How Secure Is the Brazilian Private Pension System

Ali El Hage Filho
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I. Introduction

Private pensions are expected, above any other obligation, to provide its beneficiaries with the precise benefits for which they contracted. In other words, private pension funds must endow the general public with enough confidence to encourage people to look for pension funds and join pension plans, allowing them to believe that they are building a better retirement.

Different from other forms of savings or investments, private pension plans are a long-term project, sometimes initiated at a young age, with results seen only decades later. For this reason, confidence is of immense concern. People must have ways to ensure that during this long period their personal funds will be properly separated.

Administering people's savings over the course of a lifetime in a way that delivers the contracted for benefit is a complex task. Over this long period of time, many events may occur that could be severely harmful to such "savings administration."

The present study will focus primarily on the financial risks inherent to private pension businesses and the legal instruments available to avoid such risks. The purpose of the present study is ultimately to assess the level of financial security existent in the Brazilian Private Pension System (hereinafter BPPS) as provided by its current legal framework. Three sections will follow: first, a general overview of the financial security of private pension systems and the main issues that should be of concern in creating a financially sound pension environment; second, a general understanding about BPPS and its legal structure, historical background, legislative evolution, and perspectives on the future; and third, BPPS's financial security will be assessed.

II. Financial Security of Private Pension Systems

Several risks are inherent to operating any kind of business, and private pension funds are no different. In fact, private pension funds play a

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major role in financial markets, causing a link between financial risks and their activities.

The title “Financial Security of Private Pension Systems” is related to the degree of a system’s protection against financial risks. This protection is provided primarily by an adequate regulatory and supervisory framework.

Therefore, the first task of governmental authorities when creating a financially sound private pension system is identifying the risks involved in implementing applicable regulations and effective supervision. So what are the main “financial risks” that should be of concern to regulators? Andre Laboul, in his article *Private Pensions Systems: Regulatory Policies*, identifies the “risks which have more to do with financial features of private systems,” listing them as follows:

- risk of the fund becoming insolvent;
- investment portfolio risk for the employer in defined benefit plans, and for employees in defined contribution schemes;
- interest-rate and inflation risks in funded schemes;
- risk of employers failing to make adequate contributions, in all plans;
- risk of misappropriation, in all plans;
- risk that the employer’s pension policy may change with regard to non-mandatory benefits;
- risk that the sponsor may change (e.g. following a take-over or merger);
- risk of default by an entity other than the fund (e.g. the insurance company);
- longevity risks for plans paying out annuities;
- risks from the structural shortcomings of certain systems.¹

Private pensions operate by collecting contributions, managing assets, and paying benefits. It could be said that “managing” is what makes possible the achievement of the latter purpose of paying benefits. Consequently, financial risks lay substantially in this area.

In managing the collected contributions and planning all future collections, a fund manager has to administer investments and maintain adequate reserves, thus protecting them from various risks in the cheapest fashion possible. In other words, to establish confidence, a financially sound private pension system must consist of an adequate regulatory and supervisory framework, a competent management, adequate rules for investment, mechanisms to guarantee and preserve a fund’s solvency, and guarantees of full access to information for plan members.

Moreover, adequate tax treatment is greatly responsible for the nurturing of a private pension system. Issues raised above might deliver the

highest level of confidence possible but are worthless if increased tax benefits are not available to motivate savings through pension plans.

In conclusion, a financially secure private pension system provides effective regulatory and supervisory structures, governance rules, disclosure, investment regulations, funding requirements, solvency mechanisms, and taxation.

A. Regulatory and Supervisory Structures

A regulatory framework for a private pension system serves the purposes of promoting resources mobilization and allocation through a structure that guarantees transparency, security, and stability, minimizes costs, and promotes sound investment decisions. This regulatory framework is similar to the other segments of the financial sector.2

Moreover, a regulatory framework must begin with the assessment and identification of potential risks.3 It must also be set up in such a way that the appropriate supervisory environment is created. In other words, it is imperative that governmental authorities provide supervisors with every necessary resource and capability for the exercise of effective supervision.4 While there is no consensus as to a single appropriate regulatory and supervisory framework for private pension systems, certain countries count with a comprehensive law, addressing the various issues in relation to the system, while other countries provide regulations in separate pieces of legislation.5 Regulatory and supervisory bodies also vary from one country to the other as special agencies, ministries, and insurance authorities are used as regulators and supervisors in most countries.

In addition, tax and financial market authorities are significantly present in private pension regulation and supervision. However, while those authorities provide significant assistance, it can be said that insurance and financial market authorities are predominant in regulating and supervising private pensions.6 In the majority of Organization for Economic Co-operation and Development (hereinafter OECD) countries, private pension regulators and supervisors are the same as the ones for insurance companies. This is certainly due to the fact that the supervision of pension funds is closely related to that of insurance companies. However, there have been some criticisms to this structure. Some argue that regulations governing insurance business are more stringent and should be based on the nature of the pension system rather than on the pension

3. Id. at 16.
4. LABOUL, supra note 1, at 59.
5. Id. at 58 (as in the case of United States, Netherlands, Spain, Austria Italy, and United Kingdom).
6. Id. at 59.
system provider.\textsuperscript{7} These critics are motivated by the fact that differences exist between insurance and pension businesses, however, such a regulatory position relates more closely with market competition protection, since:

some countries may consider that the market should be segmented, and that any differences in the characteristics of the various operators mean that separate markets should be defined, depending on the institutions involved; other countries may decide, while recognising that such differences exist, to limit all regulatory distortion and to aim, inter alia, for functional regulation based on operations rather than institutions, distinguishing or not between operations (e.g. second vs. third pillar, obligation of result vs. best effort, etc.).\textsuperscript{8}

There are several possible approaches to supervision methods. These can diverge according to government perspectives, risk exposure, and market structure, among other factors. However, certain basic elements are targets of most all supervisors: (i) compliance with legal and contractual obligations; (ii) financial and actuarial controls; (iii) management supervision; and (iv) economic reviews.\textsuperscript{9}

The three basic “building blocks” suggested by the Basle Committee to structure banking supervision, namely (i) ex-ante licensing activities, (ii) ongoing monitoring and inspections, and (iii) remedial and punitive problem resolution can also be seen as applicable to private pension supervision.\textsuperscript{10} Such suggestion provides an interesting and comprehensive approach encompassing all the expected functions of a proper supervisory framework.

Licensing of pension funds constitutes one of the primary functions of supervisors. Proper regulations should exist imposing standards and requirements for the creation of new pension funds or the restructuring of existing accounts. In addition, a certain level of discretionary authority should remain with supervisors.\textsuperscript{11}

Second, ongoing monitoring and inspections include supervision oversight in two main forms: off-site and on-site surveillance. Off-site surveillance is generically a review by supervisors of a private pension fund’s accounting and financial statements, which justifies rules on reporting, internal and external audits, and disclosure. On-site supervision is foreseen by all legal systems by granting supervisors the authority to access all the records and examine other relevant materials on-site. This can be structured as audits, in which there is a systematic attempt to review all aspects of the fund’s activities by tracing contributions through to individual accounts, verifying the completeness and accuracy of financial statements, and evaluating adherence to investment limitations and other

\textsuperscript{7} See \textit{id.} at 63 (discussing an opinion of the \textit{Comite European des Assurances}).
\textsuperscript{8} \textit{Id.} at 61.
\textsuperscript{9} \textit{Id.}
\textsuperscript{10} \textsc{Rocha}, \textit{supra} note 2, at 24.
\textsuperscript{11} \textit{Id.} at 8.
requirements.\textsuperscript{12}

Last, remedial and punitive problem resolution generally empowers supervisors with the authority to direct pension funds to make changes in their operations by applying corrective and punitive actions.

B. Governance Rules

Governance of pension plans consists of all the relationships between the different entities and persons involved in the management of the pension plan. It also provides the structure through which the objectives of a pension plan are set and the means of attaining those objectives and monitoring performance.\textsuperscript{13}

Pension fund governance regulations should therefore promote the administration of pension funds in the best interest of plan members and beneficiaries. Effective regulation of the governance structure of pension funds includes: the establishment of a transparent framework for the division of responsibilities in the operation; oversight of the pension fund, and accountability for all parties involved in the pension fund process. Governance regulations must also define the mechanisms for internal control, communication, and redress.\textsuperscript{14}

Several efforts have been carried out in order to establish good governance practices throughout pension funds after incidents such as the Maxwell case in the United Kingdom\textsuperscript{15} and the diversion of union pension funds in the United States by organized crime syndicates in the 60's and 70's.\textsuperscript{16}

OECD's Working Party on Private Pensions released in 2002 the so-called "Guidelines for Pension Fund Governance." These guidelines were developed as part of an OECD project on financial governance and have drawn much inspiration from the existing "OECD Principles of Corporate Governance."\textsuperscript{17} Twelve principles were set for a pension fund's governance structure and mechanisms: (i) identification of responsibilities; (ii) governing body; (iii) expert advice; (iv) auditor; (v) actuary; (vi) custodian; (vii) accountability; (viii) suitability; (ix) internal controls; (x) reporting; (xi) disclosure; and (xii) redress.\textsuperscript{18}

\begin{thebibliography}{99}

\bibitem{12} Id. at 26.
\bibitem{14} \textsc{Rocha}, supra note 2, at 26.
\bibitem{15} Maxwell company's main pension fund lost a large part of its assets as a result of lending to and investing in insolvent companies linked to the late Robert Maxwell. See \textsc{Rocha}, supra note 2, at 16.
\bibitem{17} Id.
\end{thebibliography}
Therefore regulators must direct their efforts to the development of an adequate framework, with minimal requirements as to structure and mechanisms of governance of pension funds. Although generally broad, OECD guidelines enumerate main topics that should be covered by regulation.

_Pension Fund Governance_, by Juan Yermo and Ammamnia Marossy lists aspects of concern to regulators when addressing pension fund governance structure and its mechanisms. Regulation should cover the following issues when dealing with governing structure:

- the legal form that a pension fund can take;
- whether the governing body or administrator will be internal or external to the pension fund, and whether employers or plan sponsors also play a role in it;
- the responsibilities of the governing body, its accountability, and the suitability requirements for being a member of the governing body or provide professional services to a pension fund;
- the extent of functional delegation required or possible for specific duties such as actuarial analysis, auditing, asset management, and benefit payment administration;

As to governing mechanisms, regulation should take into account:

- internal controls to address conflicts of interest, ensure adequate incentives through performance reviews and appropriate compensation, and ensure efficient communication channels within the pension fund;
- disclosure of relevant information to pension fund members on a timely and clear manner;
- redress mechanisms for pension plan members and beneficiaries to discipline mismanagement by those responsible for the operation and oversight of the pension fund.

Moreover, regulators should bear in mind the different regulatory treatment required by different types of plans, natures, and legal forms of pension funds. For instance, the main governance issues related to defined contribution (DC) plans are over the timely payment of contributions and benefits, the management of plans’ assets, and reporting and disclosure, since the plan’s benefits are determined purely on the basis of the interest earned on invested assets. On the other hand, defined benefit (DB) plans require additional governance concerns, such as more rigorous monitoring and internal controls, as they create additional responsibility for the plan sponsor and the plan administrator to provide a minimum rate of return on investments or annuitisation rates.

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20. _Id._
21. _Id._
22. _Id._ at 4.
C. Disclosure

Disclosure rules for pension funds are meant to encompass information to plan participants and the general public as well as reporting requirements for the supervisory and regulatory authorities. A fund should keep all information transparent in connection with its financial position as well as its own rules and requirements on its relationship with its members.

Members must be informed about the situation of the fund in order to be able to exert discipline and control over the fund's situation and supervisors should be provided with enough information to monitor funds thoroughly. Enhanced disclosure requirements are also a substantial contribution to the containment of agency risks and promotion of market discipline. This includes several important limitations, such as asset valuation rules, the frequency of asset valuation, and the distribution of relevant information to fund members and the general public.23

Open and closed funds may be subjected to different levels of disclosure requirements, especially due to the possibility of individual switching of plans available in open funds. According to findings made by Rocha, Hinz, and Gutierrez, open funds in most Latin American countries are subject to extensive disclosure requirements, which usually include daily asset valuation on a “mark to market” basis, account statements made available to members several times a year, and the publication of extensive and detailed information on the industry by the supervision agency, through quarterly and annual bulletins. Such an extensive disclosure of information is designed to enable workers to make informed choices and to put competitive pressure on asset managers, and also to allow switching on a fair basis.24

Nonetheless, this does not mean that closed pension fund’s disclosure of information is not an issue that requires less attention. In this sense, the OECD, in its Fifteen Principles for the Regulation of Private Occupational Pension Schemes, elaborated principle fourteen, establishing that:

Appropriate disclosure and education should be promoted as regards respective costs and benefits characteristics of pension schemes, especially where individual choice is offered. Beneficiaries should be educated on misuse of retirement benefits (in particular in case of lump sum) and adequate preservation of their rights. Disclosure of fees structure, plans performance and benefits modalities should be especially promoted in the case of individual pension plans.25

Furthermore, in his article Laboul highlights the suggestions of the

23. See Rocha, supra note 2, at 20.
24. Id.
“Goode Committee Report”26 as to information that should be provided to employees prior to joining a plan or while they are members of it:

- a statement of whether the scheme is registered with the Regulator and its registration number;
- a full statement of the nature of the pension promise detailing contributions payable, scheme benefits, and how those benefits are secured;
- a statement of the scheme’s past policy with respect to pension increases, which should be contained in the annual report;
- details of trustee arrangements;
- a general statement of the powers to make scheme amendments, the use of surplus, the application of funds in the event of winding-up, and the steps to be taken if the scheme has a deficiency;
- a statement of the members’ rights to further information, and how this can be obtained.27

A private pension system should be transparent to both plan members and supervisors, allowing them to monitor and assess pension funds, thus fostering confidence in the system.

D. INVESTMENT REGULATIONS

Investment regulations of pension funds should aim at assuring safekeeping and profitability of funds invested, taking into consideration consumer/investor protection and macroeconomic issues.28 Limits on holdings by issuer, types of instrument, and asset classes are the main topics of concern to regulators in connection with investment regulations.

The OECD Insurance Committee approved in 1999 a list of principles applicable to investments of insurance companies and pension funds.29 Diversification and dispersion, maturity, and currency matching are established as basic conditions on investments. OECD principles also suggest that investment regulations should be concerned with the risks inherent both in the investments themselves and in the commitments that those investments are intended to cover by incorporating institutional and functional considerations. These principles have stated that “while regulation inevitably takes place within an institutional context, it must focus as closely as possible on the liabilities being covered (by these in-

26. In 1993, the United Kingdom established the Goode Committee to review the country’s pension law for the purpose of pension reform. The committee generated a report with recommendations that led to the implementation of the Pensions Act of 1995.
27. LABOUL, supra note 1.
vestments), their characteristics, and in particular, their maturities – thus promoting a functional approach.\footnote{30}

Moreover, said principles set standards on regulatory coverage (investments of technical provisions should be distinguished from investments of the capital/surplus base), regulation and internal controls (governmental function should be limited to assessing the adequacy of internal controls) and investment rules \textit{per se}.

Some concepts in connection with the appropriateness of regulations as to managing pension funds’ assets are widely discussed by authors, namely whether regulation should dictate ceilings to investment on certain types of assets or should this control be exercised at the prudence of pension fund managers (prudent man rule versus quantitative approach).\footnote{31} Furthermore, this is an important issue to be considered by regulators because it has significant security and macroeconomic impacts relates to liberalising foreign investment by pension funds.\footnote{32}

1. \textit{Prudent Man Rule vs. Quantitative Restrictions}

Certain countries do not impose restrictions on investments by asset class, relying basically on general guidelines established by law and on the prudence of fund managers. Others enforce more stringent rules, specifying types of assets in which a pension fund may invest its reserves as well as limits in connection with such investments. This is generally the concept that distinguishes the “prudent person approach” from the “quantitative approach.”

Limits or restrictions imposed on investment of pension fund assets are mainly concerned with assuring diversification and with levels of default or liquidity risk that different classes of assets may have. \textsc{Dickinson} categorizes the types of restrictions on investment that can be applied to pension funds: (i) lists of approved classes of financial assets that can be held; (ii) maximum percentages of “total” investments that can be held in a given class of investment; (iii) maximum limit on the proportion of “total” investments that can be held in a single investment; (iv) restrictions on the maturity or duration matching of assets and liabilities; (v) currency matching requirements for assets and liabilities; and (vi) regulations on the use of financial derivatives in asset management.\footnote{33}

In principle, investment restrictions may seem counterproductive, as they may prevent diversification and expose fund members to a greater degree of portfolio risk. On the other hand, it is acceptable that investment restrictions may be justified in countries with underdeveloped institutional and regulatory structures and shallow or illiquid asset markets.\footnote{34}

\footnote{30. \textit{Id.}}\footnote{31. See \textsc{Laboul}, supra note 1; \textsc{Rocha}, supra note 2.}\footnote{32. See \textsc{Laboul}, supra note 1, at 68.}\footnote{33. \textsc{Dickinson}, supra note 27.}\footnote{34. \textsc{Rocha}, supra note 2.}
Andre Laboul's article draws attention to the debate over which approach is better, the quantitative or the prudent man approach, mentioning that this depends on a number of variables. In this sense, critiques are made to both approaches. For example, quantitative restrictions tend to change infrequently, and do not keep up with changes in the product characteristics and capital market conditions. In addition, the prudent man rules can be imprecise.

2. Foreign Investment

Pension fund assets represent an important proportion of both the stock and flow of long-term national savings. Regulations sometimes take this into account to the extent of influencing the direction of the investment of these assets. In addition, one economic rationale is that pension fund liabilities are domestic, therefore investing locally permits assets and liabilities to be denominated in the same currency.

Arguments in favor of restrictions on foreign investments are mostly based on the "need to shield pension plan members from foreign-exchange risks" and on the "possibility of a system-wide risk, in the event of default by institutional investors, which would cause a domino effect throughout the financial system." On the other hand, the liberalisation of foreign investment has found significant support in literature. These readings point out some countries' experiences (essentially the Chilean gradual liberalization) based on arguments of risk reduction offered by international diversification.

Hence, lowering controls on foreign investment can be justified as institutional investors have access to sophisticated and effective instruments for hedging their foreign-currency positions. In addition, "returns on internationally diversified portfolios, with a better balance between country and currency risks, have proved more stable than non-diversified portfolios."

Therefore, the macroeconomic standpoint as to regulating foreign investments by pension funds sounds more persuasive than basing such restrictions on foreign-exchange risk protection. It sounds more reasonable for a government to impose restrictions on foreign investment due to its intention of ensuring that national savings are invested in the domestic economy and encouraging the flow of investment funds into government securities and projects favoured by the government.

35. Laboul, supra note 1.
36. Id.
37. Id.
40. Reisen, supra note 37 (arguing there is not enough evidence that pension fund contribution is significant to financial development, as well as to the constitution of national savings and capital market growth).
E. Funding Requirements

A pension fund must design its structure and mechanisms in connection with financing its plans, i.e., how it is going to handle the collection and administration of funds so as to guarantee plan participants' benefits. This includes the formation of pension funds, which is the approach taken as to keep funding levels and standards of dealing with deficits and surpluses.

Employers may set up pension schemes with respect to their employees in several ways according to what is permitted by local legislation. Internal or external mechanisms (within the employer's businesses) may be set up to constitute reserves guaranteeing employees' benefits.

Gollier, in his article *Insurance and Private Pensions Compendium for Emerging Economies*, lists and explains internal and external financing mechanisms for pension schemes. As internal mechanisms, employers may adopt "overhead expenses budget," "book reserves," or "individual pension guarantees." Self-administered pension funds and group insurance are considered to be external mechanisms. The first internal mechanism, overhead expenses budget, refers to payments made according to company's internal rules directly out of the company's budget for overhead expenses. In a similar fashion, "individual pension guarantees" may be adopted when a company wishes to provide special pension benefits to some of its employees or officers on an individual basis. Book reserves are reserves set aside on the company's books with the purpose of providing pensions to its employees. Such internal mechanisms are considered to be defective, especially due to the fact that employees' benefits are not protected against employers' bankruptcy. On the other hand, some type of insurance against the employers' insolvency may be contracted in order to minimize this problem.

Self-administered pension funds are legal entities distinct from the employers; therefore they are shielded against most of the employers' or other related-companies' risks. In group insurance mechanisms, the employer and insurer jointly draft a group insurance contract specifying the respective rights and obligations of the parties.

In all of the cases above, a minimum funding level must be required from the pension schemes to ensure that they are able to fulfill its present and future obligations. Winding-up and on-going approaches are discussed among authors and regulators. The first looks at a fund from the perspective of its winding-up, while the second emphasises the notion of long-term equilibrium and considers the system as an on-going concern.

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42. Id.
43. Id. at 11.
44. Laboul, supra note 1, at 46.
Labour indicates the main types of funding rules in connection to the approaches above mentioned:

- BO, or “accumulated benefit obligation,” corresponds to what a defined-benefit pension plan would have to pay out, as measured by vested rights at current pay rates in the event of immediate termination;
- PBO, or “projected benefit obligation,” which corresponds to the ABO, but takes into account estimated final pay rates;
- GBO, or “Guarantee benefit obligation,” which corresponds to the ABO with a minimum benefit guarantee.
- IBO, or “indexed benefit obligation,” which corresponds to the ABO with indexed vested rights.

In its *Fifteen Principles*, OECD dedicated one principle to funding rules suggesting the following:

Private schemes should be funded. While full-funding exists in principle for defined contribution plans, other types of plans should be subject to minimum funding rules or other mechanisms to ensure adequate funding of pension liabilities. Rules based on winding-up approach (e.g. ABO, PBO) may be promoted as a minimum level to complement the on-going approach. Flexibility can be allowed for temporary limited under-funding under restricted circumstances. Consideration should be given to the development of adequate but flexible requirements for minimum capital/guarantee in pension funds,—taking account of the long term nature of their liabilities. Tax and prudential regulations should encourage a prudent level of funding. Private unfunded pay-as-you-go schemes at individual company level (i.e. overheads schemes) should be prohibited.

Therefore, an adequate set of rules of funding for pension funds should take into account the principles and approaches above in addition to rules of handling surpluses and under-funding situations.

It is controversial whether employers should own surpluses. On the one hand, employers have the duty to make up for deficits and should be entitled to surpluses. On the other hand, employees may be considered to have a claim to surpluses similar to profit-sharing rights under life insurance. Hence, regulation should either establish ownership/sharing of surpluses or require that this should be agreed to in the relevant contracts. In addition, regulation should focus on utilization of surpluses for granting “contribution holidays,” increasing benefits or creating extra reserves, setting conditions, and other relevant occasions.

45. Id.
46. Id.
48. LABOUL, supra note 1, at 52.
Regulation should tackle under-funding by following a set of technical issues and principles.\textsuperscript{49} Generally, employers and employees are called upon to rectify any situation of under-funding, which includes measures of increasing contributions.

F. Solvency Mechanisms

Funding requirements, investment restrictions, disclosure, and other issues may be considered as mechanisms applicable to containing pension fund insolvent risk. This sub-section will focus more specifically on government-run protection systems that are available to preserve a pension fund's solvency. Such systems guarantee that at any moment, regardless of the events that might be interfering with the relevant fund's performance, plan participants will be able to obtain their respective benefits. Generally such mechanisms aim at shielding pension plans from the risk of bankruptcy by the sponsor in the event that a plan is insufficiently funded.\textsuperscript{50}

Governmental agencies usually provide such systems, since it is assumed that the market cannot provide this kind of protection at an affordable price.\textsuperscript{51} This is usually done by "plan termination insurance," which would be utilized to protect the employees' pensions in the event the plan is under-funded, particularly at the employer's bankruptcy. Several countries have adopted such mechanisms.

In the United States, the Pension Benefit Guaranty Corporation (PBGC) is a federal agency that was set up in 1974 to ensure and protect pension benefits in private DB plans. The majority of its financing comes from insurance premiums paid by companies whose plans it protects and not from taxes. Sweden offers a similar compensation fund in which companies that have poorer credit ratings pay a higher rate. In Germany, there is the PSVaG, a mutual insurance company that purchases annuities from a consortium of private-sector insurance companies. In the United Kingdom, there is the PCS (Pensions Compensation Scheme), which meets the cost of benefits only where fraud has occurred.\textsuperscript{52}

It is important to distinguish between countries that have funding requirements and countries that operate under the book reserves method. In the latter, plan termination insurance is essential if accrued pension benefits are to be protected from bankruptcy risk. When there are funding requirements, the case for public provision of plan termination insur-

\textsuperscript{49} Id. at 53 (stating "Even though prudential principles call for a winding-up approach, a healthy fund can sometimes find itself under-funded without its viability being affected. A good example of this is provided by the case of retroactive benefit allocations, which frequently occur when flat-rate benefits are renegotiated.")

\textsuperscript{50} This is particularly applicable to DB plans because defined contribution plans are expected to be fully funded.

\textsuperscript{51} LAbOUL, supra note 1, at 75.

ance is less demanding.53

Despite the soundness of having such an insurance mechanism within a private pension system, a very significant, yet inevitable, moral problem must be taken into account. In his article, Barton listed three areas identified by the Goode Report where the existence of a compensation scheme might lead employers to take decisions that would place an intolerable burden on the scheme:

An employer might encourage the trustees to take a less prudent investment strategy than they otherwise would because the higher the return on the scheme’s investments, the lower the costs to the employer in a balance of costs scheme. The employer stands to gain all the benefits from a high risk investment strategy while the compensation fund would meet the cost of any losses;

• If an employer gets into difficulties, it might favor other creditors over the pension scheme in the knowledge that the pension scheme would be protected by the compensation scheme if it became insolvent;
• An employer may offer scheme benefit improvements as an alternative to wage increases. If the improvements applied to past service or to pensions in payment, they might create or enlarge a deficit in the pension scheme that subsequently has to be met from the compensation scheme.54

Therefore, as Laboul concluded, it seems advisable to set a priority on the implementation of preventive regulations.55 If this proved not to be practical, then consideration could be given to insolvency insurance with the hazards it entails and only under certain conditions. Thus, the setting of a ceiling, or even of a deductible amount, may reduce the moral hazard and promote better prevention by implicitly creating a situation of co-insurance with plan members.

G. Taxation

As already emphasized herein and in addition to all of the issues covered above, taxation is a matter of great importance to private pension systems. In general, it could be said that the public will look for private pensions if two main factors are present. First, whether there is confidence in the system as a whole (i.e., whether the issues raised above are well handled by regulation), and second, whether there are incentives for concentrating funds in such a system.

Usually, taxation of private pensions impacts three main stages of a pension fund’s operation: (i) when contributions or employer or employee paid premiums are paid in; (ii) while reserves are being constituted; and (iii) when benefits are paid out. Therefore, tax legislation will address issues such as tax deductibility and reduction, limitation of bene-

53. Pesando, supra note 50.
55. LABOUL, supra note 1.
fits or contributions, mode of benefits taxation, tax status of financing supports, taxation of interest, and inheritance taxation on benefits in case of death.\(^5\)

In his work, Laboul makes reference in his work to general tax treatments (on several countries studied) to private pension operations:

- Employer contributions are tax deductible, provided that the plan qualifies under existing regulations;
- The tax burden does not shift to the employees, meaning that contributions are not treated as indirect income on which employees must pay taxes;
- Employee contributions are also generally tax-deductible;
- Benefits are, in principle, taxed as regular income; and
- Income from investments and capital gains are not taxable as long as the fund complies with applicable regulations.\(^6\)

Generally, the environment must motivate the general public, namely employees, to allocate their savings in such a long-term investment and there should be incentives for employers to offer such schemes to their employees. This should be encouraged as an endeavour to foster long-term national savings growth in developing countries, which have a significant need to finance their economy.

III. THE BRAZILIAN PRIVATE PENSION SYSTEM

A. HISTORICAL BACKGROUND AND LEGISLATIVE EVOLUTION

Private pension structures can be found in Brazilian history as early as the sixteenth century when a hospital in Santos, Sao Paulo created a pension plan for its employees as early as 1543.\(^5\)\(^8\)

Private pension entities were formed as *montepios* and *caixas de pensoes*, which were widow's funds and pension funds established by private initiative by persons interested in a common social protection. There was no government involvement and no presence of applicable legislation.

It was only in 1835 that legislation began to apply to such plans. A decree was enacted that approved the *Montepio da Economia dos Servidores dos Estados* statute (MONGERAL), a government sponsored widow's fund for state civil servants. Other legislation followed\(^5\)\(^9\) with the same purposes.\(^6\)\(^0\)

\(^{56}\) Gollier, *supra* note 40, at 44.

\(^{57}\) LABOUL, *supra* note 1.

\(^{58}\) See Reis 118.

\(^{59}\) In 1889, Decree 10.269 was enacted, creating *Caixa de Pensoes dos Operarios da Imprensa Nacional*, for the government's official press employees. Law 1236, enacted on September 11, 1909, created *Montepio Municipal de Sao Paulo* to provide pensions to widows and families of employees of the Sao Paulo municipality. Decree 15.674 of September 7, 1922, was aimed at Brazilian railway workers, among others.

\(^{60}\) This shows a paternalistic tendency of the Brazilian government to privilege civil servants, which can still be seen today in Brazilian pension law, and is considered the root of the Brazilian pension system crisis, as well as the aim of pension reform, as discussed below.
In 1960, Brazil enacted a pension system. It was basically formed from several *montepios* and *caixa de pensoes* created either by governmental initiative for the benefit of civil servants or by private entities for the benefit of particular classes of workers. Private and public pension funds had the same roles within the pension system. Workers, employers, and the government funded this system.

A proper public pension system was developed only in 1960 when law 3807/60 was enacted creating the so-called *Lei Organica da Previdencia Social*, which attributed to private pension funds the complementary function.

Law 6435 enacted on July 15, 1977 regulated private pension companies and classified them as “open” or “closed” pension funds. The latter are companies set up by employers for the benefit of its employees restricted, therefore, to a particular group. Open funds are the remaining companies, in which any individual can participate. Furthermore, closed funds are to operate as non-profit organizations (*sociedade civil sem fins lucrativos*), while open funds can operate envisaging a profit, therefore, set up as corporations (*sociedade anónima*).

Law 6435 authorized insurance companies licensed to work with life insurance to operate open pension plans, which consequently made Decree-Law 73/66 (the main legal statute for insurance regulation) applicable to such plans as well.

As regulated by Decree 81240 enacted on January 1, 1978, and 81402 enacted on February 23, 1978, Law 6435 established that the two different funds (open and closed) should be subjected to the supervision and regulation of different governmental bodies. *Conselho Nacional de Seguros Privados* (CNSP) and *Superintendencia de Seguros Privados* (SUSEP), which are respectively, the regulatory and supervisory authorities for insurance operations, hierarchically subjected to the Ministry of Finance, which rules and supervises open pension funds. Closed pension funds are subjected to a similar structure. *Conselho de Previdencia Complementar* (CPC) and *Secretaria de Previdencia Complementar* (SPC) are authorities related to the Ministry of Social Security, which rules and supervises their operations.

From the enactment of the rules above, the Brazilian pension system was structured in a three-segment organization, which is still present today. The Brazilian pension system is divided into a general regime for private sector workers, multiple special regimes for civil servants at different levels of government, and a voluntary complementary regime available to all workers. The general regime, available to private sector workers, consists of a mandatory publicly managed pay-as-you-go structure.

The special schemes segment for civil servants is responsible for the Brazilian pension crisis and is the aim of pension reforms currently under discussion. Significantly more generous than the general regime, it was created without much consideration to actuarial principles resulting in
immense deficits. Congress is discussing several reforms, including an initiative to equalize such special schemes with the general scheme.

The complementary regime, which is the scope of the discussions herein, will be detailed throughout this work. After the above mentioned important legal statutes were enacted during the 1970's, no substantial legal changes were implemented until 1988 when Brazil passed a new constitution. A particular section in the new constitution addresses public and private pensions re-defining its main foundations (articles 201 and 202).

Article 202 of the 1988 Brazilian constitution, as amended by constitutional amendment no. 20 on December 15, 1998, specifically addressed private pensions. Private pensions had confirmed their complementary, voluntary, and autonomous function within the Brazilian pension system. Directives on funding, disclosure, separation of pension plan rights and obligations from workers' labor contracts were established by article 202 and its first and second paragraphs. Furthermore, a complementary law was established to regulate such directives.

Paragraphs three to six of article 202 address the special schemes, prohibiting any direct financial assistance from the government to such pension funds, which allows it only from the governmental authority in the position of the relevant fund's sponsor. It also limited sponsor's contribution to an amount equal to the worker's contribution (1:1). According to such paragraphs, a complementary law should be enacted to regulate the relationship of governmental entities as sponsors of pension funds and their respective pension funds.

Therefore, article 202 of the Brazilian constitution and complementary Laws 108 and 109 are currently the main legal statutes in BPPS, which regulate operations in connection thereof. Law 108 specifically addresses the special schemes and Law 109 governs the private pension system in general. In addition, open pension funds must observe the provisions of Decree-Law 73/66 when applicable to their operations. Closed pensions must observe Decree 4206, enacted on April 23, 2002.

B. CURRENT LEGAL FRAMEWORK OF BPPS

As already mentioned, BPPS is independent and complementary to the general regime, which is also considered to be a part of the Brazilian Fi-
nancial System (pension funds are financial institutions according to article 17 of Law 4595, enacted on December 31, 1964, the so-called Lei do Sistema Financeiro Nacional (Law of National Financial System)), and provisions applicable to financial institutions must, in general, also be observed by private pension funds.

Open and closed funds are regulated by the rules mentioned above. The special schemes are subject to closed fund regulation, in addition to the provisions set forth by Law 108. Generally, Law 108 purported to organize the special schemes, properly established them in the private pension system. Law 108 imposed that the National Treasury cannot cover any losses or deficits that special scheme funds might have. It also established governance and supervision principles.

1. Law 109

Law 109 revoked and replaced law 6435/77, basically improving and implementing many important concepts in the private pension system. Some authors believe that law 6435/77 did not need to be fully revoked and replaced, but rather that it only needed to be reformed.\(^6\) In fact, it was used as the basic structure for Law 109. However, it had to be completely substituted due to article 202 of the Brazilian constitution, as mentioned above.

Law 109 follows the principles set out by article 202 of the Brazilian federal constitution, being emphatic of its provisions as to financial security and beneficiaries’ rights.\(^7\) It is divided in eight chapters: (i) introduction; (ii) pension plans; (iii) closed pension funds; (iv) open pension funds; (v) supervision; (vi) intervention and extra-judicial liquidation procedures; (vii) disciplinary regime; and (viii) miscellaneous provisions.

Article 3 of Law 109 set out directives to governmental function within the BPPS. States should purport to (i) elaborate private pension policies; (ii) discipline, co-ordinate, and supervise the activities regulated by Law 109, making it compatible to social security polices and social and financial development; (iii) establish minimum standards of financial and actuarial security, aiming specifically at preserving liquidity, solvency, and stability of pension plans and each pension fund in the totality of their activities; (iv) guarantee to beneficiaries full access to information in connection with their benefit plans; (v) supervise pension funds and their operations imposing penalties when applicable; and (vi) protect beneficiaries’ interests. Accordingly, provisions targeting those principles are found throughout Law 109.

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\(^6\) See Martinez 755.

\(^7\) Article 8 of Law 109 makes distinctions in defining beneficiaries: “Participants” are pension plan members who have not become entitled to any benefits yet and the “assisted” are the participants or their beneficiaries receiving the plan benefits. In the present work, the utilization of the term “beneficiaries” collectively refers to participants and assisted, unless described differently.
Pension plans are addressed in the second chapter of Law 109. Private pension funds may only operate plans that they have been expressly authorized to operate, and must comply with minimum standards established by regulatory and supervisory authorities. Such standards attempt to assure transparency, solvency, liquidity, financial, and actuarial stability. Plans may be set up and regulated as DB, DC, variable contribution, and other forms of plans that reflect technical evolution and allow flexibility to the private pension regime.

An important innovation of Law 109 is a more flexible creation and structuring of benefit plans and pension funds. Law 6435 anticipated closed pension funds created only by employers. Law 109 made it possible for the creation of closed pension funds by a new entity, in addition to employers, called Sponsors by Law 109. The instiuidor (originator) refers to professional classes, unions, or other associations. Law 109 regulates the so-called multi-sponsored entities, i.e., more than one sponsor organized for the purpose of providing complementary pension benefits for associates or employees. The purpose of this regulation is to allow smaller sponsors or institutions to set up pension funds.

Law 109 also includes portability and vesting for the first time in Brazilian pension law. These two elements are essential for a trustworthy private pension system. Article 14 implements technical foundations that apply to every pension plan. These foundations apply when portability and vesting are probable, as well as the right of withdrawal of all contributions made by the employee (minus the plan's administrative costs) and the option for the employee to continue making contributions, even in the event of losing his earnings totally or partially, in order to preserve the final benefit.

In addition, article 16 of Law 109 covers non-discriminatory eligibility. Pension plans must be offered to every employee of sponsors or associates of instiuidores, including managers, directors, statutory members, and any other executive members.

C. PROSPECTS FOR THE FUTURE OF BRAZILIAN PRIVATE PENSIONS

The Brazilian private pension system envisages a perspective of substantial growth as it has continued to grow over the past few years. Technical reserves have grown from a total of R$75 billion in 1994 to R$240 billion on April 2003 (approximately, £25 and £48 billion, respectively).

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68. Some private pension plans have not been fully regulated yet.
70. See ABRAPP, at http://www.abrapp.org.br/abrapp.htm (last visited Nov. 13, 2003) and ANAAP, at http://www.anapp.com.br/publique/cgi/public/cgiliu.exe/web/templates/html/anapp/home.htm?uswer=reader (last visited Nov. 13, 2003). ABRAPP is the Brazilian association of closed pension funds, and ANAPP is the Brazilian association of open pension funds. Each entity provides the data for their relevant segment (open or closed), therefore the numbers are the approximated sums of such data (open + closed).
It is believed that such numbers will triple by 2008\textsuperscript{71} due to two important elements: the pension reforms, currently under discussion in Congress, and the development of pension funds by \textit{instituidores} and multi-sponsored funds.

1. Brazilian Pension Reforms

The main goal of the pension reforms in Brazil, which are expected to take place in 2003, is to combat the immense actuarial deficits of the special schemes. The deficits reached approximately R$70 billion (approximately £14 billion) in 2002.\textsuperscript{72}

One of the measures pursued by Brazilian pension reform is to cap the special schemes substantially by reducing the value of benefits offered in accordance with current legislation. This cap could lead to a considerable expansion for private pensions in Brazil, since workers in the special schemes would look for additional schemes should they desire a higher income after their retirement. In other words, there are approximately five million civil servants that could potentially become members of other private pension plans.\textsuperscript{73}

Moreover, there is also a proposal under discussion for a constitutional amendment, PEC 453/2003, which purports to insert into paragraphs three to six of article 202 of the Brazilian Constitution the possibility that private pension plans operate in the special schemes. This plan could lead to a substantial shift of reserves to the administration of private companies, especially open funds.

More importantly, such a great expansion in the private pension industry would increase Brazil's internal savings substantially. These savings could help the economy reach levels that would fuel the nation's financing needs. Pension funds are main players in regard to a nation's internal savings. As an example, the United States' internal savings are over US$10 trillion of which US$7 trillion are originated by the pension and insurance industries.\textsuperscript{74}

2. Pension Funds Created by Instituidores

\textit{Instituidores} may now provide pension plans to their affiliates. Resolution CGPC no. 12 enacted September 17, 2002, as amended by Resolution 03 dated May 22, 2003, regulated the \textit{instituidores}' activities.


\textsuperscript{73} Ministério de Previdência Social, at http://www.mpas.gov.br (last visited Nov. 13, 2003). According to data available at the Ministry of Social Security website, there are currently 3.7 million active and 1.6 million inactive civil servants, who are members of special schemes for civil servants.

Instituidores may set up closed pension funds or establish pension plans with another pension fund (Resolution CGPC no. 12, article 3). Its technical reserves must be administered by specialized intermediaries (financial institutions) duly authorized to operate by the Brazilian Central Bank (BACEN). The financial institution must segregate such reserves from its own assets (article 3, paragraphs 2 and 3). A resolution was also issued by Conselho Monetario Nacional (CMN) forcing financial institutions to segregate the assets of third parties. For example, the administration of third party funds shall be carried out separately from other activities performed by the financial institutions.

Moreover, pension plans created by instituidores must be structured in the DC category and funded by the beneficiaries. Employers may elect to make contributions to their employee’s plans by executing a formal agreement with the relevant instituidor. Instituidor pension funds could lead to an expansion of the private pension industry in Brazil. This expansion could follow international experiences, such as United States, where union pension funds hold a substantial portion of American pension fund’s total reserves. However, Brazilian unions do not seem to be prepared yet. There is significant work to be done within union organizations in order to make such institutions compatible to handling an enterprise such as a pension fund.

3. General Remarks

Law 109 has more than twenty provisions requiring additional regulation. From such provisions, some have been either fully or partially regulated, whereas others have not received the proper attention from the relevant authorities yet.

For example, one of the main concerns of the private pension industry is the regulation of portability. Resolution CGPC No. 09, dated June 27, 2002, has already implemented certain concepts and minimum requirements, including grace periods related to the entitlement to portability (five years for plans created after Law 109 and ten years for plans created after 2004).
before Law 109). However, Resolution CGPC No. 09 did not present a method for the calculation of the portable amount leaving it to be regulated by further complementary norms.

Finally, it should be noted that a substantial portion of the population depends on a very low income for survival. Therefore, many people are not capable of joining any complementary scheme. In other words, the general regime is extremely necessary to look after this portion of the population.

A private pension scheme is still inaccessible to a part of Brazilian population. With an underdeveloped public health system, low-income Brazilians would first seek to join a private health plan (which, by itself, is very costly to them – up to 10 percent of their income), before considering any type of retirement benefit. As the Brazilian public health system improves, this culture might also change towards a greater concern for retirement.

IV. FINANCIAL SECURITY OF BPPS

In section 1 above, seven main pillars were identified and described as the foundation of a private pension’s financial soundness. This section investigates and assesses BPPS regulations in relation to each of the pillars.

A. REGULATORY AND SUPERVISORY STRUCTURES

As already mentioned, BPPS regulatory and supervisory framework is divided into second and third pillar pensions: closed and open funds subjected to CGPC/SPC and CNSP/SUSEP’s regulatory and supervisory scrutiny, respectively.

This formation is seen in article 74 of Law 109 as a temporary measure, since the terms of article 5 provide that a new law will be issued, which properly establishes a regulatory and supervisory framework and its foundations. There are already projects under discussion, but still far from implementation. The projects plan for the creation of a specialized agency for private pensions.82

It cannot be said that the current structure is ineffective, but the proposal for a new specialized agency could have positive effects for BPPS. In the current structure, there are four different governmental authorities that deal with BPPS. Sometimes these authorities focus their efforts on identical matters. A single regulatory and supervisory authority could

80. The regulation cited in this paragraph refers to closed pension funds. Portability for closed pension funds has its own calculation methods and different grace periods.


deal more effectively with differences in the regulation of open and closed funds.

Another possibility could be to shift the regulation and supervision of closed funds to CNSP and SUSEP. This shift should occur only if it is found to be a less costly and burdensome alternative than the creation of a new agency. In any case, the regulation and supervision of private pensions should be subjected to the Ministry of Finance's governmental bodies due to the similarities of the insurance business and the importance they represent to financial markets. There is a need for compatibility with social security policies and Ministry of Social Security action should be limited to such policies.

As to the provisions in BPPS regulatory and supervisory framework related to the building blocks mentioned above, several supervisory issues are found in Law 109 and other inferior regulations. A special chapter of Law 109 is dedicated to supervision (articles 41 to 43). Other concepts are spread throughout Law 109's other seven chapters.83

As previously mentioned, pension funds and pension plans require formal authorization from regulatory and supervisory authorities before they can operate.84 This includes their statutes, plan provisions, and any amendment in connection thereof. Sponsor withdrawals, elections of executive and statutory members, mergers, acquisitions, spin-offs, or any other kind of corporate restructuring, as well as the transfer of sponsorship, plan participants, plan, and reserves between funds are also subjected to prior authorization (Law 109, articles 25, 33 and 38).

Both regulatory and supervisory authorities for open and closed funds have issued regulations in connection with licensing that require a considerably extensive list of documentation, procedures, and standards to be met for the creation of pension plans and pension funds. Resolutions CNSP 65/01 and 73/02, respectively, set out rules for the election of executive members and the minimum capital for the constitution of an open fund.85 Procedural measures for filing requests for authorization from regulatory and supervisory bodies are regulated in Circulars SUSEP 122/00 and 188/02. Closed funds must mainly observe Ordinance SPC 27/2001.86

As to monitoring and inspections, the main rules in Law 109 are as follows:

- Article 22: Closed funds must submit annual reports to supervisors with accounting measures and actuarial evaluations;
- Article 23: A closed fund must keep updated accounting records, consolidate the position of its plans, and submit the information to independent auditors. Annually, closed funds must prepare consolidated reports on their accounting and actuarial position;

83. Law 109, articles 41-43.
84. Law 109, articles 13, 33 and 38.
85. Resolutions CNSP 65/01 and 73/02.
Article 40: Open funds must prepare monthly financial statements in accordance with rules established by regulatory authorities. Insurance companies that operate pension funds must distinguish pension activities on such statements;

Article 41: Provides supervisors with the authority to access pension funds, as well as all of the records and other relevant materials they may require. Supervisors may even request and apprehend documents. Any obstruction to these requests will be subjected to legal sanctions. This authority to investigate reaches sponsors and instituidores as far as the relevant pension fund’s aspects are involved (article 41, paragraph one). Sponsors and Instituidores are also responsible for supervising the activities of the pension fund to which they are connected (article 41, paragraph two). In addition, any person subjected to the provisions of Law 109 is obliged to provide requested information to regulatory and supervisory authorities (article 41, paragraph three).

Law 109 also sets out corrective and punitive measures. Articles 42 and 43 allow for intervention in the administration of the fund by the supervisor in the event that certain conditions are met (e.g., insufficient reserves, irregularities on asset management, breach of a plan’s contractual or statutory provisions, potential harm to a fund’s solvency, and actuarial unbalances).

Article 42 refers to intervention in closed funds, while article 43 addresses open funds. The main difference is that for open funds, the person nominated by the supervisor to intervene in the administration of the fund does not have executive powers, whereas the supervisor does have executive power in the case of closed funds.

Furthermore, Law 109 dedicates a chapter to disciplinary regime, which discussed civil liability to fund executives, managers, and statutory members for any damages they might cause with regard to the fund. This liability is extended to sponsors and instituidores executives, actuaries, independent auditors, managing evaluators, and other professionals who might render technical services to the fund either directly or indirectly (article 63). The public defense office must be notified of the criminal offense (art. 64).

Decree 4206/02 also enumerates forty different violations that may be subjected to penalties under Law 109. These violations include non-compliance to investment regulations and disregard to beneficiaries' requests for information.

Law 109 encompasses main issues of concern to supervisors, gathering principles related to the three building blocks suggested by the Basle Committee for banking supervision and extendable to private pensions, as defended by ROCHAL, Hinz and Gutierrez. Regulations are developing and most of the provisions mentioned above find complementary rules in CNSP or CGPC regulation.

However, special attention should be paid to article 41 of Law 109. Indeed, it gives full authority to supervisory bodies, but it still requires a
more detailed regulation of on-site supervision. A good example to follow is BACEN’s Supervision Manual, which established several procedures in connection with on-site supervision. It provides the financial markets with transparency as to BACEN’s methods of on-site supervision.

B. Governance Rules

Law 109 focuses more on the governance of closed funds. Open funds are regular sociedades anonimas just as any other financial institution. Therefore, Brazilian insurance and corporate law shape the main features of the governance of open funds.

In addition, Law 108 focuses on the governance structure of pension funds of the special schemes. It dedicates fifteen of its thirty-two articles to the special scheme governance structure.

As previously mentioned, closed funds are set up as foundations or associations without envisaging a profit (Law 109, article 31, paragraph one). Closed funds are subjected to the directives established in Law 109, in addition to the provisions on associations and foundations provided in the Brazilian Civil Code (Law 10496 dated January 10, 2002).

Closed pension funds must keep a minimal governance structure, formed by their deliberative boards, fiscal boards, and the executive management (conselho deliberativo, conselho fiscal, and diretoria executiva). Plan member representatives must occupy one-third of the positions on both boards (Law 109, article 35).

The deliberative board is the highest governing body in a pension fund’s governing structure. It is responsible for the substantial decision making process within the pension fund’s administration. However, the execution of its decisions is left to the executive management. The fiscal board is responsible for assuring that the pension fund complies with laws and regulations, as well as with internal resolutions. The fiscal board is also responsible for assessing the pension fund’s accounting and finances.

Members of the deliberative and fiscal boards must have appropriate professional experience and not have been convicted in any administrative proceeding regarding social security laws or as civil servant. Executive management members must, in addition to these requirements, have superior education (Law 109, article 35, paragraphs three and four).

Among the members of the executive management, someone has to be nominated to be responsible for the administration of the fund’s assets and such nomination must be disclosed to the regulatory and supervisory authorities. Other members of the executive management are jointly responsible with the nominated member for any damages or losses to the pension fund that they might cause (Law 109, article 35, paragraphs five and six). In addition, the fund must hire a custodian duly registered with

87. Association is the present denomination to sociedade civil.
the Brazilian Securities and Exchange Commission (Comissao de Valores Mobiliarios – CVM) (Resolutions CMN no. 2829 and 2859).

As to governance mechanisms, the main instrument is the previously mentioned requirement of Law 109 that one-third of the positions in the deliberative and fiscal boards be occupied by plan member representatives. Internal control is still a matter that needs to be addressed further by regulation.

In fact, only a few provisions covering insurance and pension regulation can be identified to relate to internal controls. Most of the provisions relate to anti-money laundering practices, ignoring important issues such as an adequate treatment of operational risks.

Again, experience from the banking sector can be used. Although not fully developed, BACEN's regulations on internal controls are much more advanced than what is currently available in the private pension industry. BACEN's resolution 2554, as amended, requires financial institutions under its supervision to implement internal controls effective and consistent with the nature, complexity, and risk of operations carried out by said institutions.

C. Disclosure

It can be said that disclosure is one of the main concerns of BPPS regulation. From article 202 of Brazilian constitution and Law 109 to inferior SUSEP and SPC regulations, transparency and disclosure are exhaustively covered throughout their provisions.

The first paragraph of article 202 of the Brazilian constitution delegated to Law 109 the duty to assure to plan participants full access to fund information. Law 109 carried out this task by addressing disclosure in several of its provisions, namely articles 10 and 24.

Article 10 of Law 109 establishes that minimum requirements, as set out by regulatory and supervisory authorities, must be present in pension plans, contracts, proposals, applications, and certificates. Its first paragraph goes further, setting up documents that must be accessible to prospective plan members and provided to new plan members, and listing information that must be expressed in such documents (e.g., eligibility, calculation methods for benefits, and features of the plan).

Article 24 addresses closed fund transparency. Plan members must be informed about their plan's position at least annually, according to rules passed by supervisors and regulators. In addition, article 24 grants participants the right of access to fund information, upon request, that might be useful for the protection of their rights or for clarifications of their own interest.

As previously mentioned, closed funds must submit annual reports to supervisors with accounting demonstrations and actuarial evaluations (Law 109, article 22), and open funds must prepare monthly financial

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88. Reporting and disclosure will be specifically addressed in the next subsection.
statements in accordance with rules established by regulatory authorities (article 40). SUSEP’s Circular 189 dated May 24, 2002 is the current rule in connection with the frequent reporting by open funds. Open funds must submit different forms to SUSEP on different regularities (monthly, quarterly, and bi-annually), the so-called formulario de informacoes periodicas (FIP).

BACEN’s regulation as to the investment of closed pension fund assets also impose a set of rules related to disclosing to plan participants information about the investment policies of the fund, operational costs incurred, and investment results (Res. 2829, articles 7 and 8, as amended).

In general, both open and closed funds are subject to several provisions that require them to provide supervisors with extensive information, from investment demonstratives to benefits offered. In addition, plan participants can find several provisions in the relevant regulations that protect their right to comprehensive access to information related to the plan and/or fund with which they are associated.

D. INVESTMENT REGULATIONS

The main Brazilian rules on investment of pension fund assets are in Law 109, articles 9 and 28, which establish directives to closed and open fund investments, respectively. Brazilian regulation follows a quantitative approach with an extensive set of ceilings and limits set forth in CMN’s resolutions and BACEN circulars.\(^8^9\)

Resolution CMN 3034 for open funds and 2829 for closed funds and their respective amendments establish ceilings, limits, and requirements of diversification in connection with the assets in which funds might invest. Other rules, such as Resolution CNSP 98/2002 for open funds and Ordinances SPC 30, 36, and 40 complement the investment regulation framework.

Security, profitability, solvency, and liquidity are principles repeatedly mentioned throughout the regulation of investments. The general structure of such regulations are formed by provisions establishing (i) segments in which assets should be allocated; (ii) permitted asset types and classes; (iii) ceilings for investments in each permitted asset class; and (iv) diversification requirements or limits on holdings of securities by issuer and issuances.

The regulation of open fund investment is the same as that applied to insurance companies. It follows the structure summarized above. Segments for asset allocation are divided into fixed income, variable income, and real estate. Each of the three segments counts toward ceilings related to the investment in particular asset classes (e.g., pension funds may invest up to 100 percent of their reserves in fixed-income investments

\(^8^9\) Although the financial system authorities (CMN and BACEN) are in charge of regulating the investments of open and closed pension funds, their respective regulators and supervisors have also issued rules imposing restrictions and requirements in connection with their investment policies, as will be discussed below.
linked to government securities; 12 percent in urban real estate; and 30 percent in stocks listed in stock markets).  

It is important to mention that CMN’s rules establish a set of requirements in connection with the quality of issuer of securities, namely the level of corporate governance present in the issuer’s businesses. This is mainly controlled by BOVESPA (Sao Paulo Stock Exchange) principles of corporate governance.

In regard to diversification requirements, open funds cannot hold more than 5 percent of debt instruments from the same issuer; 20 percent of other securities issued by a financial institution; and 10 percent of securities issued by other companies. In addition, there are limits related to holding quotas of investment funds and securities issuances (e.g., there is a limit of 25 percent of the relevant issuance for securities in general, except for some equity instruments).

Closed funds also have a similar set of rules that differ slightly in limits and variety of asset classes. Closed funds are divided into four segments. In addition to the three segments in open fund regulation (fixed income, variable income, and real estate), there is a fourth segment: financing and loans, focusing on transactions with plan participants, namely loans and real estate financing. Segments are more complex and extensive, due to rules dividing each segment into different portfolios:

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<tr>
<th>SEGMENT</th>
<th>PORTFOLIOS</th>
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<tr>
<td>Fixed income:</td>
<td>Fixed income with low credit risk;</td>
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<tr>
<td></td>
<td>Fixed income with medium or high credit risk.</td>
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<tr>
<td>Variable income:</td>
<td>Stocks;</td>
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<td></td>
<td>Venture capital;</td>
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<td>Variable income – other assets.</td>
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<tr>
<td>Real Estate:</td>
<td>Real estate projects;</td>
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<td>Leasing and proceeds;</td>
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<td>Real estate investment funds;</td>
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<td>Real estate – other investments.</td>
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<tr>
<td>Loans and Financing:</td>
<td>Loans to plan participants;</td>
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<td></td>
<td>Real estate financing to plan participants.</td>
</tr>
</tbody>
</table>

Each segment is divided into different portfolios (mainly by different levels of risk) and regulations list permissible assets forming each portfolio and apply limits and ceilings within each of those portfolios. Moreover, there are several diversification requirements applicable to all segments.

In general, regulation of pension fund investments in Brazil are very stringent, although this can be justified by the early developing stage of

90. Resolution CMN 3034, arts. 4 & 10.
91. Corporations voluntarily commit themselves to high standards of corporate governance and disclosure that are much more demanding than those required by law. BOVESPA lists such companies in a different division, the so-called “New Market.”
the current market. This does not mean that private pension entities are not on pace with modern principles and techniques applicable to the pension industry. It only means that substantial growth is still expected. On the other hand, the set of rules set out by Law 109 on governance, disclosure, and supervision already creates an environment that permits a gradual softening of investment regulation toward a more flexible approach.

In addition, the rules mentioned above address issues related to restricted operations (such as foreign investments), registrations with CVM and clearinghouses, and specific requirements in connection with certain investment funds.

Foreign investments are generally not allowed. Resolutions CMN 2829 for closed funds, and CNSP 98/02 for open funds both expressly forbid foreign investments, though there are exceptions for cases allowed by CMN regulation. However, there is no permitted direct foreign investment in CMN and BACEN regulations.

There are only a few alternatives of investments linked to foreign currencies, subjected to very low ceilings: (i) *fundo de investimento no exterior* (FIEX) an investment fund with a portfolio formed by national and foreign securities; (ii) equity of corporations from MERCOSUR countries; and (iii) Brazilian depositary receipts (BDR) securities issued by foreign corporations, in which distribution has been authorised by CVM.

Thus, foreign investment alternatives for Brazilian pension funds are severely limited—practically non-existent. However, Brazilian needs for increasing national savings and investment in the domestic market are significant, therefore such a regulatory approach is justified.

### E. Funding Requirements

Brazilian private pension schemes are run by self-administered pension funds both in the open and closed segments. Employers may also seek group insurance mechanisms with an open pension fund (Law 109, articles 2 and 26). Articles 18 to 21 refer to closed pension fund funding rules:

Article 18: A funding plan that must be reviewed at least annually shall establish the level of contributions required to cover the fund’s obligations. At all times pension funds must be able to cover commitments they undertook, except for any exemptions made by regulatory and supervisory authorities in connection with this rule.\(^{92}\)

Article 19: This article addresses extraordinary contributions in the case of underfunding (sole paragraph, item II).

Article 20: Surpluses must be directed towards the constitution of a contingency reserve to guarantee benefits up to the limit of 25 percent of the total amount of the fund’s reserves. Amounts beyond such a limit

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92. This allows supervisors to require the utilization of approaches similar to ABO/PBO, as well as provide a level of flexibility for temporary limited under-funding in restricted circumstances.
must constitute another special reserve, which, if not used in three consecutive years, will implicate an obligatory revision of the pension plan.

Article 21: Deficits in pension plans or pension funds must be rectified by employers, employees, and beneficiaries using the same proportion of their usual contributions. This might be done by increasing contributions, creating additional ones, or reducing benefits to be granted.

Open funds must comply with solvency and liquidity margins, as established by CNSP and SUSEP. In addition, an open fund’s net worth has to be maintained at a level greater than its liabilities (Law 109, article 37, item III).

The provisions listed above are general guidelines to the principles discussed in section 1 above. Law 109 delegates to regulators and supervisors the burden of implementing complementary rules on several issues, including funding rules. However, not all of these delegations have been fully developed yet. Much of this task is left to the discretion of the supervisors on a case-by-case basis when exercising off-site and on-site supervision.

F. SOLVENCY MECHANISMS

Although not implemented, Law 109 foresees two solvency mechanisms: facultative reinsurance and solvency fund (article 11). Both instruments are aimed at assuring commitments assumed by pension funds with plan participants and beneficiaries. However, the impression left by article 11 is that not enough thought was put into drafting such provisions.

Open and closed pension funds may contract reinsurance to guarantee their obligations. In addition, regulators and supervisors may determine when reinsurance should be contracted.

The provision is silent as to the form of such reinsurance, which gives the impression that the draftsmen were certain that the market could develop such a product at a viable cost. As previously discussed, many countries have concluded that reinsurance is not a product that can be easily managed. In addition, it was not taken into consideration that Brazil has a very underdeveloped reinsurance market that only recently has gone through a very complex, slow, and bureaucratic process of privatization.

Solvency fund is foreseen in article 11 available to closed funds. No specification was made to ease the interpretation of this provision. One interpretation that could be drawn, although with uncertainty, is that this provision was indeed inspired by international experiences of plan termination insurance. This interpretation is taken from the fact the solvency fund is restricted to closed funds and such solvency fund must be instituted by law so that governmental involvement would be present.

In any case, the provision failed to assess that Brazilian pension funds are subjected to the funding rules mentioned above, which requires pension funds at all times to cover commitments they undertook, as well as to consider anti-moral hazard provisions. In fact, this issue might have not
been an issue for the draftsmen because such mechanisms are practically impossible to implement under the current BPPS and, as an obvious consequence, no inferior regulation in connection with this issue has been considered by regulators and supervisors.

G. Taxation

Several pieces of regulation apply to the taxation of Brazilian pension funds, from Law 109 and Laws 10.426/2002 and 10.431/2002 to complex regulations issued by the Federal Revenue and Customs Secretary (Secretaria da Receita Federal – SRF). In general, the three stages (contributions, funding, and benefits) are taxed as described below:

Contributions: Article 69 of Law 109 sets forth that employer and employee contributions to pension funds are deductible and exempt for income tax purposes. However, certain limits established by law must be observed. For instance, Decree 3000/99, the so-called income tax regulation (RIR), limits employee deductions of contributions made to pension plans to 12 percent of their total taxable income.

Funding: Income from investments and capital gains of sponsored pension plans is subject to regular income tax at the rates set by current legislation. Pension funds may also opt for a special regime of taxation, in which their income from investments and capital gains are taxed based on the results presented every quarter at a 20 percent rate. Individual plans are exempt from income tax (Provisional Measure 2222, dated September 4, 2001, Law 10431, dated April 24, 2002, and Ordinance SRF No. 126, dated January 25, 2002).

Benefits: Benefits are also subject to income tax above a certain limit (R$ 900.00 per month) at rates of 15 or 27.5 percent, depending on the amount of the monthly pension (RIR, articles 39, 620 and 633).

Therefore, sponsored funds have a significant tax burden. Indeed, taxation should apply to pension fund operations, however, plan participant funds should not be included, otherwise the constitution of long-term savings can be jeopardised seriously. The smaller the burden of taxation on plan member funds, the greater the reserves accumulated and the investments in the economy.93

Taxation on funding could persist in a system where qualifying criteria were implemented for favorable tax treatment. In other words, only funds that do not meet the qualifying criteria could be taxed on their income on investments and capital gains. This idea is based on the principles of U.S. pension law, which establish a series of conditions for a pension plan to be able to benefit from a tax favorable treatment.94

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While deductions and exemptions on contributions might be viewed as an incentive, taxation on funding may bring about a concern in connection with the costs of operating a pension fund, especially in connection with accumulating reserves or even constituting contingency reserves, therefore pushing away employer interests in offering such benefits to employees.

V. CONCLUSION

From the set of rules implemented to BPPS in the past five years it is easily observed that regulators have been following the development of concepts of financial security issues internationally. Financial security of the pension system is emphasized repeatedly and several concepts can be found in international studies, such as the ones utilized herein.

However, internationally accepted concepts were not always wisely implemented, since local considerations were not taken into account (e.g., the case of solvency mechanisms). Taxation also requires a revision, or at least an assessment, on the weight of the burden currently imposed to pension funding.

On the other hand, one has to admit that Brazilian regulation complies with good standards of security (at least overall), especially when considering the early developmental stage of BPPS. These good standards of security give rise to a conclusion that regulation is developing and will develop with the market accordingly.

Nonetheless, the main problems that slow down BPPS growth are more connected to the social and economic factors existent in the Brazilian economy than regulation itself. The low-income population and lack of a long-term savings oriented culture, resultant from a lack of confidence in the financial markets due to past experiences (e.g. confiscatory measures and high inflation), are the main barriers to BPPS expansion.