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STATE OF THE PENSION FUND INDUSTRY

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Regulation –

Good, Bad Cop, or Bad, Good Cop?

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Where then should regulation be stationed on the pendulum?

But maybe before we get there, just a comment on where we are as an industry. Depending on who you ask, for many, the last three or so years have marked one of the busiest periods in keeping up with regulatory compliance. For others, even with that, the industry remains way too behind international standards and regional powerhouses.

Not all regulation is created equal though, some regulation is just outright bad.

Rationale for Regulatory Intervention

Any analysis of the quality and appropriateness of any regulatory regime should probably start with understanding the theoretical basis for the need for regulation. While the list can never be made exhaustive in a single article, addressing market imperfections and prevention of market failures, compensation for asymmetric information, managing market power imbalances, minimising principal-agent conflicts, mitigating against instances of contagion, promoting operational efficiency, and stimulating competition and efficiency, count among the key reasons for the need for regulatory intervention in the industry. The anticipation is, with effective regulation comes protection against financial exploitation and

misappropriation of funds, financial stability, prevention of market abuse, promotion of transparency, and maintenance of pension funds solvency.

The rationale for regulatory intervention thus largely rests on the combination of the industry's importance to society and its considerable complexity. Needless to say, in times of economic uncertainty and a volatile financial environment, the need for a robust, well-engineered, regulatory framework is heightened.

However, if ill-designed, or poorly implemented, or both, regulation may contribute to the potential for market failure. While the intentions might be noble, the intricacies of the industry may see regulation aimed at mitigating risks of market failure, actually exacerbating exactly the same risks it is seeking to address.

Industry Remains Strategic

Contrary to the views of some, no matter how rigorous and well-crafted a regulatory regime is, regulation alone cannot be the sole tool with which to regain public confidence and trust. The industry needs to play its part too. It needs to be seen to be relentlessly working towards delivering genuine need-satisfying retirement outcomes – with or without the well-known elephant in the room. Exceptional product development and benefit design expertise will separate success from failure in an era of an abnormal economic environment.

With the introduction of a new currency, and a new monetary policy framework dispensation, under a new central bank governor, the industry finds itself at a fork on its path. Pick the wrong tine, fail to meet members' reasonable expectations once again, and you are not forgiven forever. The industry and economy have been given yet another opportunity to reset. Presiding over so much capital, the industry remains one of the few key strategic sectors in the economy that holds the levers to an effective economic turn-around, creating a conducive environment in turn for long-term investing.

As the industry plays its part, the cost of compliance should not be seen to be forever rising. Meeting regulatory requirements results in significant administrative and operational expenses for pension funds, which can detract from investment returns, ultimately reducing members' retirement savings.

Risk of Overregulation

The objectives of the primary legislation governing the industry are clearly spelt out in the main act as, to ensure protection of fund members and beneficiaries' interests, to ensure security of funds, and to ensure sustainability of the pension sector as a whole. What is needed further is a clearer articulation of the strategic regulatory road map that indicates where we are, where we want to be, how we plan to get there and by when. That clarity of strategic ambitions would greatly help establish a common and shared vision between the regulator and industry players ensuring they move in oneness.

Without realising it, any regulatory framework can quickly become very complex due to way too frequent updates. No doubt, such complexity poses challenges for smaller or less experienced pension funds, which in the case of our industry, are in the majority. The consolidation drive coming through from the regulator for all funds with under one hundred members to participate in an umbrella fund is a much welcome and long-awaited development.

With frequent updates and changes come the risk of overregulation, where an overly prescriptive approach starts to stifle innovation and flexibility, potentially hindering the ability of pension funds to adapt to changing market conditions. Experience in other markets has shown that regulatory uncertainty is a certain enemy of the industry.

Effective regulation cannot be reactionary, but proactive. It also ought not be discharged at a micro-level, but at a macro-level instead. Operational

issues are best left to industry dynamics, and a healthy and competitive industry will take care of lower fee aspirations through innovation. Under pressure to comply with a barrage of regulatory requirements, a "tick-the-box" mentality might creep in, replacing a genuine commitment to upholding good corporate governance and risk management standards with a “bare-bones compliance culture”.

Unintended Consequences

The pension fund industry has remained an innovation foot-dragger – very little evolution takes place. Forty-five years down the road, will still have a defined contribution system that looks exactly the same as it was on its invention back in 1979. In other industries there is a mass exodus from mass production to mass customisation and mass distribution. With that, the industries are taking their customers to higher standards of living. Nothing of the sort can be said of the pension fund industry – and regulation stands among the accused.

Regulatory standards designed for larger pension funds may not be suitable or proportionate for smaller funds. Failure to acknowledge that can easily lead to compliance burdens that disproportionately impact smaller players in the industry. A one-size-fits-all approach does not work. Proportionality is the key word – tailoring regulatory requirements to the size, complexity, and risk profile of pension funds. The pending regulation on compulsory umbrella fund participation for smaller funds is a clear message that our regulatory framework is being designed with a clear industry structure in mind – one dominated by a few, large, cost-effective pension funds, efficiently managed by professional trustees.

Unintended consequences are a common risk in the regulation design space. For instance, where fee caps are set for certain services in the industry, they run the risk of being adopted as the set targets and not the upper limits. We have seen it with investment management fees. Some managers now charge the same asset management fee regardless of the

investment mandate that they have been awarded, including even on money market mandates. Market behaviour is unpredictable, and regulation should be sure to minimise the potential for emergence of unintended consequences.

Industry-Regulator Tensions

Globally, ever since the vagaries of the Global Financial Crisis of 2008, the ensuing generation of regulatory regimes has been accused of regulatory overreach. In our case of course, the GFC coincided with our own economic challenges. When regulators are viewed to be overreaching their authority, or imposing regulations that are overly intrusive or burdensome, tensions between them and industry participants are bound to build up. Of course, that does not surprise some of us as regulation with no bite force is weak regulation, and painless regulation is no regulation at all. But the point remains.

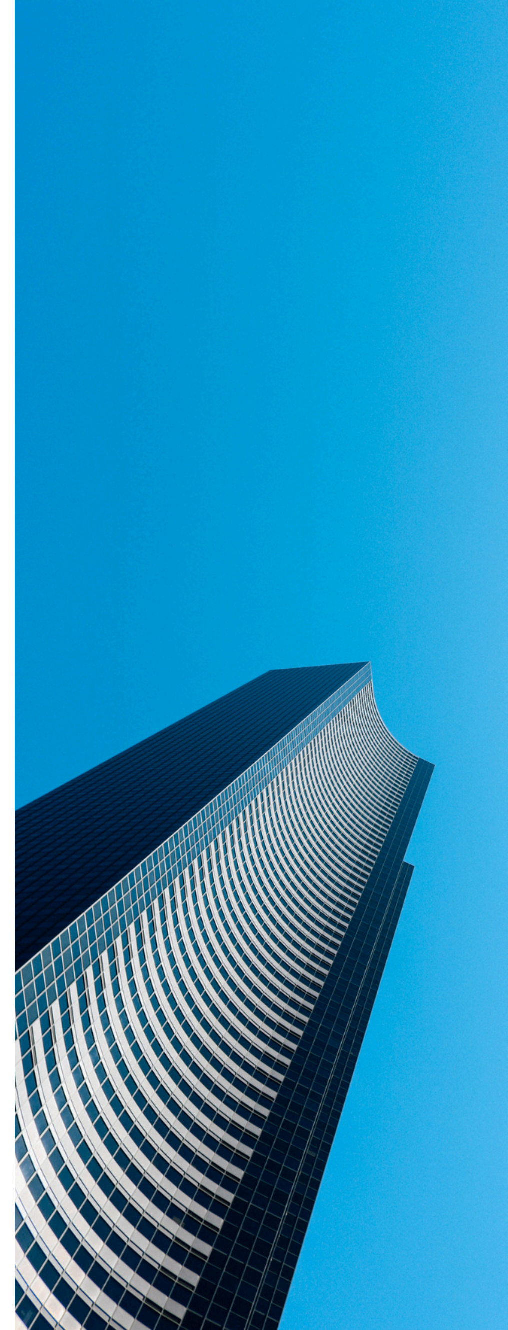
In a predominantly defined contribution environment, such as ours, investment management does most of the heavy lifting. That generally demands that those mandated with the all-difficult work of managing members' assets are allowed to do so with as little constraints as is possible. Regulation-imposed restrictions limit asset managers' ability to pursue potentially high-rewarding investment opportunities – much to the detriment of members' financial interests.

Enforcing complex regulatory frameworks demands significant resources and expertise on the part of the regulatory authorities. Where a country has lost a significant portion of its skilled manpower to emigration, competition for skills between the regulator and the industry becomes fierce. The jury on who should get priority for the scarce skills is still out, but in the meantime, members have to pay the price as the two compete for the scarce resources through higher salary offers.

Conclusion

While regulation plays a crucial role in safeguarding the interests of members and maintaining the stability of financial markets, policymakers must carefully balance regulatory objectives with the potential costs and unintended consequences associated with regulatory intervention in the industry. That underscores the requirement for cautiously balancing regulatory objectives with the need for efficiency, innovation, and investor protection.

As for the industry participants, regulation is your best friend – keep it close. Engage with the regulator as much as is possible. We find the folks at the Commission very engaging. Use that to the industry's advantage and for the advancement of members' interests.



Our monthly publication is aimed at inviting conversations from like-minded individuals with a view to engaging in forward-thinking-led discussions on how we can collectively improve the state of our industry.

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