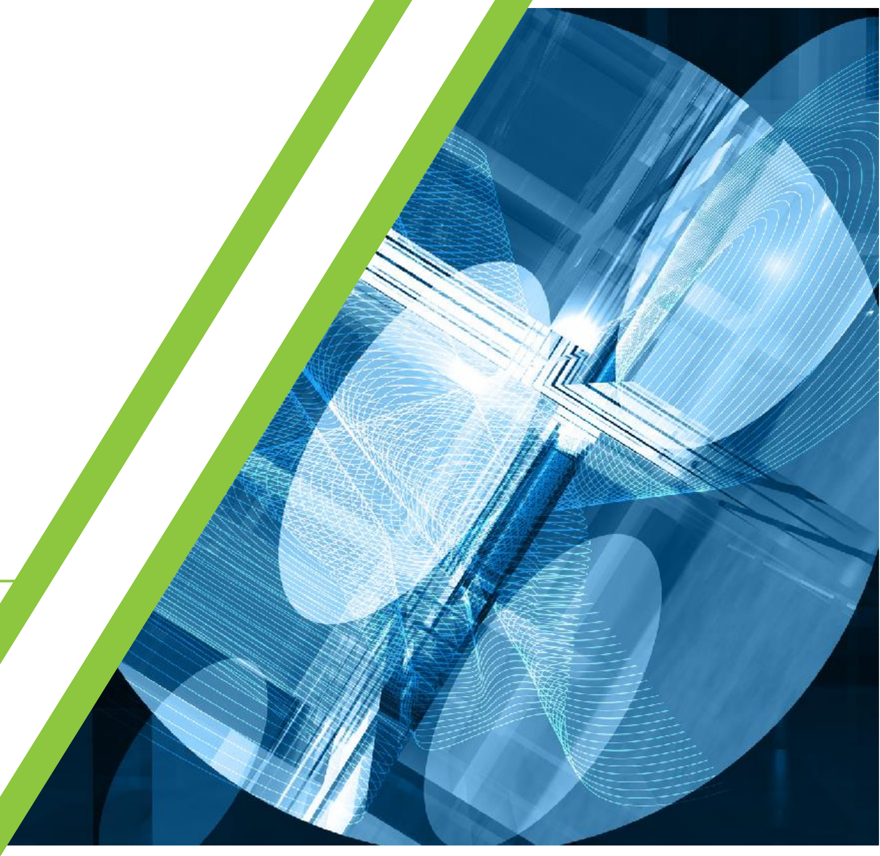
Recommendation of the Council on Guidelines on Pension Fund Asset Management



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Background Information

The Recommendation on Guidelines on Pension Fund Asset Management was adopted by the OECD Council on 26 January 2006 on proposal of the Insurance and Private Pensions Committee and its Working Party on Private Pensions. The Guidelines, which formed an integral part of the Recommendation, set out a basic framework for the regulation of pension fund investment, where regulation is defined in a broad sense and included: 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). The Recommendation was abrogated on 28 June 2012 following the incorporation of the text of the Guidelines in the 2009 OECD Recommendation on the Core Principles of Occupational Pension [OECD/LEGAL/0373].

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 [C(2004)41], 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

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 provisions[1] 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 3 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 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.

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[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).

[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 [C(2002)30, paragraph 12].

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OECD Legal Instruments

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