Pension Fund Investment Regulation: Prudent Person and Quantitative Limits Approaches
(Room Document N°25, Session 3)

Conference on Pension Reform in Russia:
From Legislation to Implementation
Russell Galer, OECD
Moscow, 24-26 October 2003
Outline of Presentation

- I. Background
- II. Prudent Person Rule
- III. Quantitative Limits
I. Background

- Amounts, allocations and investment performance of pension fund assets vary widely across OECD countries.
  - Depends on many factors, such as:
    - Age of the pension programs
    - Percent of population coverage
    - DB/DC
    - Asset regulation
    - Depth and performance of domestic markets
    - Demographic characteristics of pension fund
    - Impact on plan sponsor of funding and accounting rules
Background (cont’d)

- Trend is clearly towards defined contribution plans

  - In countries with less significant private plan legacy (Hungary, Mexico, Poland, . . . .)

- But also in countries with DB history (US, UK, Australia)
Goals of Regulating Pension Fund Asset Management

- First, prevent harm by providing boundaries
  - Program failure would have substantial cost
  - Remove inherent systemic risks, temptations, conflicts
  - Limit excessive risk-taking

- Second, provide a framework conducive to success
  - Encourage appropriate behaviours and processes
  - Enable investment appropriately balancing risk/return to meet plan obligations or otherwise assure outcomes appropriate for the pension program

- Third, produce other “exogenous” results
  - E.g. domestic markets; SRI/ETI
Two Basic Approaches to Regulation

- Prudent Person Rule
  - Establish a broadly applied *behavioural standard* applicable to the manner in which pension funds are managed and to the inv. mgmt. process

- Quantitative Limitations
  - Place numerical boundaries on investment by asset class
  - Assuming the limits are not excessively restrictive, *there remains substantial discretion*.

- Under both regulatory approaches, pension fund governance is extremely important.
Prudent Person Rule or Quantitative Limits?

- Trending towards prudent person rule
  - Anglo-American jurisdictions
  - EU Directive
  - Tendency to reducing quantitative constraints

- Which countries may be more likely to retain quantitative limits?
  - Newer security markets and professional asset management industries
  - Mandatory systems with individual risk-bearing
  - Insurance-oriented systems (technical requirements)
II. Prudent Person Rule

- The basic rule:

  “A pension fund manager must discharge his/her duties with the care, skill, prudence and diligence that a prudent person (or expert) acting in a like capacity would use in the conduct of a similar enterprise of like character and aims.”

- Behaviour-oriented; fund-specific
Prudent Person Rule = Procedural Prudence

- Compliance with PPR is judged by reviewing the means rather than end results alone. The relevant questions focus on the management process:

  - **How** was the investment decision made?

  - Did the governing parties (trustee, board, fund managers) go about the business of managing the pension fund in a way that other similarly-situated, responsible, prudent parties would have?

  - If they did not, did they proceed prudently by diligently considering the reasons for departing from the norm – in light of the particular circumstances of their pension fund?
Prudent Person Rule = Procedural Prudence

- The focus of regulation is not “what” is decided, but “how” it is decided and how it is implemented.
  - Due diligence and due care
  - Rigorous decision-making and review processes
  - Clear and thorough documentation
  - Delegation to or consultation with experts when appropriate
  - Monitoring and review of those to whom responsibilities were delegated
PPR – Some Key Elements

- Duty of Loyalty (affirmative duty; bar against entering conflict situations)
- Principle of Diversification
- Avoidance of undue risk
- Benchmarking Against Industry Standards and Customary Practices
- Segregation of Assets
PPR Corollaries – examples [* = EU Directive]

- *Act in best or exclusive interest or for sole benefit of members; act under duty of loyalty
- Assure adequate liquidity corresponding to fund needs
- *Diversify portfolio
- *Avoid single-issue concentration
- Avoid undue risk; balance security and profitability
- *“Ensure security, quality, liquidity and profitability of the portfolio as a whole”
- *Avoid or limit conflicts of interest and self-dealing
- Limit/prohibit *loans, leverage, *derivatives
- ‘Match’ nature of assets held with nature of liabilities (ALM) [*Directive technical provisions]
- *Asset segregation/custody/trust/ring-fencing
- *Create written investment policy
Benefits of PPR?

- Fund-specific
- Accommodates shifting understanding of investment and risk management
- Relies on industry standards and best practices
- Encourages use of professionals and experts
III. Quantitative Limits Approach

establishes numerically boundaries applied to specific classes of investments

- Domestic assets (gov’t. securities, equity, bonds, real estate, venture capital, etc.)
- International/Foreign Investment (direct limits, currency matching)
- Minimum Diversification
- Ownership Concentration
- Conflict of Interest/Self Investment (employer stock; loans to sponsoring firm/employer or investment manager)
- Ceilings vs. floors (floors, i.e., requiring amounts to be invested in a given asset class, are generally avoided)
QL Rules: “One-size-fits-all” asset allocation?

- State determines the initial allocation parameters for all pension funds.
  - *Cf., PPR* – The fund’s governing body makes this determination
- But are parameters too hot, too cold, or just right?
  - Too loose? No one is constrained; the rule is ineffective.
  - Too restrictive? Fund managers are significantly constrained; the rule ignores particularities of each fund, limits ability to harness professional expertise; undermines competition based on performance.
  - “Just right”? Extremists and outliers constrained; but may prevent some from implementing unique, but responsible, strategies.
- Are QLs alone a sufficient regulatory mechanism?
QL rules are silent about how to conduct the investment management function within the established numerical boundaries.

Pension fund managers still must:
- Determine an overall investment policy;
- Establish asset allocation strategy (within the given parameters);
- Select investment managers (internal/external?) and/or pick individual securities themselves (“stock-picking”);
- Execute trades;
- Etc.
As a result, QL jurisdictions use qualitative ‘corollaries’

- **Italy:**
  - Sole interest of members;
  - Investment policy;
  - Diversification principle;
  - Avoid single company concentration;
    - Efficient resource management (contain and minimize transaction and management costs);
  - Governing body monitoring obligation;
  - 3rd party depository;
  - Use of professional investment managers [Fondi pensione negoziali (FPN)]
As a result QL jurisdictions use ‘corollaries’ too

- Poland:
  - Sole purpose rule;
  - Investment policy to include “investment rules and standards” and 3-year financial plan;
  - Obligation to invest with eye to both security and profit efficiency;
  - Self-investment prohibitions;
  - Permissive delegation to external portfolio manager
As a result QL jurisdictions use ‘corollaries’ too

- Slovak Republic [Supp. Pension Insur. Co.s (SPICs)]
  - Principle of careful and rational persons;
  - 1-year and 5-year financial plan and investment strategy;
  - Liquidity requirement;
  - Self-investment prohibition;
  - Independent custodian
Conclusion: PPR & QLR rely on fund governance

- The investment management function is extremely complex. PPR and QL approaches both leave substantial discretion to the pension fund

- Determine investment policy in light of overall risk preferences, anticipated liquidity needs, contribution expectations, and long and short term plan obligations
- Establish asset allocation parameters of portfolio
- Consider role of alternative asset classes
- Consider investment style/techniques (passive/active; growth/value, etc.)
- Investment manager selection (internal/external)
- Individual security selection (stock-picking)
- Conducting necessary transactions (buy/sell; best execution)
- Consider fees and other costs
- Monitor and review of performance (benchmarking, etc.)
- Reassessment of overall policy
Thank You