Slovakian system, where one year after the introduction of the mandatory accounts system around 10% of members switched within a 6 month period. A flat switching fee (around €16) was therefore introduced, paid for by members as well as restrictive timing of switches and switching is now accompanied by various administrative hurdles, which together have reduced switching to less than 0.1% of members. At present, there is no restrictive timing of switches and members may switch provider several times a year, in which case (with one exception) the obligation of paying €16 switching fee applies. However, for switching in

[45] See '*Future of Financial Advice Package'* http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=reforms.htm (Australian Government 2011 and 2010)

period longer than one year from the last switching (assuming that certain conditions set in relevant law of Slovak Republic are met) there is no switching fee.

Alternatively, some mandatory systems control costs by restricting the number or timing of switches of providers (which, as noted, was introduced in Slovakia). For example, in Colombia individuals can switch AFP every six months and in Peru every 3 months, whilst in Bulgaria, Estonia Hong Kong[46] and Mexico (with some exceptions) members can switch annually.

Rather than a cap, a 'reasonable' or non-excessive test could be imposed on intermediaries' charges. For example, the pension supervisory authority in Macedonia, MAPAS, checks the costs of the agents of the pension companies via onsite inspections. Such a test will be introduced in the Netherlands from 2013 and the conduct of business supervisor, AFM, will have more power to take measures if fees are excessive.[47]

e. Other Sales Controls

Other financial sectors generally apply controls on selling financial products which are also applicable to pensions. For example, IOSCO guidelines point out various regulatory measures for dealing with conflicts of interest including: *internal control system,*[48] *disclosure,*[49] *suspension of transactions, information barriers between departments and affiliates* and *a review committee for conflicts*.

Internal control requirements are imposed on intermediaries in virtually all IOPS members (Austria and Poland being exceptions) and disclosure requirements (normally relating to conflicts of interest and remuneration) in most. Conflicted transactions and Chinese walls are imposed in around one-third of the respondents, with conflicts of interest committees operating in only a few (Israel, Mexico, Namibia and Nigeria)**.**

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[46] Employees are allowed to transfer their MPF accrued benefits relating to their own mandatory contributions to a scheme of their own choice once per calendar year.

[47] The AFM operate an open norm, which implies that intermediaries are in principle free to agree with a consumer on what is an appropriate fee as long as this fee is reasonable given the type and amount of services provided. The AFM can apply sanctions if clients have to pay excessive fees that are evidently not in the interests of the client. Whether fees are assessed as excessive is dependent on facts and circumstances of a case. As an illustration, the AFM is able to assess based on the following questions: i) is the fee unreasonable given the number of hours an intermediary spends on the advice?; ii) is the number of hours spend on the advice unreasonable given the scope of the advice?; iii) is the scope of the advice unreasonable given the demand for advice or the needs of the client?; or iv) is the hourly tariff unreasonable given the expertise of the intermediary? (norm is available in Spanish).

[48] IOSCO Principle 31 of their '*Objectives and Principles of Securities Regulation for market intermediaries'* (ISOCO 2003a) states the following: "*Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters*." http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf

[49] The EU's MiFID Directive (EU 2004) notes that the key element of this framework is the management and the avoidance of conflicts – not just disclosure. While the framework also addresses circumstances in which the disclosure of conflicts of interest might be necessary, this is a measure of last resort and not a means for managing conflicts of interest. Firms subject to the Directive will be required to establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. See http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

Prudential requirements around conflicts of interest are being tightened in some countries (such as Bulgaria).

In addition to controls on intermediaries, standard controls on selling financial products also apply in most IOPS Member jurisdictions, including:

- Cooling off periods after an agreement has been signed (normally 7-14 days);

- Limits on product lock ins;

- Limits on cross selling or subsidizing pensions by offering other goods (e.g. is outlawed in Chile).

- Sales people having to check that the advice they provide is suitable or appropriate and document this (see following section).

Cooling off periods apply in around half of the IOPS responding jurisdictions, whilst only a few jurisdictions impose limits on product lock-ins (Israel and Thailand), or limits in cross selling or subsidisation (Bulgaria, Colombia, Costa Rica, Nigeria). In Chile, for example, intermediaries are forbidden from giving away benefits to members in order to induce them into buying a pension product. This is also valid for tied agents from insurance companies of APFs.

f. Ban Inducement Commissions

An alternative way to control costs within pension systems is to prevent intermediaries being paid by commission where they are specifically induced to sell a particular product and thereby the incentive to churn clients between providers. The Netherlands is one IOPS Member which is in the process of imposing such a ban.

Another example is in the UK, where the FSA is addressing these incentivization and mis-selling issues through its Retail Distribution Review, which, amongst other things addresses the potential for advisor remuneration to distort consumer outcomes. New requirements from 2013 include:

- Advisers set their own charges for their services as they will no longer be able to receive commissions set by product providers;

- Advisers should have charging structures based on the level of service they provide, rather than the particular provider or product they recommend;

- Advisers should disclose those charges to consumers up front, using some form of price list or tariff (confirming the specific amount to be paid later on);

- Ongoing charges should only be levied where an ongoing service has been agreed with the client (expect for charges for advice on regular contribution products);

- Product providers will be banned from offering commission to advisers and will also face other requirements if they offer to deduct adviser charges from their products.

The Consumer Focus report, though welcoming these developments, raises the concern that these measures will not, however, address transactions bias. Although, there are additional rules for pension transfers requiring advisors to have higher levels of training and specific authorization from the FSA to undertake such work,[50] Consumer Focus urge the FSA to conduct further reviews in this area, for example tracking firms which gain a particularly high percentage of their fees from some switching rather than new business.

Other anecdotal evidence suggests that moving towards upfront commissions may have some unintended consequences. The main one is that fewer consumers end up getting advice, particularly those with lower income profiles. This is partly due to the fact that some of the main providers of advice stop such services altogether (as has been the case with some of the retail, 'high street' banks in the UK). In addition, the UK has found some providers pushing to lock consumers into products with trailing commissions just before the ban on such charges comes into force, thereby locking consumers into services they do not need and the providers will no longer have to give.

At the European level, the review of the Markets in Financial Instruments Directive (MIFiD)[51] addresses the issue of inducements paid for financial services, including investment advice. Proposals include banning third party inducements for intermediaries providing independent advice (as these are incompatible with the independent nature of the advice). However, there may be a problem with this solution, at least in the case of trailing commissions, as a ban may represent an unfair acquisition of property (in this case the contractual right to receipt of a commission over a number of years). By way of contrast, it is interesting to note that the review of EU Directive on Insurance Mediation supports transparency of how intermediaries are remunerated rather than such an outright ban on commissions per say.[52]

The Australian government is has enacted legislation to implement the Future of Financial Advice Reforms (FOFA), which include a prospective ban on conflicted remuneration structures including on up-front and trailing commissions and like payments (e.g. soft dollar payments) for both individual and group risk within a default superannuation fund from 1 July 2013.

In South Africa the Financial Services Board (FSB) has introduced prohibition on fees and commission. Commission is capped in terms of the Long Term Insurance Act (per class of business). All fees must be agreed upfront with clients in writing.

g. Use of Default Funds/ Impose Product Restrictions

Though information disclosure is an important tool for consumer protection, following the financial crisis there appears to be a growing opinion that disclosure alone has not done a good job (judging by the reviews underway of financial products selling in various countries). Disclosure only affects the way that information is provided to members, who may still be faced with decisions that are too complex for them to make.

Consequently, rather than imposing suitability requirements or other regulatory controls on selling, there is currently a move in relation to other financial sectors to restrict product offerings as a way to ensure that inappropriate advice is avoided and products are not mis-sold.

One aspect of this which is used in pensions is to require the use of a default provider and/ or a default investment fund. Such funds are designed to be appropriate for the broad membership of the pension

[50] See http://www.fsa.gov.uk/smallfirms/resources/factsheets/pdfs/pension_transfers.pdf

[51] http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

[52] See http://ec.europa.eu/internal_market/insurance/docs/mediation/imd_final_en.pdf

plan[53] and therefore are by their nature a suitable product. The fact that in most systems the majority of members end up in the default fund means that intermediation and the selling of pensions therefore becomes less important. Issues such as inappropriate advice are avoided and other problems around costs and conflicts of interest can be reduced. The use of defaults may be a more appropriate way of tackling suitability issues for pensions than for other sectors as pensions are often compulsory and therefore simply not buying the product is not an option.

Banning or restricting products may work slightly differently in the pension sector. In some jurisdictions the structure or range of pension products is prescribed. In other jurisdictions, where a broader range of products can be used in the pension sector, regulators and supervisors may rather choose that a product does not qualify to be sold as a pension (and therefore would not receive the usual tax or other incentives). Most IOPS respondents had this power – with the exception of Australia (where ASIC is a disclosure not a merit regulator), Netherlands (for occupational pensions), Poland and the Slovak Republic. In several countries products require pre-approval from the pension supervisor (as is the case, for example, in Colombia, Hong Kong, Italy and Pakistan). In Chile pension products are defined by law and no new pension product could be introduced without legal modification.

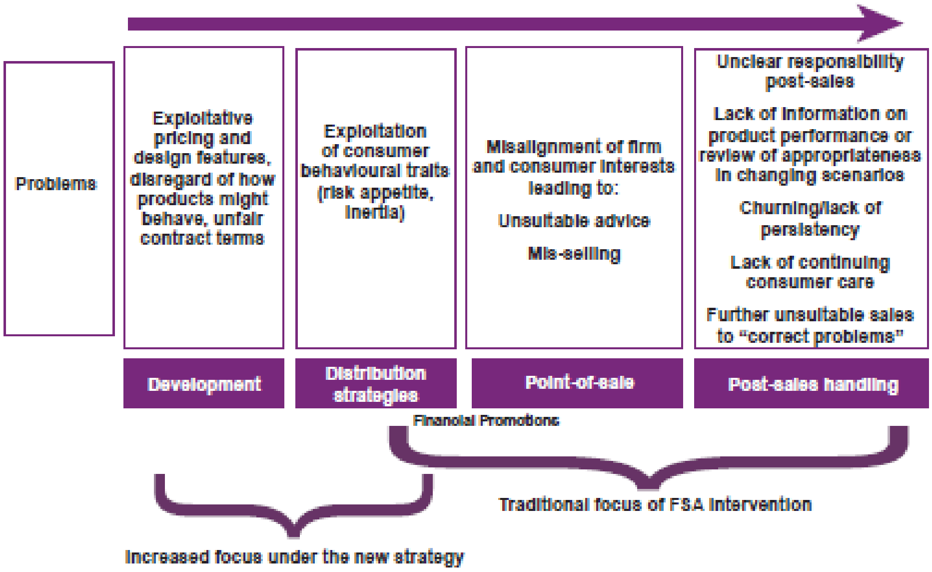
The Financial Service Authority (FSA) in the UK is one authority which is looking to adopt such an approach.[54] The authority notes that in the past their regulatory approach was based on the assumption that effective consumer protection would be achieved provided sales processes were fair and product feature disclosure was transparent. The general philosophy has previously been to accept that most retail financial products are suitable for some consumers and so the FSA should not intervene in their design – their main role being to make rules and supervise the market at the point-of-sale to stop products reaching the wrong consumers, rather than questioning their design.

However, they accept that this has not been effective in preventing waves of severe customer detriment – indeed citing pensions mis-selling as one of the main problems in the past (costing in FSA £11.8bn in compensation). The FSA state that they have therefore come to recognise that there are fundamental reasons why financial services markets do not always work well for consumers, and that a significant shift in approach is required. Going forward they intend to be more proactive, both introducing more prescriptive requirements for the governance of product development and introducing specific product interventions, such as prohibiting the sale of specific products to specific customer segments. These measures will be combined with the recommendations in the 'Retail Distribution Review', including those on the payment of intermediaries previously discussed.

[53] See (IOPS 2012 forthcoming), Working Paper No. 18 *Supervising Default Investment Funds*

[54] See FSA, (2011), '*Product Intervention Discussion Paper'*

Figure 5: Where problems can occur in the product life cycle



Source: (FSA 2011)

The FSA do, however, accept that there are important tradeoffs to be struck – between consumer protection and consumer choice, between effective regulation to prevent customer detriment and the costs that will inevitably be imposed.

The European Commission (EC) is also working in this area, with the MiFID review devoting a section to organisational requirements for the launch of products and services.[55] The possibility of banning specific activities, products or practices is also discussed.

The newly created Bureau of Consumer Financial Protection (CFPB) in the United States, an independent bureau within the Federal Reserve, will have the authority to regulate the offering and provision of consumer financial products covered by the federal consumer financial laws.

This could potentially be appropriate for pensions – with only appropriate or approved products allowed on the market (or at least as default funds).

By way of contrast, the AFM, the conduct regulator in the Netherlands, uses control mechanisms to influence the way institutions develop, approve and review products. AFM takes into account the outcomes of these processes and intervenes in the process and can require the institution to review the product in order to achieve the desired outcome. The AFM considers improving the process of product development, approval and review as a more appropriate tool than product pre-approval by the regulator. It has formulated a number of criteria that serve as indicators for the quality of the product development, approval and review process. These have been developed to assess to what extent the institution takes into account the interest of the client. The AFM discusses the outcomes of the assessment with the financial institutions.

However, the AFM recognizes that, while institutions cooperate most of the time, the lack of formal powers makes it hard to enforce improvements; therefore the AFM has initiated the development of formal

[55] http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

powers in this area (new regulation is currently being developed and which will enable the supervision of product development from the start of 2013).

III. Supervisory Tools

Regardless of the type of solution that is pursued, there would be a variety of tools and mechanisms that the supervisor could use in implementing, investigating and enforcing the solution.

a. Industry Codes of Conduct

There are several different ways of trying to control - or at least disclose - conflicts of interest which intermediaries may face and which could influence the advice given and pension products sold to individuals.

One important way to oversee intermediaries is through self-regulation, with industry associations imposing standards or codes of conduct on their own membership. This would include industry bodies for financial intermediaries requiring members to exercise a duty of care towards their clients, declaring whether they are independent agents or tied to one provider and how they are paid (whether on a fee or a commission basis). Such industry codes operate in one form or another in just over half the jurisdictions of IOPS members responding to the survey, and are being drafted in additional countries (such as Colombia and Pakistan).

The OECD's '*Consumer Policy Toolkit'* (OECD 2010) discusses codes of conduct in detail. The publication states that codes developed by industry can provide advantages over direct government regulation, although many rely on some form of endorsement or oversight by government to be effective and credible and are more effective when the self-regulatory body has widespread industry support. The report notes that self-regulation that goes hand in hand with industry developed codes has the potential to achieve improvements in business practices using negotiation and consultation. The Toolkit goes on to discuss how self-regulation can also play a role in making markets work well for consumers, particularly in terms of the quality of products and services they receive. Self-regulation helps achieve better market outcomes by influencing business incentives under conditions which make it difficult for consumers to assess product attributes and for firms to signal quality.

The issue with codes of conduct is how are they 'policed' and who undertakes (and how successfully) the sanctioning and enforcement. One example of strict oversight is in South Africa where codes of conduct are supervised in terms of risk based supervision. Transgressions of the provisions of the Code are referred to an enforcement tribunal.

The Guidance on Intermediaries to IAIS Insurance Core Principle 18 (IAIS 2011) notes that: "*where a self-regulatory organisation (SRO) is involved in the supervision of intermediaries, the supervisor should ensure that the SRO meets appropriate standards before being allowed to exercise authority. The supervisor should maintain oversight of the self-regulatory system by verifying that its functions are being performed adequately and that its standards are sufficiently robust and take appropriate action to deal with any shortcomings." (18.2.16) "An SRO's regulatory and professional requirements may not address all the aspects of the supervision of insurance intermediaries in which the supervisor has an interest. Therefore, where an SRO shares some of the supervisory responsibility, the supervisor should nevertheless not abdicate its overall responsibility for supervision as a result of the operation of such as system." (18.2.7)*

b. Supervisory Guidance

Most supervisors themselves lay out what is expected of intermediaries by establishing conduct of business principles etc. (Bulgaria and Poland being exceptions).

Box 2. Supervisory Guidance

Australia: The regulatory guide provided by ASIC on *Advice to Super Fund Members* (ASIC 2009) provides guidance to financial advisers on how conflicts of interest should be handled, amongst other issues. ASIC also provides guidance in regulatory guides such as: Regulatory Guide 175 Licensing: Financial product advisers—Conduct and disclosure (RG 175); Regulatory Guide 84 Super switching advice: Questions and answers (RG 84); and RG 181 Licensing: Managing conflicts of interest.

Hong Kong: Through the "Guidelines on Conduct Requirements for Registered Intermediaries", the MPFA provides guidance on the circumstances in which the MPFA will be satisfied that a registered intermediary has, or has not, complied with the statutory conduct requirements.

Macedonia: MAPAS provides guidance on the standards that intermediaries should follow through: Licensing, Program for taking the exams, recommendations and obligations for trainings and education the intermediaries by the pension companies.

Mexico: CONSAR's secondary regulation regarding sales agents establishes that AFOREs must verify that their sales agents perform in a personal, responsible, truthful and honest manner, and that they must observe the following principles in every moment:

1. For the registration and switches of members, sales agents must respect the member´s choice by providing them with all the information needed for a right decision, abstaining from guaranteeing them a certain level of return.

2. For the orientation and attention of applications, the member´s confidentiality must be respected, and sales agents must act with ethics, transparency and in good faith, without placing other interests before member interest and generating public confidence towards the retirement savings system. All this by showing complete knowledge of the member´s rights regarding their account and the financial mechanisms that stimulate the member´s savings, adjusting to their needs.

3. For marketing and promotion activities, sales agents must provide truthful, complete, current, trustworthy and responsible information, particularly regarding information about the characteristics of products and services that AFOREs offer, providing the sources of the information so that workers may consult them. Sales agents must also abstain from using payrolls, files, information systems or any other mechanism or tool obtained through no right of their own or that may violate the worker´s privacy and that may allow sales agents to generate massive switches.

Netherlands: Most of AFM's guidance documents concern pension intermediaries' advice to employers instead of employees. This is because the majority of pension products in the Netherlands is sold to employers, not directly to employees (see for example *http://www.afm.nl/en/professionals/afm-actueel/nieuws/2010/apr/pensioenadviezen-mkb.aspx*). Nevertheless, part of our guidance documents covers pension advice to consumers. *http://www.afm.nl/nl/professionals/afm-voor/adviseurs-bemiddelaars/advies.aspx* AFM writes guidance documents and thematic reports through which we continuously investigate and also give feedback to the intermediaries. Further, we provide checklists for employers to raise awareness of what are the characteristics of a good advice. Finally, we occasionally give presentations to the industry.

Slovak Rep.: standards specifying rules which are intermediaries expected to follow are set in relevant legislation. Intermediaries may get more detailed information within consultation with the National Bank of Slovakia.

A variety of approaches would apply as to the extent to which, and how, compliance with such codes or guidance is enforced. On top of national supervisors, international organizations may also be sources of guidance. For example, IOSCO provide a *Code of Ethics* (IOSCO 2006) which applies to providers of

Collective Investment Schemes, and *Guidelines for Regulation of Conflicts of Interest Facing Market Intermediaries* (IOSCO 2010).

c. Fiduciary Duty

Another way of exercising control over intermediaries and providers is to make them fiduciaries, thereby creating a greater duty of care to those they are serving and advising, or at least making this responsibility explicit. A consequence of making a person a fiduciary is that the person is required to place the interests of pension fund members above their own commercial interests (and therefore it is easier for members to seek retribution should problems occur or a poor service be delivered) - though this is often difficult to enforce in practice and therefore other oversight mechanisms will be still required.

Intermediaries have such fiduciary duties in around three-quarters of the responding IOPS members (Austria, Bulgaria, Costa Rica, Mexico and Poland being exceptions), with pension providers being responsible for their intermediaries in most (Poland again being an exception). For example, the law was changed in Mexico to make pension funds responsible for the actions of their agents. The FOFA reforms in Australia will impose a duty upon intermediaries to put clients' best interests ahead of their own (the 'best interest duty').[56] In Chile, the fiduciary duty of intermediaries extends to a financial responsibility. Pension intermediaries in Chile are mostly individuals (not firms). They must take out an insurance policy to ensure correct advice is given to members/beneficiaries. The amount of insurance taken out is proportional to the sum of the balances of the members who the intermediary assisted in the previous year.

d. Corrective Measures

The final tool available to supervisors to overcome intermediation problems and to incentive better performance by intermediaries is though imposing corrective measures.

In order to get to the bottom of these problems, first complaints have to be gathered in a transparent and usable fashion, and supervisory inspections have to be carried out.

i. Complaints Mechanism

A well functioning complaints mechanism is an important tool for the supervisory oversight of intermediaries for spotting and controlling conflicts of interest, along with other problems. Indeed, the OECD *Guidelines for the Protection of Members and Beneficiaries of Occupational Pension Plans* (OECD 2003) recommend that:

> *6.1 Members and beneficiaries (and individuals claiming the right to be deemed a member or beneficiary under a pension plan) shall be entitled to a fair process or procedure in which their entitlements, rights and benefits under the pension plan may be claimed or asserted.*
>
> *6.2 The claim process or procedure should be expeditious and transparent. It should be easy to understand and have only reasonable or no cost to the individual claimant.*
>
> *6.3. The process should include independent administrative or judicial recourse if initial claims of rights or benefits are denied by the pension plan administrator, fiduciary, or employer. This process*

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[56] See '*Future of Financial Advice Package'* http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=reforms.htm (Australian Government 2011 and 2010)

should provide for adequate remedial measures to redress the loss of rights or benefits suffered by the member or beneficiary whose claim has been found to be valid.

The points made in relation to insurance in the IAIS Insurance Core Principles (IAIS 2011) are in some cases also applicable to pensions. It is important for the protection of consumers that their complaints against providers and intermediaries not only be promptly and fairly investigated and processed internally by the provider, but that those complaints also be knowable to the relevant supervisory authority.

Supervisory authorities can learn of complaints:

- Directly from consumers;
- Through inspections of providers complaints database (listing number, nature and time to process complaints);
- Through formal reports from providers;
- From ombudsmen;
- From consumer protection groups;
- From the press/ media.

All pension supervisory authorities responding to the IOPS questionnaire receive complaints directly from consumers, and almost all from complaints received through formal reports from providers (Austria, Mexico, Serbia and Spain being exceptions), whilst around half received complaints from consumer protection groups and/ or ombudsmen. The MPFA in Hong Kong also noted that complaints can sometimes be received via the media, which the AFM, the consumer protection agency in the Netherlands, also note as monitoring.[57]

IOPS members were roughly evenly split between those which do and those which do not have alternative dispute mechanisms (ADM) in place. This contrasts with the Joint Forum report (Joint Forum 2008) which found that for the banking, insurance and securities sectors most countries require firms across all three sectors to operate dispute resolution procedures.

As the IAIS Insurance Core Principles point out (IAIS 2011), despite the efforts of providers and supervisory authorities, from the consumer's viewpoint, a fair number of complaints do not get satisfactorily resolved. In these situations, litigation remains, or should remain, an option. However, it is often to the consumer's benefit to resolve disputes in ways that are simpler, quicker, cheaper, and less stressful than litigation.

A variety of alternative dispute resolution (ADR) methods have been developed in many jurisdictions. These methods often are administered by government bodies or by industry associations that include

[57] Twice a year, AFM monitors trends in consumer behaviour and attitudes on the financial markets by conducting online quantitative research, whereby a member of the market research team drafts the survey in close cooperation with an external market research firm. The results are reported in "De Consumentenmonitor". Additionally, AFM conducts research on market developments. The reports are on the website: *http://www.afm.nl/nl/consumenten/actueel/brochures.aspx*. AFM also carries out 'focused' or 'thematic' research based on market analysis.

consumer representatives. The *OECD's 'Consumer Policy Toolkit'* (OECD 2010) addresses dispute mechanisms in detail –for further details of pension ADRs used by IOPS members.[58]

ii. Supervisory Investigations

When it comes to the investigation of alleged patterns of misconduct toward consumers, it is also important that supervisory authorities conduct on-site investigations into the market conduct of providers and intermediaries. Investigation and correction may be the only way to overcome conflicts of interest problems. The IAIS Insurance Core Principle (IAIS 2011) note in their Standard on Intermediaries that: "*the supervisor ensures that insurance intermediaries licensed in its jurisdiction are subject to ongoing review*." (18.2) and the Guidance states that "*the supervisor should have adequate powers to conduct supervision of intermediaries, including powers to issue rules and take enforcement action*." (18.0.27)

IOSCO [59] outline the following risk indicators which may indicate mis-selling by intermediaries and which could therefore trigger a supervisory investigation:

- *Inadequate training and assessment of competency of sales force*- the sales force does not understand the products being sold and hence fail to alert investors to the risk issues.

- *Salesmen rewarded by commission and set aggressive sales target* -the salesman could be incentivized to sell products that are unsuitable for the customer.

- *Aggressive selling techniques adopted* - here sales targets drive the salesman and this could lead to mis-selling

- *High level of customer complaints* - this could signify a number of issues such as aggressive sales techniques, poor performing products or products that have been mis-sold.

- *High level of sales force turnover* - high levels of sales force turnover may indicate over ambitious sales targets

- *Rapid growth of sales,* which might lead to strains on systems, rapid take-on of inexperienced salesmen- inexperienced salesmen could lead to a future claim for mis-selling.

- *Sales targets* start being missed might lead to desperate attempts to boost sales – as above

- *Unusual sales force incentive structures,* e.g. transfer payments of certain excessive amounts of the management fees to the intermediaries biased by the mediated volume of units on a currently repeated basis (reward heavily biased towards volume of products sold) - this again could be another indicator of a sales force that is incentivized to sell as much product as possible possibly to the detriment of the suitability for customer.

- *Inadequate control over the salesmen and their practices* - weak controls over period of time could lead to high compensation claims and hence possible solvency issues for the CIS operator.

The Joint Forum report (Joint Forum 2004) notes a different inspection routine by country (some reviewing all firms, other using a targeted approach).

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[58]See also (OECD 2007) '*Recommendations on Consumer Dispute Resolution and Redress*'

[59] See (ISOCO 2003b) '*Investment Management Risk Assessment: Marketing and Selling Practices'*

iii. Enforcement Measures

Following these inspections, the final tool which supervisors can use to ensure the effectiveness of any solution related to intermediaries is via corrective measures. Tough deterrent measures – for example the public disclosure of fines or high profile court cases etc. - are a way of keeping intermediaries in line.

As the IAIS point out (IAIS 2011), corrective actions by the supervisory authority should vary according to the seriousness of the intermediary's conduct.[60] Consequently, punishments or corrective actions can include:

- Cancellation of license or registration
- Temporary suspension from practicing the profession
- Publicizing of the conduct constituting a breach of regulations
- Fines
- Private or public admonishment
- Criminal prosecution
- Civil remedies to clients
- Obligation to take training or refresher courses, rehabilitation plans, portfolio transfers, and the like.

To ensure proportional and effective correction actions, 'enforcement pyramids' – such as the one outlined in the IOPS Toolkit for Risk-based Supervision may be useful when overseeing intermediaries (as with all other types of supervisory intervention).[61]

Almost all responding IOPS Members have the power to remove the license of an intermediary (Hong Kong and Lithuania being exceptions) and likewise to issue fines (an exceptions being Australia). Less than half are able to pursue a criminal prosecution or to publicly disclose penalties (in order to act as a warning for the rest of the industry). This is in line with the Joint Forum report (Joint Forum 2004) on banking, insurance and securities sectors which notes that though some jurisdictions do impose sanctions most others prefer more informal measures than imposing fines (via supervisory process and engagement).

Corrective powers are being strengthened for the oversight authorities in numerous counties – including Bulgaria and Hong Kong. The Australian Government's proposals related to financial advice,

[60] The IAIS consider the following actions as especially serious:

- *Providing inaccurate or inappropriate information to clients taking out insurance, the insured, beneficiaries, or the insurers that may be regarded as a grave breach of general laws and regulations on intermediation*
- *Providing partial (biased) information*
- *Conducting practices that are detrimental to the rights of people taking out insurance, the insured, beneficiaries, or the insurers*
- *Intermediating on behalf of entities not authorized to operate in the jurisdiction*
- *Using names reserved for insurers*
- *Delegating functions to unauthorized assistants.*

[61] See www.iopstoolkit.org Module 5

which also cover the superannuation system, include a strengthening of ASIC's powers to act against unscrupulous operators, with the enhancing of powers relating to the licensing and banning of individuals from the financial services industry.[62] It has also been noted that the newly created Bureau of Consumer Financial Protection (CFPB) in the United States will be a powerful authority for rule-writing, examination, and enforcement.[63] Meanwhile, the Financial Services Board in South Africa has also recognized that a relatively 'hands-off' approach to 'Treating Customers Fairly', which relies on financial firms 'doing the right thing' is insufficient, and that it also has to be more pro-active with specific interventions (FSB 2010). The move to a Twin Peaks in South Africa will mean substantially stronger market conduct regulation at the FSB (South African Treasury 2011).

IV. Conclusions

One result of the financial crisis of recent years was to highlight a myriad of on-going problems around the advice given on and the selling of financial products – with the pensions sector not immune to such scrutiny.

As a consequence, there is a great deal of review of financial intermediaries underway around the world, and interesting developments and reforms are also being conducted in the pensions sector.

As discussed, pension intermediation has some unique challenges of its own, and is particularly complex to analyse due to the different pension systems in place around the world and the different roles which intermediaries play in these systems. Though the challenges encountered, and the solutions which will therefore be appropriate, differ by country, some broad trends can be identified, as follows:

- Intermediaries have been removed completely from some mandatory pension systems, in order to tackle the problem of high marketing costs and conflicts of interest;
- Default funds and auto-enrolment mechanisms are increasingly being used to get around suitability issues;
- As with other financial sectors, there is a trend to ban intermediaries from charging commissions (i.e. being paid by product providers to sell their products), in order to avoid conflicts of interest, and to move to structures that are more aligned with members' interests;
- The training and qualifications required of pension intermediaries is being tightened (as with other financial sectors);
- As 'softer' control measures – such as disclosure of information and self-regulation – have not been seen to be successful, financial oversight authorities have been strengthening their powers, including conducting more intensive oversight of intermediaries, and even more radical approaches such a banning products outright. These trends are also reflected in the pension sector.

[62] See '*Future of Financial Advice Package'* http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=reforms.htm (Australian Government 2011 and 2010)

[63] http://banking.senate.gov/public/

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