

OECD GUIDELINES ON PENSION FUND ASSET MANAGEMENT

Recommendation of the Council

These guidelines, prepared by the OECD Insurance and Private Pensions Committee and Working Party on Private Pensions, were adopted by the OECD Council on 26 January 2006.

1. Pension funds are one of the most important players in the financial markets of the OECD countries, managing more than \$15 trillion of assets in 2003, which represents over 80 percent of the OECD's area GDP. Pension funds also play a key social role in channelling retirement contributions to finance retirement benefits. The investment of pension assets is one of the core functions performed by private pension arrangements. In order to promote both the performance and the financial security of pension plan benefits, it is critical that this function is implemented and managed responsibly. Policymakers have therefore a key role to ensure that regulations encourage prudent management of pension fund assets so as to meet the retirement income objectives of the pension plan.

2. The investment function varies depending on the type of pension plan. In the case of defined benefit plans, the goal of the investment function is to generate the highest possible returns consistent with the liabilities and liquidity needs of the pension plan, and in light of the risk tolerances of affected parties. In a defined contribution plan, the main goal of the investment function is to generate gains that accrue to individual member account balances in light of her investment goals.

3. The OECD Guidelines on Pension Fund Asset Management set out a basic framework for the regulation of pension fund investment, where regulation is defined in a broad sense that may include: the main body of the pension law; related laws (e.g. trust law); tax requirements; standards set by pension and financial sector supervisory authorities; codes of conduct developed by professional associations (e.g. a pension fund association); collectively bargained agreements; or plan documents (e.g. trust documents).

4. The Guidelines start with the basic premise that the regulatory framework should take into account the retirement income objective of a pension fund. Two other essential aspects of the regulatory framework are the prudent person standard and the statement of investment policy. Regulations may also include quantitative limits, but only as long as they are consistent with and promote the prudential principles of security, profitability and liquidity pursuant to which assets should be invested. Minimum levels of investment on certain assets, for example, would not be considered consistent with these principles. On the other hand, limits on investment in assets belonging to the plan sponsor are recommended by the OECD Guidelines.

5. The Guidelines on Pension Fund Asset Management, which are contained in Annex I to the draft Council Recommendation, address regulatory concerns that arise in the management of pension fund assets. The Guidelines aim to guide policymakers, regulators, supervisors and other entities involved in pension fund administration and management, particularly pension fund asset management. They are non-binding and aim to present good practices. As noted in various annotations to the Guidelines, their precise manner of implementation may vary from country to country, the aim being that the underlying objectives of each Guideline are met.

6. These Guidelines apply to the regulation of the individuals or entities responsible for managing the pension fund assets, typically the governing body of the pension fund, but also the asset management companies associated with them. Like previously developed principles and guidelines, these guidelines are intended to apply to occupational, private pension plans, that is, to those whose membership depends on an employment relationship – regardless of whether the plans are voluntary or mandatory (on the part of employers or employees) and regardless of whether the plans serve as the primary or supplementary means of providing retirement income¹. Non-occupational plans and funds are not specifically addressed by these guidelines. Nonetheless, given the nature of the particular topic addressed – pension fund asset management – most of the guidance may be also applied to non-occupational pension programmes that are

¹ In EU countries, these Guidelines may not apply to those occupational, private pension plans which fall outside the scope of the directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the Activities and Supervision of Institutions for Occupational Retirement Provision.

supported by privately managed pension funds. Similarly, administrators of government worker's pension programmes, to the extent funded, may also find these guidelines valuable.

7. These Guidelines were developed by the Working Party on Private Pensions and the Insurance and Private Pensions Committee. They complement the "Recommendation of the Council on Core Principles of Occupational Pension Regulation", adopted by the OECD Council in July 2004.

8. The annotations in Annex II explain the rationale for the Guidelines and provide additional information on certain issues. Annex II is not formally part of the draft Recommendation and may be updated or amended as necessary by the Insurance and Private Pensions Committee.

APPENDIX

Recommendation on Guidelines on pension fund asset management

THE COUNCIL,

Having regard to Articles 1, 3 and 5(b) of the Convention on the Organisation for Economic Cooperation and Development of 14 December 1960;

Having regard to the Recommendation of the Council on Core Principles of Occupational Pension Regulation, to which this Recommendation is complementary;

Considering that the investment of pension funds is a central function of private pension arrangements;

Considering that regulations should encourage prudent management of pension fund assets so as to meet the retirement income objectives of the pension plan;

Considering that the Guidelines presented in Annex I are based on previous work carried out in this area by the Insurance and Private Pensions Committee and its Working Party on Private Pensions;

Considering that the Guidelines address regulatory concerns that arise in pension fund asset management;

Noting that these Guidelines are intended to apply to occupational, private pension plans and the pension funds and asset management companies associated with them;

Noting that these Guidelines may also apply to funded, non-occupational plans and funds;

Noting that the Guidelines identify good practices for the regulation of pension funds, where "regulation" is understood to include a broad variety of instruments, e.g. laws; tax requirements; standards set by supervisory authorities; codes of conduct developed by professional associations; collectively bargained agreements and plan documents;

Recognising that evolutions of the pension funds structure or functioning may call for further updating and adaptation of these Guidelines;

On the proposal of the Insurance and Private Pensions Committee and its Working Party on Private Pensions;

I. RECOMMENDS that Member Countries invite public authorities to ensure an adequate regulation of pension fund asset management, having regard to the contents of Annex I to this Recommendation, of which it forms an integral part.

II. INVITES Member Countries to disseminate these Guidelines among pension funds, noting also the annotations provided in Annex II, as from time to time amended.

III. INVITES non-Members to take account of the terms of this Recommendation and, if appropriate, to adhere to it under conditions to be determined by the Insurance and Private Pensions Committee.

IV. INSTRUCTS the Insurance and Private Pensions Committee and its Working Party on Private Pensions to exchange information on progress and experiences with respect to the implementation of this Recommendation, to review that information and to report to the Council not later than three years following its adoption and, as appropriate, thereafter.

ANNEX I

GUIDELINES ON PENSION FUND ASSET MANAGEMENT

1. Retirement income objective and prudential principles

1.1 The regulation of pension fund asset management should be based on the basic retirement income objective of a pension fund and assure that the investment management function is undertaken in accordance with the prudential principles of security, profitability, and liquidity using risk management concepts such as diversification and asset-liability matching.

2. Prudent person standard

2.1 The governing body of the pension plan or fund and other appropriate parties should be subject to a “prudent person standard” such that the investment of pension assets is undertaken with care, the skill of an expert, prudence and due diligence. Where they lack sufficient expertise to make fully informed decisions and fulfil their responsibilities the governing body and other appropriate parties should be required to seek the external assistance of an expert.

2.2 The governing body of the pension plan or fund and other appropriate parties should be subject to a fiduciary duty to the pension plan or fund and its members and beneficiaries. This duty requires the governing body and other appropriate parties to act in the best interest of plan members and beneficiaries in matters regarding the investment of pension plan assets and to exercise “due diligence” in the investment process.

2.3 The legal provisions¹ should require the governing body of the pension plan or fund to establish a rigorous process by which investment activities are carried out (see Guideline III on investment policy), including the establishment of appropriate internal controls and procedures to effectively implement and monitor the investment management process.

3. Investment policy

3.1 The governing body of the pension fund should set forth in a written statement and actively observe an overall investment policy.

3.2 The investment policy should establish clear investment objectives for the pension fund that are consistent with the retirement income objective of the pension fund and, therefore, with the characteristics of the liabilities of the pension fund and with the acceptable degree of risk for the pension fund, the plan sponsor and the plan members and beneficiaries. The approach for achieving those objectives should

¹ Throughout this document, legal provisions are defined in a broad sense. They may include the main body of the pension law, related laws (e.g. trust law), tax requirements, standards set by pension and financial sector supervisory authorities, codes of conduct developed by professional associations (e.g. a pension fund association), collectively bargained agreements, or plan documents (e.g. trust documents).

satisfy the prudent person standard taking into account the need for proper diversification and risk management, the maturity of the obligations and the liquidity needs of the pension fund, and any specific legal limitations on portfolio allocation.

3.3 The investment policy should at a minimum identify the strategic asset allocation strategy for the pension fund (the long-term asset mix over the main investment categories), the overall performance objectives for the pension fund, and the means of monitoring and, when necessary, modifying allocations and performance objectives in the light of changing liabilities and market conditions. The investment policy should also include any broad decisions regarding tactical asset allocation, security selection and trade execution.

3.4 A sound risk management process that measures and seeks to appropriately control portfolio risk and to manage the assets and liabilities in a coherent and integrated manner should be established.

3.5 The investment policy for pension programmes in which members make investment choices should ensure that an appropriate array of investment options, including a default option, are provided for members and that members have access to the information necessary to make investment decisions. In particular, the investment policy should classify the investment options according to the investment risk that members bear.

3.6 Parties who are responsible for the overall implementation of the investment policy should be identified together with any other significant parties that will be part of the investment management process. In particular, the investment policy should address whether internal or external investment managers will be used, the range of their activities and authority, and the process by which they will be selected and their performance monitored. An investment management agreement should be required if external investment managers are used.

3.7 There should be procedures and criteria by which the governing body or other responsible party periodically reviews the effectiveness of their investment policy and determines whether there is a need to change the policy, its implementation procedures, the decision-making structure, as well as the responsibilities linked to its design, implementation, and review.

4. Portfolio limits

4.1 The legal provisions may include maximum levels of investment by category (ceilings) to the extent that they are consistent with and promote the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested. Legal provisions could also similarly include a list of admitted or recommended assets. Within this framework, certain categories of investments may be strictly limited. The legal provisions should not prescribe a minimum level of investment (floors) for any given category of investment, except on an exceptional and temporary basis and for compelling prudential reasons.

4.2 Portfolio limits that inhibit adequate diversification or impede the use of asset-liability matching or other widely-accepted risk management techniques and methodologies should be avoided. The matching of the characteristics of assets and liabilities (like maturity, duration, currencies, etc) is highly beneficial and should not be impeded.

4.3 Where the legal provisions establish maximum levels of investment by category (ceilings), there should be an established procedure for correcting excesses within specified time limits.

4.4 Self-investment by those undertaking investment management of pension funds should be prohibited or limited, unless appropriate safeguards exist. Investment in assets of the plan sponsor, in

parties related or affiliated with any pension entity or pension fund managing company is prohibited or strictly limited to a prudent level (e.g. 5 percent of the pension fund assets). When the plan sponsor, the pension entity or the pension fund managing company belong to a group, investment in undertakings belonging to these same groups should also be limited to a prudent level, which may be a slightly higher percentage (e.g. 10 percent of the pension fund assets).

4.5 Investments in assets issued by the same issuer or by issuers belonging to the same group should not expose the pension fund to excessive risk concentration.

4.6 Investment abroad by pension funds should not be prohibited and, among other risks, should take into account the currency matching needs between pension plans assets and liabilities.²

4.7 Legal provisions should address the use of derivatives and other similar commitments, taking into account both their utility and the risks of their inappropriate use. The use of derivatives that involves the possibility of unlimited commitments should be strictly limited, if not prohibited.

4.8 All legal provisions setting forth quantitative portfolio limits should be regularly assessed to determine whether they are unnecessarily inhibiting the ability of pension fund asset managers to implement optimum investment strategies and amended to the extent necessary.

5. Valuation of pension assets

5.1 The legal provisions should establish a proper, transparent and disclosed basis for valuing pension assets.

5.2 Where national rules do not require valuation at current market value or under a fair valuation methodology, it is recommended that the valuation be accompanied by the disclosure of the results that would have been obtained using a current market value or fair valuation methodology.

5.3 The legal provisions should require pension assets to be valued for accounting, reporting, actuarial and funding purposes. Ideally, permitted valuation methodologies for these purposes should be consistent, and where inconsistent, the differences in methodologies should be transparent. In appropriate circumstances, rules may permit methods that reduce short-term volatility of values over time for actuarial and funding purposes.

5.4 Special methods may be needed to value securities in less liquid markets and assets such as real estate. The legal provisions may set out specific methodologies for valuing such assets which should, as far as possible, take into account the risk inherent to illiquid markets.

5.5 The methodology used for valuing pension fund assets should be transparent to the pension fund's governing body, all others involved in the investment management process for the pension fund, and members and beneficiaries.

² These limitations on investments abroad are identified in the document “OECD Code of Liberalisation of Capital Movements. Portfolio Investment Abroad by Insurance Companies and Private Pension Funds: Widened Application of the OECD Code of Liberalisation of Capital Movements and Related Amendments”.

ANNEX II

ANNOTATIONS TO GUIDELINES ON PENSION FUND ASSET MANAGEMENT

1. Retirement income objective and prudential principles

1. The regulation of pension fund asset management should be based on the basic objective of a pension fund which is to serve as a secure source of retirement income. The regulation should identify a set of prudential principles, including security, profitability (performance), and liquidity of the portfolio as a whole using risk management concepts such as diversification and asset-liability matching. As explained in greater detail below (Guidelines II and IV), the basic regulations take the form of prudent person standards and, in certain cases, portfolio limits.

2. Prudent person standard

2. Under a prudent person standard, the pension fund's governing body or another responsible party is given broad authority to invest the pension assets in a prudent fashion in light of the particular needs of the plan or fund. Under this standard, a governing body is expected to undertake obligations related to the investment management function with the requisite level of skill to effectively carry out that function, and absent that level of skill or knowledge, to obtain the external assistance of an expert in the particular matter in which the governing body is deficiently skilled or lacking in knowledge, as suggested in the pension fund governance guidelines approved by Council. The trend has been to require that prudent persons undertake their obligations with the skills and knowledge that an "expert" (rather than an "ordinary person") would bring to their required tasks. The "expert" standard should be applied in light of the sophisticated and complex issues that arise in the area of portfolio asset management.

3. The standard of prudent behaviour should include a fiduciary duty, i.e., an obligation to make investment management decisions in the best (sometimes expressed in the terms of the "sole" or "exclusive") interest of plan or fund members, and a duty to exercise "due diligence" in the investment process, i.e., an obligation to adequately research and monitor investments and those to whom the investment management function is delegated. The fiduciary duty often is accompanied by additional rules to avoid circumstances in which it may be challenged. For example, many countries prohibit pension fund governing bodies and those working for the governing body from entering into situations, relationships or transactions that would create (or give the appearance of creating) a conflict of interest that would undermine their ability to carry out their fiduciary duty to the pension fund and its members. Policymakers and regulators should give serious and due consideration to the promulgation of such rules in addition to establishing a fiduciary duty.¹

4. It is also important that policymakers and regulators determine to whom the prudent person standard and the related fiduciary and due diligence duties should apply. At a minimum, these standards

¹ Conflicts of interest are also addressed in the Recommendation of the Council on Guidelines for Pension Fund Governance.

and duties should apply to the governing body of the pension fund and to other relevant parties, such as asset managers to whom discretionary investment responsibilities have been delegated.

5. The prudent person standard focuses on behaviour and process rather than on outcomes. It seeks to assure that those responsible for managing pension fund assets do so in a professional manner with the sole aim of benefiting the pension fund and its members. Because of its procedural focus, the prudent person standard places significant emphasis on the ability of pension fund governing bodies to hire qualified assistance and establish appropriate internal controls and procedures to effectively implement and monitor the investment management process.² The establishment and use of a comprehensive investment policy (see section III) is considered a crucial aspect of satisfying the prudent person standard.

6. Portfolio limits (see section IV) can serve to establish important boundaries that prevent or inhibit inappropriate or extreme investment management decisions, but they alone cannot effectively regulate the manner in which pension fund asset management decisions are made within those boundaries, and, in fact, are silent with respect to activity that is "within bounds." Therefore, jurisdictions that rely solely on a series of quantitative portfolio limits to regulate pension fund asset management should consider establishing a prudent person standard to work in tandem with portfolio limits. In this regard, countries that rely primarily on portfolio limits should, at a minimum, also set forth prudent person standards for pension fund governing bodies.

3. Investment policy

7. Parties responsible for managing the investment management of pension assets should establish an investment policy and describe it in a written statement. This should be required regardless of whether the investment regulations use the prudent person standard, portfolio limits or some combination of the two. An investment policy should be established regardless of plan type, whether defined benefit or defined contribution. As noted in the guidelines, pension programmes that include member direction may be required to address additional or different issues in their investment policies.³ Similarly, the investment policies of defined benefit plans may differ from those of defined contribution plans. In particular, the relationship between actuarial determinations, funding obligations and investment management is significantly more complex for defined benefit plans, and the relationship should be adequately considered in an investment policy.

8. The investment policy should establish clearly the financial objectives of the pension fund and the manner in which those objectives will be achieved. The investment objectives should be consistent with the retirement income objective of the pension funds, and therefore, with the fund's liabilities. They should also satisfy the relevant legal provisions (prudent person standard and portfolio limits), and more generally, the principles of diversification, and matching of assets and liabilities (maturity, duration, currency, etc).

9. The investment policy should take into consideration the short and long term obligations of the pension fund, including any necessary funding and actuarial matters that may impact on those obligations. Short term obligations include the obligation to pay benefits to those in or who will enter pay status (retirement); salaries, administrative costs and fees that are to be paid by the pension plan from pension fund assets; and anticipated costs arising from portability provisions that might apply to the plan.

² Put otherwise, the prudent person standard requires robust operational and other governance structures. The reader is referred to the Recommendation of the Council on Guidelines for Pension Fund Governance.

³ For special considerations regarding member-directed accounts, see Core Principle 5 (Protection of Rights of Members and Beneficiaries in Occupational Pension Plans) in the Recommendation of the Council on Core Principles of Occupational Pension Regulation.

10. The investment policy should identify the strategic asset allocation (the long-term asset mix over the main investment categories), the overall performance objectives of the pension fund, and the means of monitoring and, when needed, modifying broad asset allocations and performance objectives in the light of changing liabilities and market conditions. More specifically, the policy statement should include appropriate performance benchmarks and assessment timeframes and address the extent to which deviations from the strategic asset allocation will be tolerated.

11. The implementation of a sound risk management process is essential to appropriately measuring and controlling portfolio risk and the overall risk profile of the pension fund, including the extent of matching between assets and liabilities. The governing body may establish a target level of asset-liability matching that can be monitored through appropriate risk management techniques that take into account the main risk factors influencing the assets and liabilities of the pension fund.

12. The investment policy should address whether internal or external investment managers will be used, the range of their activities and authority, and the process by which they will be selected and their performance monitored. Where delegation of the asset management function is envisaged, an investment management agreement should also be required. Similarly, the investment policy should consider the costs of investment management and related activities, including research and transaction costs and compensation, especially of external service providers.

4. Portfolio limits

13. By setting forth portfolio limitations, regulators explicitly restrict the range of asset allocation strategies available to those charged with pension fund asset management responsibilities by establishing quantitative limits on investment, typically by asset class. Typically these limits are established as maximum permitted levels of investment (ceilings) in various asset categories and markets. The general intent of such portfolio limits is to implement the prudential principles of security, profitability and liquidity at the regulatory level, rather than pension fund level, and to effect or make an initial strategic asset allocation decision applicable to all pension funds subject to the legal provision. Portfolio limits may be applied to ensure a minimum degree of diversification and asset-liability matching.

14. A list of admitted/recommended assets and markets could also be established (possibly at a broad level only). In some circumstances, such a list could be compulsory. It could also be optional, but in that case there should be the possibility to require the firm to justify any substantial deviation from the list.

15. Certain categories of investment may be strictly limited (as for instance loans without appropriate guarantee, unquoted shares, certain equities which may raise major risks of conflicts of interest, illiquid assets, and, in general, investments that lack sufficient transparency). It may also be relevant to set limits on investment by pension funds in companies (or investment vehicles) holding a large volume of such categories of assets.

16. Portfolio limits regulation may also be used in accordance with the principle of diversification to establish maximum levels of investment in a given asset, in a single issue, or in securities of the same issuer (single or group issuer) as a proportion of a pension fund's total portfolio. This is one of the most widely-used types of portfolio limits regulation and is often used in prudent person-oriented jurisdictions.

17. Portfolio limits that prohibit or significantly limit self-investment by those undertaking investment management of pension assets are also recommended. These limitations either may be set forth explicitly, or they may be incorporated within a prudent person approach to regulation. Where explicit limitations rather than outright prohibitions are set, the legal provisions should establish a prudent ceiling (e.g. no higher than 10 percent of the pension assets) on the ability of pension fund managers to invest

pension assets in shares or other financial instruments of their own company and affiliated companies. Similar limits should be placed on the ability to invest pension assets in the shares or other financial instruments of the employer sponsoring a pension plan or fund and affiliated companies of that employer. The specific limit should take into account the risks that come with the investment in the sponsoring company. In the case of a single sponsor, investment in sponsor assets should be limited to a prudent level (e.g. 5 percent of the pension fund assets). When the sponsor belongs to a group the total investment in companies that are part of this group may be limited to a slightly higher percentage (e.g. 10 percent of the pension fund assets). Similarly, legal provisions should include maximum limits on the investment of pension assets in parties related to or affiliated with any of the service providers of a pension plan, in order to address conflict of interest concerns. (As noted in the discussion of the prudent person standard, legal provisions addressing conflicts of interest situations are often used in conjunction with (or in lieu of) an explicitly stated fiduciary duty)

18. For member-directed occupational pension plans, the principle of diversification and rules prohibiting or limiting self-investment may be important aspects of pension fund investment regulation, and regulators should assess whether their regulation of such pension programmes adequately addresses these issues in member-directed pension fund accounts. These concerns can be reviewed and addressed at two levels. First, the pension funds (or other pooled investment vehicles) in which members are permitted to invest can be regulated to prevent the portfolios from inappropriate self-investing or investing in a manner that would violate the principle of diversification. Second, additional rules could be placed on members to whom investment choice is available.

19. Where the legal provisions establish maximum levels (ceilings) of investment by category in accordance with the principle of diversification, there should be an established process by which pension funds are required to correct any excesses within specified time limits. Similarly, it may also be necessary to address temporary violations caused by unanticipated or unusual fluctuations in market valuations of pension fund portfolios. Policymakers and regulators should account for the fact that simultaneous decreases in the value of one asset category and increases in the value of another may have substantial implications on portfolio allocations that are tested against portfolio limits on a percentage of portfolio basis.

20. Certain types of portfolio limitations should generally be avoided. In contrast to the establishment of maximum levels of investment levels, the establishment of minimum levels of investment (floors) for a given category of investment should be prohibited. "Floors" force pension funds to invest specified portions of their portfolios in particular asset categories, leaving pension fund asset managers no or little ability to walk away from what they might determine to be unwise investments or investments inappropriate for their portfolios. "Floors" might also artificially inflate prices in particular asset classifications. As stated in the guideline, legal provisions should not prescribe a minimum level of investment for any given category of investment, except on an exceptional and temporary basis and for compelling prudential reasons. Investment floors have also been used when a new private pension system starts functioning and it is felt that only certain financial assets offer sufficient transparency or liquidity. In such cases, it is usually preferable to impose ceilings on those assets not considered apt for investment.

21. Quantitative portfolio limitations that inhibit adequate diversification or impede matching of the characteristics of assets and liabilities (maturity, duration, currencies, etc) should be avoided. In this regard, policymakers and regulators should take account of and give proper consideration to modern and effective risk management methods, including the development of assets/liabilities management techniques. Application of these techniques may result in portfolios that are heavily weighted in bonds, for example, and, which, as a result, could violate portfolio limit regulatory regimes, and yet not necessarily be regarded as inadequately diversified or imprudent. It is important that the regulation of investment portfolios take into account the portfolio of commitments and obligations of pension funds, and legal

provisions should, therefore, set out a framework of general principles that adequately addresses the matching and similar risk management techniques. In this regard, it may be useful to tailor regulations to the nature of contractual guarantees (with regard, for example, to returns, interest rates, indexation, etc), maturities, and payout terms (e.g., annuities or lump sums) of the particular pension programme.

22. Prohibitions on investments abroad can undermine the key goals of portfolio limits regulation – to assure appropriately diversified pension fund portfolios and should be avoided. These limitations may also undermine the profitability objective. To the extent that national markets are not correlated, the ability to diversify investment internationally should reduce risk. Additionally, in some countries domestic markets may be inadequately diversified, for example by being dominated by a small number of large firms or unduly exposed to one type of industry. (The benefits of international portfolio diversification for pension funds, however, might need to be weighed against other policy considerations. For instance, in many countries pension funds are a significant component of national savings and play an important role in the development of domestic markets.) When investing in foreign assets, political and currency risks should be duly considered and adequately addressed. Countries may also consider rules addressing currency risks and the location of the title to foreign assets or of the pension trust.

23. Derivatives are complex financial instruments that have an increasing place in pension fund portfolios. The use of derivatives as a management instrument may prove useful and effective if done in a prudent fashion in order to reduce investment risks or facilitate efficient portfolio management. Specific rules may need to be established in order to ensure that their use is consistent with appropriate risk-management systems. The use of derivatives that involves the possibility of unlimited commitments and, more generally, the use of derivatives for speculative purposes should be prohibited.

24. Policymakers and regulators maintaining portfolio limits should regularly assess whether or not their legal provisions are creating adverse incentives that might be undermining or unnecessarily inhibiting the ability of pension fund asset managers to implement optimum investment strategies. Amendments to such legal provisions should be made if it is found that they are unnecessarily constraining. To the extent that the security of pension fund assets is not put at risk, they should also consider making quantitative portfolio limits less restrictive and increasing reliance on a prudent person standard. As noted in the discussion of the prudent person standard, although the prudent person rule and portfolio limits are sometimes viewed as competing forms of regulation, they can work as effective complements to one another – and policymakers and regulators should strive to obtain the appropriate balance.

5. Valuation of pension assets

25. In order for pension fund assets to be appropriately managed, the pension fund's governing body and other parties involved in pension fund asset management must be able to readily ascertain the value of the pension assets for which they are responsible, regardless of the nature of the investments held in the pension fund. In general, current market values should be used where available. If not available, a fair valuation methodology acceptable under general accounting standards should be used. Where alternative methodologies are used, it is recommended that the use of such methods be accompanied by the disclosure of the results that would have been obtained using a current market value or fair valuation methodology.

26. In all cases the methodology used for valuing pension fund assets should be transparent to the pension fund's governing body and those involved in the investment management process for the pension fund. Valuations and methods used should be readily available or disclosed to members and beneficiaries.

27. Some jurisdictions permit the use of various methods of smoothing asset values over time in the context of actuarial and funding determinations for defined benefit pension plans and defined contribution plans with guarantees. Where smoothing is employed, regulators and supervisors should seek to assure that

it does not mask significant underlying concerns regarding the overall asset allocation of a pension fund portfolio or the performance of any specific investments or asset classification. Because smoothing techniques may have a significant impact on actuarial and funding determinations, regulators and supervisors that work in an environment where the smoothing of asset values is permitted should fully understand the nature of the potential impact. Smoothing of asset values may be unnecessary if funding obligations pertaining to experience and actuarial gains and losses can be spread over time.