

III Conference on Insurance Regulation and Supervision in Latin America

Corporate Governance, Investment Regulation and the Prudent Person Rule

Juan Yermo, OECD

San Pedro Sula, Honduras, 15-18 July, 2002

Structure of Presentation

- OECD Work on asset management
- Goals of Regulation of Asset Management
- The Governance of the Investment Management Process
- Quantitative Investment Rules
- Prudent Person Rule (PPR) Approach
- The PPR for US pension funds
- Impact of PPR Approach on Supervisory Activity

OECD's work on asset management

- Generally:
 - Insurance Committee
 - Working Party on Private Pensions and 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

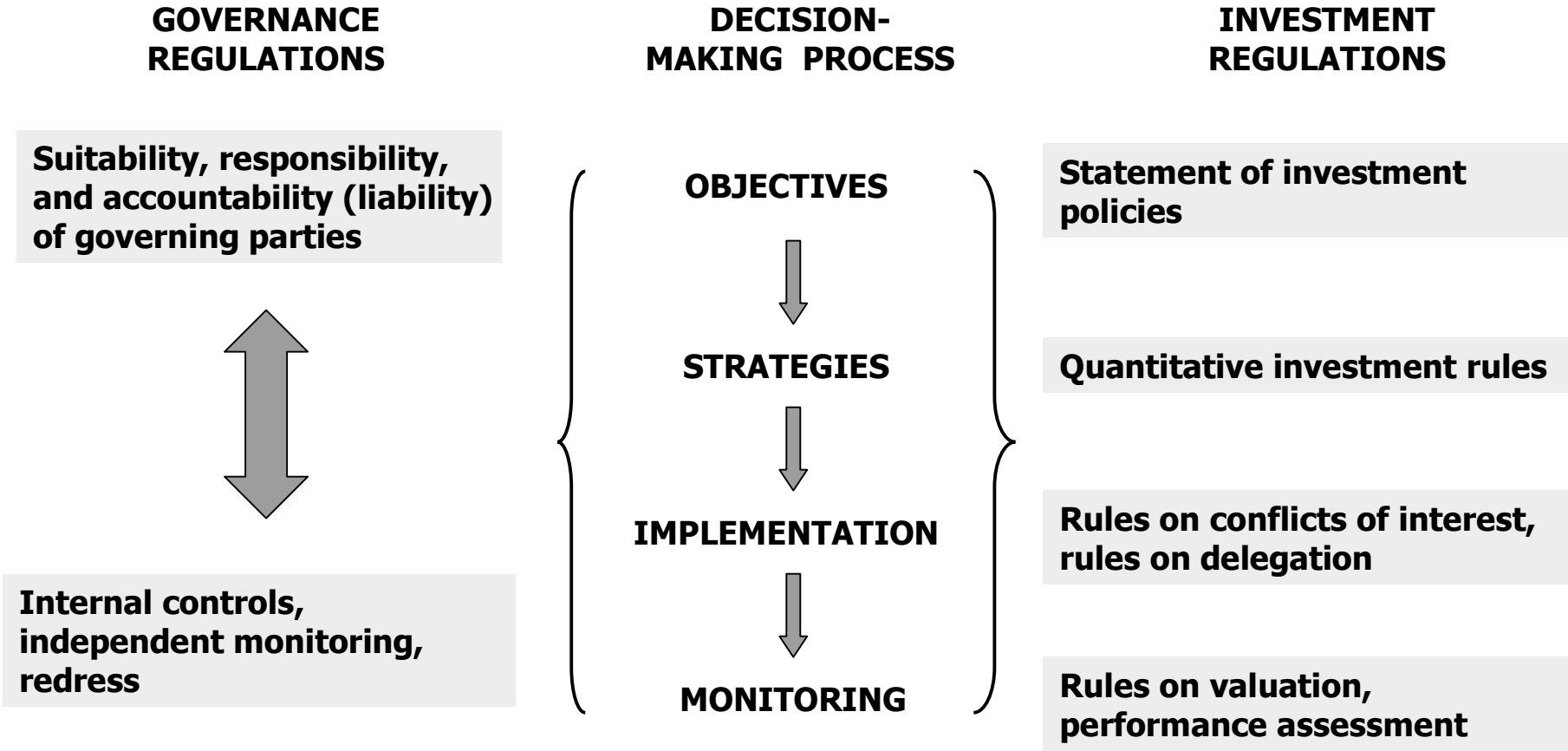
The Goals of Regulation of Asset Management

- 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 program

The Process of Investment Management: Decision-making process

- 1. Objectives:
 - Asset liability matching (traditional life insurance, annuities, and DB pension funds)
 - Return maximisation given acceptable level of risk (unit linked / variable annuities, accumulation based life insurance, DC pension funds)
 - Diversification (across securities, but across asset classes depends on liabilities)
- 2. 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)
- 3. Implementation Plan
- 4. Monitoring Process
- 5. Assessment and Revision

The Process of Investment Management



What is the Prudent Person Rule?

“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.”

What is the role of the PPR in the investment management process?

- The PPR sets out:
 - the fiduciary responsibility of the governing parties
 - the legal liability and therefore the “accountability” of the governing parties
- The PPR requires:
 - a definition of what is prudent in specific circumstances
 - a method for redress
- Hence the PPR has aspects of both governance and investment regulation: ultimate objective is the resolution of an “agency” problem
 - method of aligning the interests of the parties

Origins of the PPR: the Anglo-Saxon approach

- Identify **fiduciary responsibility and liability** 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
- Fiduciary standard refined in trust law (adopted by pension funds, bank trusts)
- Fiduciary relationships arise outside traditional “trust” context, including business/ financial contexts (e.g. corporate directors vs shareholders; mutual fund board / investors).

PPR - Key Elements

- Segregation of Assets
- Fiduciary liability
- Duties of asset manager arising as a result of his/her fiduciary responsibility (interpreted by courts or/and set out in statutes)
- Court-based redress

Example: The PPR for US pension funds

- Segregation of Assets (trust)
- Fiduciaries are personally liable for mismanagement
- Duty of “Loyalty”: exclusive purpose rule, tying interest of the asset manager to the client (fiduciary responsibility)
- Duties of “Prudence”:
 - Diversification
 - Due diligence and due care: documentation, delegation (skill and/or obtain appropriate assistance or delegation), internal controls, independent monitoring
 - Shareholder activism
- Department of Labour can sanction application of the PPR but judiciary still plays a central role in application of the rule to fact-specific circumstances

Quantitative investment rules

can be used to establish the boundaries of “prudence”

- Diversification objectives
 - Limits on single securities or issuers
 - Limits by asset class (volatile asset classes such as equities, junk bonds, real estate, venture capital, foreign securities, etc.) – ***but optimal extent of diversification is entity-specific, depends on the entity’s liabilities!!***
- Liquidity objectives
 - Limits on asset classes of low liquidity such as real estate (more relevant for life insurance than pension funds because of early surrender risk)
- Conflicts of Interest objectives
 - Limits on Self Investment (Employer Stock, Loans)
- Corporate governance objectives
 - Ownership concentration limits
- Ceilings vs. floors

PPR and Quantitative Investment Regulations

- Quantitative rules reduce extent of discretion to interpret “prudence” in asset allocation
- Other aspects of PPR still valid: Asset managers still 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.
- Anglo-Saxon countries use quantitative limits to address:
 - 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).

PPR and risk-based supervision

- Stress testing, VAR and other risk management assessments techniques can be adopted in a modern application of the PPR
- Preventive measures (supervision) preferable to corrective measures (redress through courts), but may not always be feasible (e.g. occupational pension funds)
- For risk-based supervision, need to endow authority with strong sanctioning powers.
- Risk-based supervision helps meet both prudential and consumer protection objectives
- Risk-based supervision makes most quantitative restrictions obsolete

Implications of the PPR for institutional investors

- The PPR establishes a broadly applicable behavioural standard that can be applied to the process by which investment management decisions are made in:
 - Pension funds
 - Mutual funds
 - Savings plans (bank trusts, non-insurance contracts)
- In insurance contracts, assets are the property of the insurance company (contrast with pension funds, despite similarity of product). But what about:
 - With profit life insurance/annuity policies
 - Unit-linked life insurance/annuity policies

Some Pros and Cons: PPR

Pros

- Supervisor is able to rely on fund governance
- Entity specific
- Flexibility to address changing market conditions or entity-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’
- But for “industry practice” there may be little guidance to fund managers

Concluding Remarks

- The prudent person and its supporting legal architecture 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 asset management practices, investment portfolios and returns.
- The type of rule has impact on nature of the supervisory function.
- Irrespective of the presence of quantitative rules, robust governance structures and mechanisms are needed to establish, manage, and monitor the investment management process.
 - The prudent person approach makes this need somewhat more transparent.