Pension Fund Investment Regulation: Prudent Person and Quantitative Limits Approaches

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From Legislation to Implementation

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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 <u>care, skill, prudence and diligence</u> that a <u>prudent person (or expert) acting in a like capacity</u> would use in the conduct of a <u>similar enterprise of like character and aims</u>.”
    - 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 <u>investment policy</u> in light of overall risk preferences, anticipated liquidity needs, contribution expectations, and long and short term plan obligations
  - Establish <u>asset allocation parameters</u> of portfolio
  - Consider role of alternative asset classes
  - Consider investment style/techniques (passive/active; growth/value, etc.)
  - <u>Investment manager selection</u> (internal/external)
  - <u>Individual security selection</u> (stock-picking)
  - Conducting necessary transactions (buy/sell; best execution)
  - Consider fees and other costs
  - <u>Monitor and review</u> of performance (benchmarking, etc.)
  - <u>Reassessment of overall policy</u>

Thank You