Second OECD Conference on Private Pensions in Brazil

Investment Regulation : The Prudent Person Approach To Pension Asset Management

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Structure of Presentation

- OECD Work on Pension Asset Management
- Goals of Regulation of Pension Asset Management
- Quantitative Limits Approach (briefly)
- Prudent Person Rule (PPR) Approach
- Comparing Investment Performance
- Application to Individually-Directed Occupational Plans
- The Role of Fund Governance: The Process of Investment Management
- Impact of PPR Approach on Supervisory Activity

OECD’s work on pension asset management

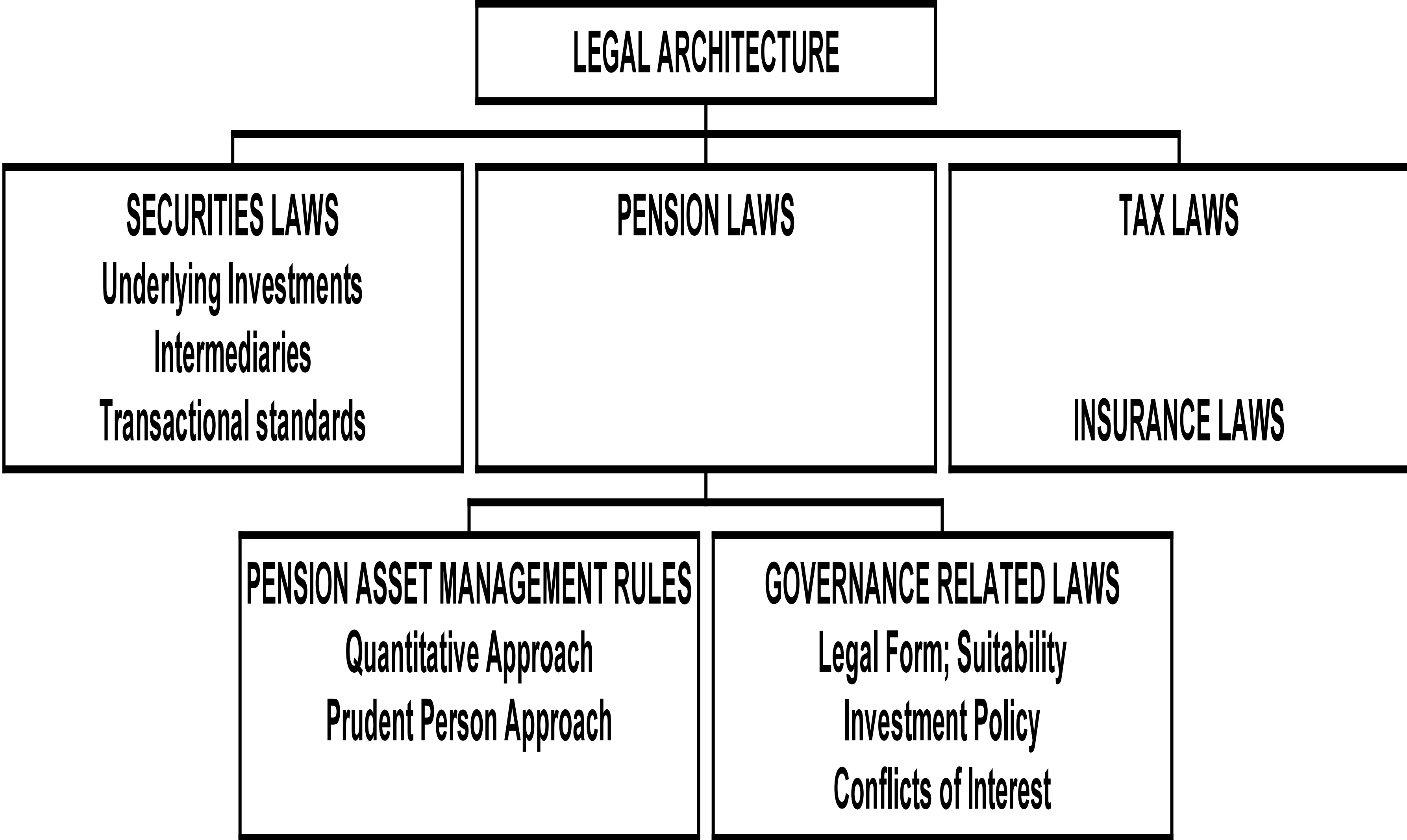
- Generally:
    - Working Party on Private Pensions
    - Principles; Standards/Assessment Template (FSAP - IMF/World Bank)
    - International Network of Pension Regulators & Supervisors (INPRS)

- Standards/Principles arise from survey work and data collection, policy analysis and delegate review, consideration and debate

- On-going work re: pension investment management
    - Quantitative rules/prudent person rule
    - Fund governance
    - Pension fund investment management process
    - Funding standards

The Goals of Regulation of Pension Asset Management

- First, prevent harm by providing boundaries
  - substantial costs associated with program failure
  - remove inherent systemic temptations/conflicts
  - limit excessive risk taking
- Second, provide a framework conducive to success
  - encourage appropriate behaviors and processes
  - enable wise investments
- Third, produce other "good" results
  - reflect policy matters exogenous to pension program


LEGAL ARCHITECTURE
SECURITIES LAWS
Underlying Investments
Intermediaries
Transactional standards
PENSION LAWS
TAX LAWS
INSURANCE LAWS
PENSION ASSET MANAGEMENT RULES
Quantitative Approach
Prudent Person Approach
GOVERNANCE RELATED LAWS
Legal Form; Suitability
Investment Policy
Conflicts of Interest

Two Basic Approaches

Quantitative Limits

Prudent Person Rule

-- and also "Combined Approach"

- "prudent person plus"

Quantitative Rules

establish the numerically boundaries of classes of investments

- Asset Class (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)
- Ceilings vs. floors

- Please see OECD Secretariat's background paper for precise data on OECD countries

The Prudent Person Rule ("PPR")

establishes a broadly applicable behavioural standard that can be applied to the process by which investment management decisions are made

"A fiduciary must discharge his/her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims."

Origins/Background: PPR

- Anglo-Saxon Common Law (actions in ‘equity’)
  - Judicial Standard: situation-specific, factual analysis
  - “Most elusive concept in Anglo-American law” ?
  - Trust Law
- A standard for those “entrusted” with powers to be used in the interest of others - e.g., those taking care of other people’s money and other property
  - stringent standard: “Highest known to the law” (US courts)
  - language of moral duty and obligation
- Economic Analysis: Resolution of “Agency” Problem
  - method of aligning the interests of the parties

Origins/Background: PPR

- Fiduciary relationships arise outside traditional “trust” context, including business/ financial contexts.
  - E.g., corporate directors / s-holders; mutual fund board / investors
  - As a result:
    - Legal form used can vary: trust, contract, corporate
    - The precise contours of the substantive rule can vary
- With respect to pensions, more recently rules have been codified in the form of statutory law
  - E.g., UK1995; US 1974
  - but judiciary still plays an important role in application of the rule to fact-specific circumstances

PPR - Key Elements

- Segregation of Assets
- Process: “Procedural Prudence” relies on fund governance
  - Due Diligence and Due Care
  - Decision-making and Review Processes
  - Documentation
  - Delegation: Skill and/or obtain appropriate assistance or delegation
  - Duty to Monitor
- Duty of Loyalty (affirmative duty)
  - plus strict prohibitions: rules preventing situations giving rise to conflicts of interest
- Principle of Diversification
  - Prudent Management
  - Avoidance of Undue Risk
- Role of Industry Standards and Customary Practices

PPR - Variation in rule

- Rule applicable in numerous contexts
  - E.g., corporate, private trust, pension trust
- Historical variation in application/interpretation - Examples
  - “avoidance of undue risk” in investment
    - preservation of nominal value / inflation-protection
    - equities inherently riskier or not
    - investment-by-investment analysis of risk/whole portfolio approach
    - Why? Shifting understands of risk and risk management; development of securities markets
  - “delegation” of responsibilities/tasks
    - Not allowed [traditional rule]
    - Permitted [current trend]
  - “level of skill”
    - ordinary person (UK)
    - prudent expert (US)

PPR and Quantitative Approaches Are Not Mutually Exclusive

- PPR-type countries use quantitative limits to address
  - e.g.,
    - most egregious matters (self-investment, unregulated markets),
    - concerns regarding liquidity of an asset class (real estate) or
    - underdeveloped/developing investment mgmt. industry or markets,
    - policy concerns exogenous to pension fund investment performance (international investment limitations).

- In Quantitative Rule jurisdictions, pension fund governors need standards/guidance for how to manage assets, establish precise asset allocations and invest within each asset class -- even in the presence of a set of rigorous quantitative limitations.

Some Pros and Cons: PPR

Pros

• Supervisor is able to rely on fund governance

• Plan/fund specific

• Flexibility to address changing market conditions or fund-specific change

• May encourage fund differentiation (e.g. by investment style)

• Accommodates current standard investment theory and practice

• Regulators can intervene to provide necessary guidance: given sufficient legal liability concerns, industry is quite responsive

Cons

• Supervisor **must** rely on fund governance; internal processes and controls may be difficult to regulate and monitor

• May encourage inappropriately aggressive investments; "short-term-ism" (but evidence suggests not)

• Evidence of 'herding' -

    •see OECD background paper

• But for "industry practice" there may be little guidance to fund managers

Comparing Investment Performance: PPR vs. Quantitative Limits

- Data appears suggestive of better performance under PPR approach

- But studies of fund performance under PPR suggest
  - “herding”around benchmarks (-)
  - cautionary behavior (+)
  - *See studies cited in OECD background materials*

- Is Rate of Return the only appropriate measure of a successful regulatory regime?
  - See slide 4 on “goals of regulation”: First, “prevent harm”

- Comparison is difficult and may be misleading

Comparing Investment Performance (2)

- How do you classify countries with relatively non-binding quantitative limits?
  - A review of country data indicates that in many cases established limits appear not to ‘bind’ as they are substantially higher than average allocations to the asset classes with limits.
  - Are pension asset managers in such cases acting in accordance with some implicit rule of prudence with respect to their portfolio management functions?

- Portfolios and Investment returns reflect a number of factors:
  - Time horizon in which returns measured
  - Home markets:
    - Available investment products in “home” markets
    - Market cycle variation
  - Fund maturity; need for liquidity
  - Asset-liability management approach
  - Accountancy rules
  - Minimum funding rules
  - Legal caps on investment return; guaranteed return rules

Application to Occupational Individually-Directed Plans

- The role of the prudent fiduciary (US)
  - Important role for fiduciary as intermediary:
    - Selection and monitoring of available investment options and service providers
    - Disclosure; education; investment advice
    - Use of intermediary may reduce need for other regulation
      - Cf. Fund regulation for "Chilean" type programs
  - Enron: A brief diversion -
    - Was the intermediary prudent?
    - A lesson on self-investment?
    - The mixed motives of voluntary, occupational plan formation
- A role for quantitative limits?
  - an awkward 'fit' for individually- directed plans
    - Debate re: Enron-related legislative proposals

The Role of Fund Governance: The Process of Managing Investment Management (1)

- Relevant for BOTH approaches to regulation

- Governance/Process is the cornerstone of successful application of the Prudent Person Rule

- Although often overlooked, Governance/Process is also central to investment management under a Quantitative Limits Approach
  - Quant. limits regulation takes away only one part of the fund manager's task -- the basic asset allocation decision
    - Even so, cross-country data indicates that limits often do not significantly limit the need to make decisions at this level.

The Process of Investment Management (2)
Basic Elements

- 1. Suitability of governing/responsible parties
- 2. Clear designation of responsibilities and liabilities
- 3. Statement of Investment (and Funding) Policy
    - identify objectives, broad strategy
    - identify investment performance expectations/needs
    - establish standards/method of review
    - expectations/method to assess relevant fees/costs
    - establish roles as needed for other parties (auditors, actuaries, consultants, asset managers and their mandates)
- 4. Implementation Plan
- 5. Monitoring Process
- 6. Assessment and Revision

Supervision: Prudent Person Rule

-PPR reliance on governance has significant implications for supervision

- Governance: Assure strong governance mechanisms

- Reporting: Establish reporting and valuation rules

- Examination: Establish a method to identify aberrant behavior and unusual investment patterns (unusual allocation; trading volume; performance volatility)

- Corrections/Penalties: Establish rules to address violations
    - Methods of measuring harm, making corrections, assessing penalties

- Additional Avenues For Monitoring: Consider role of courts; participants, members, customers; service providers.

Concluding Remarks

- In its two paradigmatic forms - the prudent person and quantitative limit approaches (each alone or combined) - legal architecture serves an important function: It frames the investment management activity, by:
  - (1) circumscribing what policy makers view as unacceptable practices,
  - (2) directing attention of asset managers to certain rules of behavior or process, and
  - (3) moving investment managers to consider certain types of investments they may not have otherwise considered.

- In doing so, it can significantly influence pension asset investment management practices, portfolios and returns.

- The type of rule has impact on nature of the supervisory function.

- Both the prudent person and quantitative limit approaches require pension fund managers to have a robust governance structure to establish, manage, monitor the investment management process.
  - The prudent person approach makes this need somewhat more transparent.