

## **FIFTEEN PRINCIPLES FOR THE REGULATION OF PRIVATE OCCUPATIONAL PENSIONS SCHEMES**

### **Adequate regulatory framework**

Principle N°1: An adequate regulatory framework for private pensions should be enforced in a comprehensive, dynamic and flexible way (taking into account the complexity of the schemes) in order to ensure the protection of pensions plans beneficiaries, the soundness of pensions funds and the stability of the economy as a whole. This framework should however not provide excessive burden on pensions markets, institutions, or employers.

### **Appropriate regulation of financial markets**

Principle N°2: A productive, diversified investment of retirement savings which spreads risk requires well-functioning capital markets and financial institutions. The development of advance-funded pension systems should go hand-in-hand with a strengthening of the financial market infrastructure and regulatory framework (including the development of new financial instruments and new markets such as inflation-indexed markets and the improved functioning of retirement annuity markets).

### **Rights of the beneficiaries**

Principle N°3: Non-discriminatory access should be granted to private pensions schemes. Regulation should aim at avoiding exclusions based on age, salary, gender, period of service, terms of employment, part-time employment, and civil status. It should also promote the protection of vested rights and proper entitlement process, as regard to contributions from both employees and employers. Policies for indexation should be encouraged. Portability of pensions rights is essential when professional mobility is promoted. Mechanisms for the protection of beneficiaries in case of early departure, especially when membership is not voluntary, should be encouraged.

### **Adequacy of the private schemes**

Principle N°4: Proper assessment of adequacy of private schemes (risks, benefits, coverage) should be promoted, especially when these schemes play a public role, through substitution or substantial complementary function to public schemes and when they are mandatory. Adequacy should be evaluated taking into account the various sources of retirement income (tax-and-transfer systems, advance-funded systems, private savings and earnings).

## **Regulatory system and separation**

Principle N°5: An institutional and functional system of adequate legal, accounting, technical, financial, and managerial criteria should apply to pensions funds and plans, jointly or separately, but without excessive administrative burden. The pension fund must be legally separated from the sponsor (or at least such separation must be irrevocably guaranteed through appropriate mechanisms).

## **Funding**

Principle N°6: 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.

## **Calculation Techniques**

Principles N°7: Appropriate calculation methods for asset valuation and liabilities funding, including actuarial techniques and amortisation rules must be set up and based on transparent and comparable standards. Increased reliance on modern and effective risk management, industry-wide risk management standards for pension funds and other institutions involved in the provision of retirement income should be promoted. The development of asset liability management techniques should be given proper consideration.

## **Supervisory structures**

Principle N°8: Effective supervision of pension funds and plans must be set-up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent miss-selling cases arising from irregularities in the distribution and expenses methods.

## **Self-supervision**

Principle N° 9: Self-regulation and self-supervision should be encouraged. The role of independent actuaries, custodian services and internal independent supervisory boards should be promoted within an appropriate regulatory framework.

### **Fair competition**

Principle N°10: Regulation should promote a level playing field between the different operators and take account of the usefulness of a functional approach. The fair competition should benefit to the consumers and allow for the development of adequate private pensions markets

### **Investment**

Principle N°11: Investment by pension funds should be adequately regulated (see selected principles for regulation of investments by insurance companies and pension funds in Annex). This includes the need for an integrated assets/liabilities approach, for both institutional and functional approaches, and the consideration of principles related to diversification, dispersion, and maturity and currency matching. Quantitative regulations, and prudent-person principles should be carefully assessed, having regard to both the security and profitability objectives of pension funds. Self-investment should be limited, unless appropriate safeguards exist. Liberalisation of investment abroad by pension funds should be promoted, subject to prudent management principles.

### **Insurance mechanisms**

Principle N°12: The need for insolvency insurance and/or other guarantee schemes has to be properly evaluated. These mechanisms may be recommended in some cases but in an adequate framework. Recourse to insurance mechanisms (group and reinsurance) may be promoted.

### **Winding-up**

Principle N°13: Proper winding-up mechanisms should be put in place. Arrangements (including, where necessary, priority creditors' rights for pension funds) should be put in place to ensure that contributions owed to the fund by the employer are paid in the event of his insolvency, in accordance with national laws.

### **Disclosure and education**

Principle N°14: Appropriate disclosure and education should be promoted as regards respective costs and benefits characteristics of pensions 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 pensions plans that offer individual choice.

### **Corporate governance**

Principle N°15: The corporate governance role and capacity of pension funds should be considered. This includes: the role of guidelines (statutory or voluntary) for governance activities; the impact of shareholder activism by pension funds on corporate behaviour; and the governance of pension funds themselves and the role of trustees.

## ANNEX

### SELECTED PRINCIPLES FOR THE REGULATION OF INVESTMENTS BY INSURANCE COMPANIES AND PENSION FUNDS

#### **Preliminary remarks**

1. The following principles have been discussed by the OECD Insurance Committee and approved at the occasion of its June 1999 meeting. This list is not intended to be exhaustive. The principles identified herein are applicable to investments corresponding to the technical commitments of insurance companies and pension funds, and to the portion of share capital or surplus that is included when computing solvency margins or mandatory guarantees. Aspects more specifically related to foreign investments are not addressed here but are dealt with in OECD Codes related work.

#### **A. GENERAL FRAMEWORK**

##### *Objectives*

2. The regulation of investments must simultaneously pursue the twin goals of the security and profitability of the funds invested, i.e. they must guarantee commitments but generate financial income as well. Regulations that promote only one of these objectives would not be effective.

##### *Integrated approach*

3. The regulation of insurance company and pension fund investments must be integrated in the overall approach towards financial soundness of the firms involved and focus on assets and liabilities alike (as well as on regulations relating thereto). In this regard, investment regulation must be concerned with the risks inherent both in the investments themselves and in the commitments that those investments are intended to cover. It must, in particular, take into consideration the provisions which regulate these commitments and be adapted consequently.

##### *Institutional and functional approach*

4. The regulation of investments must incorporate both institutional and functional considerations. While regulation inevitably takes place within an institutional context, it must focus as closely as possible on the liabilities being covered (by these investments), their characteristics and, in particular, their maturities and thus promote a functional approach.

5. A functional approach can reduce distortions of competition, but it can also tailor regulations more closely to product characteristics and especially to contractual guarantees (with regard to returns, interest rates, indexation, surrender values, etc.), maturities, payout terms (as annuities or lump sums), and so on. It is useful to be able, one way or another, to distinguish between investments that correspond to contracts involving, for example, defined benefits or defined contributions, guaranteed or non-guaranteed interest rates, investment responsibility that lies with the contract-holder or the financial institution, second- or third-pillar schemes, insurance products that do or do not include profit-sharing, linked or not to investment funds, with or without minimum surrender values, etc. It would also be useful to make distinctions based on a fund's degree of maturity, which, *inter alia*, plays an important role in determining how liquid investments should be.

6. The functional approach must, however, be seen in the proper perspective, i.e. from the standpoint of the institution making the investment. While it is necessary to minimise regulatory distortions that could affect the offer of similar products by two different institutions, it is also important to take a comprehensive view of the structure and range of other risks to which a given institution is exposed. It is essential that the two approaches—institutional and functional—be linked.

### ***Regulatory coverage***

7. Regulatory provisions should be differentiated, distinguishing between investments that correspond to liabilities (technical provisions) or to the capital/surplus base (and, within that base, between funds that count towards solvency ratios or guaranteed minima and “other free funds”). Theoretically, investments corresponding to the “free” component of capital/surplus need not be regulated, or at least not in the same manner.

### ***Regulation and internal controls***

8. A regulatory framework is necessary. The economic, social and financial importance of the investments of insurance companies and pension funds requires the existence of legal rules and, in the absence of sufficient guarantees, does not enable the organisation of such regulations to be delegated entirely to these economic agents.

9. This being said, the volume of regulation must be limited, and the insurance and pension industries should be encouraged to set up appropriate systems of internal controls. Assessing the adequacy of such systems is a matter for government.

## **B. INVESTMENT RULES**

### ***Basic principles***

10. Whatever the instrument used to set in place a prudent investment policy (quantitative restrictions and/or prudent-person rules<sup>1</sup>), it is important that there be strict adherence to the following basic principles:

- diversification and dispersion<sup>2</sup>;
- maturity matching (including the liquidity principle);
- currency matching, in the broad sense.

### *Quantitative regulations*

11. No minimum level of investment should be prescribed for any given category of investment, except on an exceptional and temporary basis and for compelling prudential reasons.

12. “Maximum” levels of investment by category may be justified on prudential grounds<sup>3</sup>; in that case, it may be advisable to:

- allow firms to exceed such ceilings under certain conditions (e.g. time limits) and possibly subject to prior authorisation by the competent authorities;
- differentiate between maxima, depending on whether or not they are included in solvency calculations, and allow ceilings to be exceeded on the basis of that differentiation<sup>4</sup>;
- take account of how investments are valued, and of the actual impact of that valuation on the quantitative restrictions<sup>5</sup>.

13. Investment in a given asset must be limited as a proportion of the insurance company or pension fund’s total portfolio. If an investment involves special risks, it can also be limited as such, in relation with its importance<sup>6</sup>. This applies in particular to cases of self-investment, in which a pension fund invests in shares in its parent company (and affiliated companies)—investments which should be strictly limited (the recommended maximum being 5-10 per cent).

14. It is recommended that a list of admitted/recommended assets be drawn up (possibly at a broad level only). Such a list could be exhaustive and compulsory. It could also be optional, but in that case there should be the possibility to legally require the firm to justify any substantial deviation from the list.

15. Certain categories of investments may be strictly limited (as for instance loans without appropriate guarantee, unquoted shares, company’s shares which raise major risks of conflicts of interest). In that case, it may also be relevant to set limits on investment by insurance companies and pension funds in companies (or investment vehicles) holding a large volume of such categories of assets.

16. With internationalisation and economic globalisation, the rules related to the place in which investments should be located are steadily losing their operational significance. Even so, the authorities should receive guarantees that investments can be recovered. Other measures should prevent any unlawful appropriation of funds.

17. The use of financial derivatives as a management instrument may prove useful and effective if it is done in a prudent fashion. Specific rules need to be established in order to ensure that their use is consistent with appropriate risk-management systems. The use of derivatives that involve the possibility of unlimited commitments should be strictly limited, if not prohibited.

18. Currency matching is a basic principle of investment management, but one that must be approached comprehensively<sup>7</sup>. Derivatives may be used for this purpose if they help to achieve such a match.

19. A wide range of methods are used to value investments, and it would be advisable to enhance their compatibility and comparability. Apart from methodological convergence, it is crucial to seek maximum transparency. In this regard, it is recommended that the use of any one method be accompanied by disclosure of the results that would have been obtained using the main alternative methods<sup>5</sup>. It is essential that valuation be incorporated into investment regulations in order to prevent unexpected cumulative or clashing effects.

20. Matching the maturities of assets and liabilities is essential, and it requires that a framework of general principles be instituted. In this regard it is important that the regulation of the investment portfolio takes the portfolio of commitments into account. The maturity of pension funds plays a key role in the investment strategies. The matching may, on the other side, be heavily influenced by various issues which affect the actual maturity of the products, for instance in insurance: surrender values, taxation of early exits, etc. The regulation of investments should integrate further the techniques related to assets/liabilities management (ALM).

21. Appropriate and compatible accounting methods must be set up so that information about investments is sufficiently transparent. Appropriate mechanisms for periodic statements by funds managers may also be considered.

### ***Prudent-person principles***

22. It may be useful to consider further the prudent-person principles (or even better, the prudent expert concept, which underlines the need for genuine expertise as well as prudent conduct). These principles could, when the authorities deem them adequate, make it possible to reduce the number of quantitative regulations. There are certain prerequisites to their implementation, however, including government confidence in the internal systems for investment management and control instituted by the insurance and private pension industries.

23. Whatever principles a firm may adopt, there must be competent and honest managers to apply them. It is therefore essential to take every possible step to ensure an adequate level of ability and integrity, using strict criteria that are comparable from one firm to another. The authorities ought to adopt criteria concerning the expertise that is required of investment managers.

24. Insofar as prudent-person principles are applied and quantitative rules eased, greater financial and legal responsibility should be attached to any imprudent transactions by corporate officers who abuse the freedom conferred by the application of these principles. The company must justify the existence of appropriate structures to control decisions taken on the basis of the “prudent person principle”, for instance through the nomination of another qualified person within the board or the executive staff.

25. While the development of prudent-person principles can be admitted, insofar as it is possible given the characteristics of the relevant insurance and private pension industry, these principles should nevertheless be incorporated into an appropriate regulatory framework. Such a framework should provide a minimal body of rules, the extent of which would vary according to the aforementioned characteristics.

26. The modalities of application of current prudent-person principles may not be sufficiently precise, which could result in imprudent attitudes. These principles—or at least the interpretation thereof—may also vary substantially from one country, sector or company to another. It would be useful to define a common but flexible general framework for such rules that could serve as a model and a basis for formulating rules that are more specific and better suited to individual cases, countries or sectors. The framework of prudential rules should take account of the differences that exist between today’s institutions, operations and regulations.

*Implementation of the principles.*

27. The implementation of these principles must take into account the existing related international agreements.

**NOTES**

- 
1. It is important to avoid confusion between “prudent person” rules and “prudential” rules which encompass any rules (quantitatives, prudent person, etc.) whose objectives are, in particular, the promotion of financial security of concerned operators.
  2. Diversification: breakdown between categories; dispersion: breakdown within a given category.
  3. These levels should avoid setting up excessive constraints.
  4. An investment may exceed admitted ceilings on assets corresponding to technical provision (“representative assets”) if the capital of the company is sufficient enough to avoid this exceeding investment to be including in “representative assets”.
  5. The actual effect of a given ceiling for listed shares will vary, depending on whether the shares are valued at their market or book value.
  6. Not only could a firm be prohibited from acquiring a particular asset if that asset would represent more than a given percentage of its total assets, but it could also be forbidden to acquire more than a given percentage shares of that asset.
  7. It should also be noted in this respect that the developments of the “EURO” in the European Union have dramatically modified EU rules related to currency matching.
  8. The valuation of investments on the basis of historical cost should therefore be supplemented by a valuation based on market value and vice versa.