

**OCCUPATIONAL PENSIONS CORE PRINCIPLES AND METHODOLOGY**

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### 1. Introduction

In November 2000, the OECD Working Party on Private Pensions (OECD Working Party) approved a set of 15 Basic Principles for the Regulation of Private Occupational Pension Plans", which were endorsed in April 2001 at the inaugural meeting of the International Network of Pensions Regulators and Supervisors (INPRS). Since then, the Working Party has developed additional guidelines on selected principles, in particular on pension fund governance and on rights of members and beneficiaries. The guidelines on pension fund governance were approved by the group in July 2002, while the guidelines on the protection of the rights of members and beneficiaries were approved in September 2003.

In May 2001, the OECD Ministerial Meeting supported the development by the OECD of principles and best practices of pension regulation and supervision. The Programme of Work of the INPRS, which is serviced and supported by the OECD, has set out as one of its main activities the promotion of the recognition of further principles and best practices for pension regulation and supervision. The OECD and the INPRS are thus expected to be at the core of future development of private pension principles.

This work will be conducted in co-operation with other international organisations, especially the World Bank (WB), the International Monetary Fund (IMF), the International Organisation of Securities Commissioners (IOSCO), the Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones (AIOS), the International Association of Insurance Supervisors (IAIS), and the International Social Security Association (ISSA).

The first output of this exercise is the development of a methodology to assess the observance of the 15 Basic Principles in the jurisdictions of member countries. Such an assessment can be used by the authorities to identify weaknesses in their regulatory and supervisory systems and implement the 15 principles.

This document may therefore be used as part of an informal self-assessment exercise to be carried out by the relevant authorities themselves. To the extent that resources are available, a more formal exercise may be launched. At the request of a delegation, a team consisting of OECD Secretariat staff, experts from the OECD delegations, as well as staff from international organisations with a proven expertise in the area of occupational pensions could join an assessment. The exercise could also be extended to non-OECD countries represented in the INPRS. The feedback obtained on the self-assessment exercises will also be taken into account when developing new guidelines and finalising the assessment methodology.

The previous version of this document was also sent to the International Monetary Fund (IMF) and the World Bank for their use in the Financial Sector Assessment Program (see [www.imf.org/external/np/fsap/fsap.asp](http://www.imf.org/external/np/fsap/fsap.asp)).

### 2. The Occupational Pension Core Principles Methodology

The fifteen basic principles have been reorganised into seven core principles in order to ease their assessment. Such reorganisation is also consistent with the approach taken in other assessment exercises, in particular, the assessment methodology developed by the IAIS for the Revised Insurance Core Principles. The language used in the seven core principles is *unchanged* from the language in the basic principles.

Where relevant, the Secretariat used material from the OECD Working Party's ongoing work concerning the regulation of pension plans, funds, and entities, as well as relevant INPRS material. Where

germane, the Secretariat has also used the published objectives, principles, and relevant assessment criteria of the IOSCO and IAIS, adding to or modifying those criteria as necessary to how private occupational pension plans are generally structured and operate<sup>1</sup>.

The document is structured into seven main sections, corresponding to the seven core principles that have been identified. The core principles are ordered according to their logic from a regulatory perspective. The first core principle covers the conditions for effective regulation and supervision of occupational pensions. The second core principle covers the establishment of pension plans, pension funds, and pension entities. The third core principle covers the governance of these pension entities and their relationships to plan sponsors and external service providers, such as actuaries, auditors, consultants, asset managers, custodians, and collection/record keeping agencies. The fourth core principle covers funding, winding-up, and calculation techniques. The fifth core principle covers asset management. The sixth core principle covers the protection of the rights of members and beneficiaries. Finally, the seventh core principle covers the application and monitoring of these regulations through a supervisory framework.

The statement of each core principle is followed by a short introductory discussion, where the objectives of the core principle are discussed. A set of criteria then follows, which is intended to highlight areas of good practice that should assist jurisdictions in implementing the core principles. The criteria are divided into two groups, "essential" and "advanced". The "essential" criteria are those that would normally apply to occupational plans, while the "advanced" criteria provide more detailed guidance for the implementation of a core principle<sup>2</sup>.

The practical implementation of these core principles may vary from country to country, the aim being that the underlying objectives of the core principles are met. For example, the legal provisions used to implement the criteria may be included in the main body of the pension law in some cases. In other cases, certain criteria may refer to 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), or collectively bargained agreements. Among other factors, the practical application of these core principles will also depend on whether the plans are mandatory or voluntary, the needs of employers and the adequacy of other pension benefits.

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<sup>1</sup> Another useful reference was the "Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision".

<sup>2</sup> In some cases, the length of the "essential criteria" is more limited than that of the "advanced criteria". This reflects the limited discussion the group has had on some issues such as funding regulations (Core Principle 3). In the case of governance (Guideline 2) and rights of members and beneficiaries (Core Principle 6), the "essential criteria" reflects exactly the text of respective guidelines approved by the Group.

<b>Basic Principles</b>	<b>Core Principles</b>
Basic Principle 1 (Adequate regulatory framework), Basic Principle 2 (Appropriate regulation of financial markets), Basic Principle 10 (Fair competition)	Core Principle 1 (Conditions for effective regulation and supervision)
Basic Principle 5 (Regulatory system, and separation)	Core Principle 2 (Establishment of pension plans, pension funds, and pension fund managing companies)
Basic Principle 15 (Corporate Governance)  Basic Principle 9 (Self-supervision)	Core Principle 3 (Governance)
Basic Principle 6 (Funding), Basic Principle 7 (Calculation techniques), Basic Principle 13 (Winding-up), Basic Principle 12 (insurance mechanisms)	Core Principle 4 (Pension plan liabilities, funding rules, winding-up, and insurance)
Basic Principle 11 (Investment), Principle 7 (Calculation techniques)	Core Principle 5 (Asset management)
Basic Principle 3 (Rights of the beneficiaries), Basic Principle 4 (Adequacy of the private schemes), Principle 14 (Disclosure and education)	Core Principle 6 (Rights of members and beneficiaries and adequacy of benefits)
Principle 8 (Supervisory structures)	Core Principle 7 (Supervision)

#### **4. Definitions**

*Autonomous pension fund:* in occupational plans, a pension fund that is legally separated from the plan sponsor taking the form of either a special purpose legal entity (a pension entity) or a separate account managed by financial institutions on behalf of the plan/fund members. In personal plans, autonomous pension funds are established as independent entities that act as the plan provider or as accounts legally separated from the plan provider (who normally acts also as the fund manager). Both in occupational and personal pension plans, the plan/fund members have a legal or beneficial right or some other contractual claim against the assets held in the autonomous pension fund.

*Defined benefit (DB) plan:* any pension plan other than a defined contribution plan, including all plans in which the financial or longevity risk are borne by the plan sponsor. Benefits to members are typically based on a formula linked to members' wages or salaries and length of employment. In some plans, the sponsor guarantees only a rate of return.

*Defined contribution (DC) plan:* a pension plan by which benefits to members are based solely on the amount contributed to the plan by the sponsor or member plus the investment return thereon. This does not include plans in which the employer that sponsors the plan guarantees a rate of return.

*Governing body (of the pension fund):* the person(s) or entity(ies) ultimately responsible for managing the pension fund with the overriding objective of providing a secure source of retirement income. In cases

where operational and oversight responsibilities are shared or divided between different committees within an entity, the governing body is the executive board of the entity. Where the pension fund is not a legal entity, but managed directly by a financial institution, that institution is the governing body of the pension fund.

*Legal provisions:* 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).

*Non-autonomous pension funds:* a pension fund that is not legally separated from the plan sponsor, which is usually an employer. The pension assets may form a reserve in the plan sponsor's balance sheet ("book reserves") or they may be held in legally separated vehicles but are the property of the plan sponsor ("financial reserves"). Pension plan members have no legal claim on the pension fund assets.

*Occupational pension plans:* a pension plan that is linked to an employment relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups of employers (e.g. industry associations), professional and labour associations (e.g. trade unions). Generally, the plan sponsor is responsible for making contributions under the terms of occupational pension plans, but employees may be also required to contribute. Sponsors may also have administrative or oversight responsibilities for these plans.

*Pension entity:* a special-purpose legal entity, such as a trust, foundation, or a corporate entity that owns and may also control the pension fund on behalf of the pension plan/fund members. Plan members may have either a legal or a beneficial ownership right over the pension fund, or a contractual claim against the special purpose entity with respect to their rights to the pension fund assets.

*Pension fund manager:* a financial institution that acts as the manager of some or all of the pension fund assets.

*Pension fund managing company:* a financial institution whose exclusive business purpose is the management of pension funds and may also administer other aspects of the pension plan.

*Pension plan:* a pension plan (or scheme) is an arrangement for the provision of retirement income that is set out in a legally binding document such as a contract, trust agreement or other formal document. A pension plan has an explicit retirement objective or - in order to satisfy tax related conditions or contract provisions - the benefits can not be paid at all or without a significant penalty unless the beneficiary is older than a legally defined retirement age. The elements of the pension plan may be mandated by law or statute or set forth as pre-requisites for special tax treatment, as is the case for many tax qualified savings or retirement programme designed to provide the plan's members and beneficiaries with an income after retirement. In addition to having an explicit retirement objective, pension plans may offer additional benefits, such as disability, sickness, and survivors' benefits.

*Plan sponsor:* The employer or group of employers, labour and professional associations that establish an occupational pension plan. The plan sponsor may also be responsible for various aspects of the operation of the pension plan.

*Private pension plan:* a pension plan where an institution other than general government administers the payment of pension benefits. Private pension plans are managed by the employer acting as the plan sponsor, a pension entity or a private sector provider. Private pension plans may complement or substitute for social security systems. In some countries, these plans may operate as part of a social security system and may include plans for public sector workers.

#### 4. Scope of the Core Principles

These Core Principles apply to private occupational pension plans, except those supported by non-autonomous pension funds. The Core Principles are not designed to cover either personal pension plans (PPPs) or public pension plans (which may include social security systems as well as occupational plans for public sector workers).

Occupational pension plans depend upon an employer, group of employers or a professional/labour association (e.g. a trade union) establishing a plan (or scheme).<sup>3</sup> In addition to the plan features (e.g. contributions, benefits, retirement age, etc), regulators and supervisors have an interest in how the plan will be managed (e.g. how benefits will be financed, how assets will be invested, etc) and how the rights of members and beneficiaries will be protected.

Legal provisions should have the aims of protecting the rights of members and beneficiaries and ensuring the long-term financial viability of pension plans, particularly since occupational plans are generally designed to be material complements to national social security systems. Accordingly, occupational pension plans may be subject to regulatory analysis from the perspectives of labour contract and market policies, financial market policies, and (in most countries) tax policies. This template, however, primarily focuses on how occupational pension plans, funds and related entities are managed to reflect their inherent "fiduciary" nature.

Plan sponsors use different concepts under applicable national law (e.g. contract law, trust law, provisions for foundations) to establish occupational pension plans. They generally also choose among two main funding vehicles, pension funds and insurance policies. Pension funds are normally segregated from plan sponsors into autonomous pension funds, though a few countries still permit plan sponsors to carry pension liabilities on the company balance sheet or as external financial reserves (non-autonomous pension funds). In turn, autonomous pension funds may be established as special-purpose pension entities (e.g. trusts, foundations, mutuals, and corporate structures), or as pools of assets or separate accounts of financial institutions (e.g. a separate account of an insurance company).

Pension plans often use standard financial institutions— banks, insurance companies, and investment management firms— along with other service providers to function. This use can take many forms. In many

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<sup>3</sup> In *occupational pension plans*, the employer is a necessary party even if the employer's discretion is very circumscribed. In some countries, such as in Switzerland, Hong Kong, or Australia, employers are required to create occupational pensions that meet or exceed prescribed standards. In other countries, notably the United Kingdom and Japan, employers may provide occupational pension plan in lieu of some portion of the state pension regime ("contracting-out"). In yet other countries laws (as in the Netherlands) and collective agreements between employers and representatives of employees - typically trade unions - (as in Denmark and Sweden) compel employers to participate in broad, collectively bargained pension arrangements with prescribed standards. Finally, countries often facilitate and encourage voluntary employer-sponsored pensions through collective bargaining laws and laws that explicate and regulate the terms and conditions of (typically) tax-advantaged pension plans. Voluntary employer-sponsored pensions may apply to single employers or employer groups in a related trade or occupation.

*Personal pension plans* (PPPs) entail a direct contractual relationship between an individual and a financial institution (bank, insurance company, collective investment scheme, or pension fund managing company). In some instances personal pension plans are mandated by law or are an alternative to participation in a state pension regime. In most mandated PPPs individuals must subscribe with specially prescribed collective investment schemes with narrowly circumscribed portfolios. In some countries with mandated (or alternative) PPPs, however, individuals may choose among a wide range of financial institutions and portfolios. With respect to voluntary PPPs, individuals typically have a wide range of choice among financial institutions and portfolios.

instances, the standard financial entity is acting only as a service provider, for example acting as the asset manager of some of the pension fund assets. Pension regulators and supervisors may therefore rely on other financial market regulation and supervision to oversee the operation of these service providers. In some instances, the resulting pension arrangement is effectively an insurance arrangement, in which cases even greater reliance on the relevant supervisor may be appropriate. But even in these latter arrangements, there are residual core activities within the purview of the pension regulator or supervisor.

In some countries, national law may prescribe that only special-purpose financial institutions (pension fund managing companies) are permitted to manage pension funds or provide certain services (e.g. asset management) to pension entities. The guidelines (specifically, Core Principles 2 and 8) make provisions for the licensing of these financial institutions that are dedicated exclusively to the management of pension funds.

## **6. Criteria for Assessing Observance of the Occupational Pension Core Principles**

### **Core Principle 1: Conditions for effective regulation and supervision**

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 plan members and beneficiaries, the soundness of pensions plans and funds and the stability of the economy as a whole. This framework should however not provide excessive burden on pensions markets, institutions, or employers.

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).

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.

### ***Discussion***

Successful implementation of the occupational pension core principles depends upon the existence of an institutional framework that ensures the adequacy of the legal provisions in a changing environment of occupational pension provision. The legal provisions also need to take into account external factors, such as the tax treatment of occupational pensions, the role of public pension plans, and labour market regulations.

The ultimate goal of pension regulation and supervision is to protect the rights of plan members and beneficiaries. However, a precondition for occupational pension provision is encouraging, or in some cases ensuring, that employers establish and maintain pension arrangements. Hence, the legal provisions should not place an excessive administrative burden on pension plan sponsors nor require them to bear undue costs and risks.

The implementation of the occupational pension core principles also assumes the existence of a properly functioning financial sector. Occupational pension provision relies on a variety of financial institutions and other service providers. It may involve the management of investment and actuarial risks through funding vehicles that operate in the financial system. Hence well-regulated and supervised financial systems are an essential complement to pension-related legal provisions. Pension regulators and

supervisors also rely on other financial sector regulators and supervisors to perform their functions and meet their objectives effectively.

The operation of occupational pension plans also assumes the existence of liquid financial markets that offer securities suitable for long term investment. Implementation of the occupational pension core principles also requires policies aimed at ensuring a level playing field between different private pension providers. Competition policy can play a key role in ensuring that plan sponsors and members have adequate choice in a robustly competitive environment that engenders price and product competition.

### ***Essential Criteria***

- 1.1 Occupational pensions are subject to a set of legal provisions that regulate the main aspects of the operation of those plans.
- 1.2 The legal provisions promote the protection of pensions plan members and beneficiaries and the soundness of pension funds.
- 1.3 The legal provisions provide the necessary flexibility in order to permit the efficient operation of occupational pension plans;
- 1.4 The legal system allows the enforcement of financial contracts pertaining to occupational pensions. In particular, there is a body of ethical, professional and trained lawyers and judges, and a court system, whose decisions are enforceable. Comparable standards apply in cases where alternative dispute mechanisms exist.
- 1.5 Accounting standards for plan sponsors of occupational pensions are comprehensive, documented, transparent and consistent with international standards.
- 1.6 The legal provisions take into account the state of development of financial markets.
- 1.7 The legal provisions encourage efficiency in pension provision.

**Core Principle 2: Establishment of pension plans, pension funds, and pension fund managing companies.**

An institutional and functional system of adequate legal, accounting, technical, financial, and managerial criteria should apply to pension 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).

***Discussion***

The establishment of pension plans, funds, and entities is normally carried out in the context of pension, tax, or other legislation that stipulates certain features that plans, funds, and entities must have. While basic standards for the establishment of occupational pension plans can be identified, countries vary in the type of funding vehicles permitted (autonomous pension funds or/and insurance policies), the type of autonomous pension fund (pension entity or separate accounts), and the legal form of the pension entity (trust, foundation, corporate entity, etc).

The choice of funding vehicle depends on the legal framework of the country as well as the objectives of the pension plan and the role and responsibilities of the plan sponsor. If the plan sponsor decides or is required to establish an autonomous pension fund as an independent legal entity (that is, as a pension entity) to segregate the pension assets, the function of these entities needs to be defined. In some cases, the pension entity may also be responsible for the management of the pension fund and other aspects of the administration of a pension plan. In such cases, legal provisions are required to encourage the investment of the pension fund in a prudent way and that the pension entity has governance mechanisms in place to ensure an effective control of decision-making processes. Legal provisions are also needed to define the type of legal form of pension entities that should be permitted. Plan members may have either a legal or a beneficial ownership right over the pension fund, or a contractual claim against the pension entity with respect to their rights to the pension fund assets.

The main alternative to setting up the pension fund as a pension entity is to deposit the contributions in a separate account or pool of assets of a financial institution or a dedicated provider (pension fund managing companies) where they are invested with the objective of funding the retirement benefits of the plan members and beneficiaries.

In some countries, instead of establishing an autonomous pension fund the plan sponsor may buy pension insurance policies, hence shifting the plan's risks covered by these policies to the insurance company. The regulation and supervision of insurance companies is designed as to ensure that these institutions build up sufficient internal reserves to meet any pension plan promises.

In a few OECD countries yet another alternative is permitted. Plan sponsors may establish non-autonomous pension funds<sup>4</sup>, and finance retirement benefits through, for example, the book reserve methods. The insurance of employer pension liabilities in these cases is often mandatory.

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<sup>4</sup> .Since the guidelines do not cover such types of funds, any further reference to pension funds should be understood as referring to the autonomous kind.

The choice of pension arrangement also determines the feasibility of a broad licensing procedure. The sheer numbers of plans, funds, and entities often involved in an occupational system means that a licensing process sometimes is not practicable. Instead, regulations may require the registration of the plan and pension entity, or may simply require the submission of the relevant plan and other documents to the regulatory or supervisory authority. In general, however, the establishment of pension plans and pension entities should be subject to a set of minimum requirements. The less regular and comprehensive supervision is and the less developed is the infrastructure for ensuring fiduciary accountability through legal and judicial process on an on-going basis, the more important it is to have a broader set of minimum requirements that are verified during the initial process of establishing pension plans, pension funds, and pension fund managing companies.

A licensing process should be required for pension fund managing companies, since these are financial institutions whose exclusive business purpose is the management of pension funds (and sometimes also the administration of certain aspects of the pension plan). It should be noted, however, that only certain OECD countries recognise the establishment of such institutions. Generally, financial institutions that hold an asset management license or are otherwise permitted to engage in asset management under another body of applicable law (e.g. securities or insurance laws) should be able to act as pension fund managers without a need for an additional license.

### ***Essential Criteria***

- 2.1 Legal provisions are in place applying to the establishment of pension plans and pension funds, including the legal form of pension funds that are established as independent legal entities and their governance structure.
- 2.2 Occupational pension plans have a formal, written charter or document, describing the plan's objectives and parameters, the duties and responsibilities of the governing body and the plan members' and beneficiaries' rights. In some cases, documents may reflect the extent to which various features of the plan are subject to collective bargaining. The legal provisions require also that by-laws, articles of association or trust instruments, describing their objectives and governance structure (including structure of responsibilities and fiduciary liability) are prepared for pension plans and funds jointly or separately.
- 2.3 The legal provisions require the legal separation of pension plan assets from the assets of the plan sponsor<sup>5</sup>.
- 2.4 To the extent that the legal provisions require that dedicated providers (pension fund managing companies) manage autonomous pension funds set up as pools of assets or separately managed accounts, there is a licensing process for these specialised financial institutions.
- 2.5 The legal provisions identify the authority responsible for licensing of pension fund managing companies, define its powers and tasks, and detail the licensing/registration requirements.
- 2.6 A minimum amount of capital is required for all pension fund managing companies.

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<sup>5</sup> Non-autonomous pension funds including book reserve schemes do not fall under the scope of the core principles.

### *Advanced Criteria*

- 2.7 The plan document should describe at least the following aspects:
  - The pension plan's objectives and parameters (e.g. contributions, benefits and other guarantees).
  - The identification of the plan sponsor, and its main responsibilities;
  - The identification of the governing body and its main responsibilities, where relevant;
  - The type of funding vehicle (a pension fund or an insurance policy), the type of pension fund (autonomous or non-autonomous, and if autonomous, whether it is a pension entity or a pool of assets or separate account managed by a financial institution);
  - The conditions for membership in the plan;
  - Dispute resolution procedures for members and beneficiaries.
- 2.8 The legal provisions require that the pension plan objectives include at least the following two objectives:
  - to efficiently mobilise savings during the worklives of members so as to provide income during retirement in accordance with the plan rules;
  - to prudently and efficiently manage the funds and information on behalf of the members and beneficiaries;
- 2.9 The legal provisions require that the pension plan establish, where relevant, mechanisms for the management of longevity and other biometric risks.
- 2.10 As a precondition for establishing pension funds as independent legal entities, draft by-laws, articles of association, or trust instruments should be required. Such documents should describe at least the following aspects:
  - the legal form of the pension fund (trust, foundation, corporate entity);
  - the governance structure of the pension fund, including the identification of the governing body of the pension fund and its main responsibilities;
- 2.11 In countries where specialised pension fund managing companies are used, the licensing process for these companies should include the submission to the relevant authorities the following documents:
  - the financial and business plan of the pension fund managing company,
  - investment strategy or policy,
  - a description of the internal control mechanisms,

- the certification of the existence of the necessary material and personal preconditions to undertake activities,
  - and, in the case of outsourcing of certain operations, the conditions for or copies of relevant contracts and information on the contractor.
- 2.12 The licensing process for pension fund managing companies should involve the verification by the relevant authorities that the legal form, governance structure, and financial and business plan of the pension fund managing company complies with all the relevant legal provisions.
  - 2.13 The legal provisions should call for the modification of the financial or business plan of the pension fund managing company (or the disqualification of the entity) if they contain inappropriate provisions or if it is determined that the safe operation of the company would otherwise be jeopardised.
  - 2.14 The legal provisions should require that the licensing process of pension fund managing companies includes the assessment by the relevant authorities of the fitness and propriety of the governing body of the pension fund managing company.
  - 2.15 The legal provisions should grant the relevant authority the power to revoke the license of a pension fund managing company in case of serious irregularities, if any licensing requirements are not met, or in case of serious infringement of the law in force.
  - 2.16 Special authorisation may be required for financial institutions other than pension fund managing companies that act as administrators of pension funds.

### **Core Principle 3: Governance**

The 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.

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.

### ***Discussion***

Occupational pension plans function on the basis of agency relationships between plan members and beneficiaries, on the one hand, and the persons or entities involved in the administration or financing of the pension plan, such as the plan sponsor, trade unions (in some countries) and plan administrators, on the other. The governance of pension plans consists of all the relationships between the different entities and persons involved in the operation of the plan. Governance also provides the structure through which the objectives of a pension plan and the means of attaining those objectives are set and through which performance is monitored.

To the extent that pension plans are financed exclusively via group insurance contracts (e.g. deferred annuities), the authorities' main concerns are over the timely payment of contributions to the plan and the appropriate selection and monitoring of insurers and insurance products. The existing regulatory and

supervisory framework for insurance would normally cover all aspects of the governance of insurance companies and products. On the other hand, if pension funds are established it is essential to develop a regulatory framework for the management of these funds in the best interest of plan member and beneficiaries, taking into account the role of plan sponsors as benefit providers.

The agency relationships present in the operation of pension funds call for a regulatory and supervisory framework that protects pension plan members and beneficiaries from conflicts of interest and related problems.

Governance regulations for pension funds need to be designed under the guidance of the overriding objective that, despite their differences, all pension funds are established with a common objective, which is to serve as the source of funds for retirement benefits.

Effective regulation of the governance structure of pension funds includes the establishment of a transparent framework for the division of responsibilities in the operation and oversight of the pension fund, and the accountability and suitability of all parties involved in the pension fund process. The legal provisions should in particular identify the governing body of the pension fund, that is, the persons ultimately responsible for the management of the pension fund.

Good governance of pension funds requires the members of the governing body to be subject to standards of fitness and propriety. These standards may be applied also through disqualification provisions. Governance regulations should also define mechanisms for internal control, communication, and redress, and promote the role of independent service providers, such as actuaries, custodians and auditors in sound governance practices.

### **Pension plan governance**

#### ***Essential criteria***

- 3.1 The legal provisions require that every occupational pension plan have a designated governing body or administrator that is vested with the power to administer the pension plan. Where a pension plan is financed via a pension fund, the governing body of the plan and the fund may be the same person(s) or entity.
- 3.2 The legal provisions require high standards of integrity in the operation of occupational pension plans.

#### ***Advanced Criteria***

- 3.3 The legal provisions require that there are appropriate governance procedures in place to ensure the timely transmission of pension plan contributions in accordance with rules governing the amount and timing of contributions. Legal provisions are also in place requiring the timely payment of pension benefits and of funds in case of plan departure.
- 3.4 Where there are member contributions, procedures should assure that deposit is made to the relevant accounts in a timely manner corresponding to when the contribution was made or withheld from the member's pay.
- 3.5 The legal provisions establish procedures to deter, detect, record, report and remedy fraud in occupational pensions. In particular, procedures are in place to avoid the fraudulent diversion of the contributions by sponsoring employers or others involved with the plan's execution.

## Pension fund governance

### *Essential Criteria*

- 3.6 Legal provisions require that every pension fund have a designated governing body or administrator that is vested with the power to administer the pension fund. The responsibilities of the governing body are consistent with the overriding objective of a pension fund, which is to serve as a secure source of retirement income. The governing body cannot completely absolve itself of its responsibilities by delegating certain functions to external service providers. For instance, the governing body should retain the responsibility for monitoring and oversight of those service providers.
- 3.7 The legal provisions require that the governing body of the pension fund is accountable to the plan members and beneficiaries and the competent authorities. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, it is legally liable for its actions.
- 3.8 The legal provisions require that the members of the governing body of pension funds are subject to minimum suitability standards in order to ensure a high level of integrity and professionalism in the administration of the pension fund.
- 3.9 Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities, the governing body could be required to seek expert advice or appoint professionals to carry out certain functions.
- 3.10 The legal provisions require that an actuary is engaged by the governing body for all defined benefit plans financed via pension funds.
- 3.11 The legal provisions require the actuary to play a "whistle-blowing" function. As soon as the actuary realises, on performing his or her legal duties, that the fund does not or is unlikely to comply with the appropriate statutory requirements and depending on the general supervisory framework, he or she shall inform the governing body and - if the governing body does not take any appropriate remedial action - the supervisory authority without delay.
- 3.12 There are legal provisions requiring that custody of the pension plan assets is carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, its assets are legally separated from those of the pension fund. The custodian cannot absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.
- 3.13 The legal provisions require that an auditor, independent of the pension entity, the governing body, and the plan sponsor is appointed by the governing body or appropriate authority to carry out a periodic audit consistent with the needs of the arrangement. Depending on the general supervisory framework, the auditor shall report promptly to the governing body - and if the governing body does not take any appropriate remedial action - to the competent authorities wherever he or she becomes aware, while carrying out his or her tasks, of certain facts which may have a significant negative effect on the financial situation or the administrative and accounting organisation of a pension fund.

### ***Advanced Criteria***

- 3.14 The operational functions that should be identified and assigned include, but are not limited to, collection of contributions, record-keeping, actuarial analysis, funding and contribution policy, asset-liability management (for defined benefit and hybrid plans), investment strategies (for both DB and DC plans), asset management, disclosure to plan members, and regulatory compliance.
- 3.15 The governing body's main responsibilities should include at least:
  - monitoring the administration of the pension fund in order to ensure that the objectives set out in the fund by-laws, statutes, contract, or trust instrument, or in documents associated with any of these are attained (e.g. diversified asset allocation, cost-effectiveness of administration, etc);
  - selecting, compensating, monitoring, and, where necessary replacing staff with operational responsibilities as well as external service providers (e.g. asset managers, actuaries, custodians, auditors, etc);
  - ensuring the compliance of the activities of the fund with the pensions law (e.g. investment regulations, reporting and disclosure requirements, control of conflicts of interest situations, improper use of privileged information, etc);
- 3.16 The members of the governing body should be legally liable for the management of the pension fund on a personal basis. It is recommended that they insure themselves against claims arising from this liability.
- 3.17 The governing body should ensure that all its professional staff and the external service providers have the relevant qualifications and experience required to carry out their functions in accordance with the objectives of the pension entity. For example, asset managers and actuaries working in a pension entity should be required to have a relevant professional certification.
- 3.18 The legal provisions require the governing body of a pension fund to satisfy itself that collectively it has sufficient expertise to understand the important issues related to the use of derivatives, and that all individuals conducting and monitoring derivatives activities are suitably qualified and competent.

### **Internal controls**

#### ***Essential Criteria***

- 3.19 The legal provisions require that there are appropriate internal controls in place to ensure that all persons or entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension fund's bylaws, statutes, contract or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.
- 3.20 The legal provisions require that reporting channels are established between all the persons and entities involved in the administration of the pension fund in order to ensure the effective and timely transmission of relevant and accurate information.

### ***Advanced Criteria***

- 3.21 Objective performance measures may be established for persons and entities involved in the administration of pension plans, funds, and entities.
- 3.22 Rules and procedures are put in place to identify and deal with situations where there may be a conflict of interest.
- 3.23 Where a conflict of interest situation involves a member of a governing body, the case should be reviewed and monitored by the members of the governing body that are not subject to the conflict.
- 3.24 There should be appropriate controls to prevent the improper use of privileged or confidential information. A code of conduct may be established, requiring employees of a pension entity or pension fund managing company to observe high standards of integrity, honesty, and fair dealing. Internal review mechanisms may be put in place to verify and sanction the compliance with the code of conduct.
- 3.25 The reporting process for the decisions taken by the governing body should be recorded on written reports.

#### **Core Principle 4: Pension plan liabilities, funding rules, winding up, and insurance**

Private occupational plans 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 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 plans at individual company level should generally be prohibited.

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.

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.

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.

### ***Discussion***

Funding is a concept that primarily pertains to occupational pensions in which one or more sponsoring employers promise a definable outcome and the financing risk remains with the employer or employers. Such pensions generally are labelled defined benefit plans. Defined benefit pensions may be single employer or multiple-employer with risk sharing within the sponsoring group. The provisions outlined below apply to employer sponsored defined benefit plans.

Where such benefits are financed from an autonomous pension fund, the legal provisions should establish a framework for ensuring the adequacy of the assets to meet benefit payments. The main alternative to funding is book reserve financing (non-autonomous pension fund), but this is not a method to be recommended as international best practice and is only accepted in a few countries, where they are used in conjunction with insolvency insurance, a guaranty pool, a contingency bond or similar arrangement. Private unfunded pay-as-you-go plans at individual company level should generally be prohibited.

The primary objective of funding rules is benefit security; that is, to make it more likely that promised benefits will be paid, regardless of the financial fortunes of the employer(s). Generally this means investing in diversified assets mostly unconnected with the employer(s). Such rules also minimise financial uncertainty for the shareholders and bondholders of those firms that sponsor pensions and may minimise claims against the public, directly or indirectly, in the event of pension promises not being delivered by insolvent employers.

In contrast, in a defined contribution arrangement, an employer's liability ends when the firm makes the contribution, aside from fiduciary liability arising from failing to adhere to the terms of the plan or as managing trustee.<sup>6</sup> In general, covered workers bear the investment risk in defined contribution plans.<sup>7</sup>

In defined benefit pensions, *ongoing* funding rules require that the value of the plan's liabilities in respect of all potentially promised benefits are periodically calculated, taking into account relevant contingencies, with respect to existing and former plan members (the actuarial value of projected benefits). Secondly, funding requires the plan's liabilities with respect to existing plan members be allocated over time in relation to service (work) under the plan. Thirdly, with the exception of book reserve financing, funding rules seek to assure that dedicated assets – that is, past contributions and investment returns -- match this potential ongoing liability as it accrues and matures over time (accrued liability on an ongoing basis).

In addition, countries may need to have *terminal* funding rules that seek to assure that plan assets at least equal all promised benefits to date if the plan were to be terminated/wound-up (the accumulated benefit obligations or terminal liability). In general, holding assumptions constant, the accrued ongoing liability is greater than the terminal liability. However, there are exceptions where this is not the case (e.g., plant-closing liabilities), and in some countries, experience has been that the tighter rules in defining terminal liability are necessary to complement the normal discretion given trustees and actuaries in defining ongoing liability.

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<sup>6</sup> Even for defined contribution plans, pension regulators need to assure that contributions are made in a predictable way that matches the pension plan's own rules and ties at a minimum to an annual accounting period for compensation. See Guideline 2 for more discussion.

<sup>7</sup> In some countries' defined contribution arrangements, management of assets is transferred to an insurance entity or a foundation co-managed by representatives of employers and covered workers. Even though those arrangements are designed to give workers definable outcomes (at least up to some minimum return), they are nonetheless defined contribution in the sense that the employers' liabilities are fixed by the amount of required contributions. Workers can only look to the insurance company or pension fund foundation to deliver on the promise. This is also the case in those instances where the asset in a defined contribution arrangement is an insurance product. IAIS standards should be applied when the assets are insurance products. The provisions in this section on funding rules, however, may be useful in examining the operations of autonomous third-party pension foundations that are attempting to meet a rate of return promise.

## **Measurement of pension liabilities in defined benefit plans**

### ***Essential Criteria***

- 4.8 Legal provisions are in place requiring the funding of defined benefit occupational pension plan liabilities.
- 4.9 Legal provisions are in place that require the determination of defined benefit pension plan liabilities corresponding to the financial commitments or obligations which arise out of the pension arrangement, defined as the accrued benefit rights of pension plan members and beneficiaries in ongoing pension plans.
- 4.10 These legal provisions require the use of appropriate calculation methods, including actuarial techniques and amortisation rules that are consistent with generally recognised actuarial standards and methods.

### ***Advanced Criteria***

- 4.11 The legal provisions define one or more measures of ongoing liability to be used in determining annual contribution requirements to defined benefit pension plans. The ongoing liability measures should presume that the plan remains in place with respect to its existing members at the time of valuation.<sup>8</sup> In calculating ongoing liability plan sponsors and pension entities should take into account the particulars of all plan benefit formulas and rights using approved valuation factors (see below).
- 4.12 These legal provisions (referencing generally recognised actuarial standards and methods) provide guidance concerning the appropriate range of actuarial assumptions for ongoing liability with respect to separation, disability, and mortality during active service, salary or wage growth (including any indexing requirement) in determining ongoing liability and expected income from assets. For discount rates and longevity, see below.
- 4.13 In many countries, legal provisions also establish a clear measure of terminal liability (also called winding-up liability) that reflects the country's laws about the rights of participants if the plan were to be terminated on or about the time of valuation (accrued rights). These rights often correspond to the rights of workers (early leavers) who leave plan coverage (separation) before retirement with a vested benefit payable at the plan's annuity starting date. The concept of terminal liability can be important for minimum funding rules (below).
- 4.14 Any definitions of accrued rights and terminal liability reflect any indexing factors prescribed by law or plan terms that apply from separation (or plan termination) to the annuity starting date and, if relevant, after the annuity starting date. These definitions also should reflect benefits that become vested upon plan termination.
- 4.15 The legal provisions (referencing generally recognised actuarial standards and methods) provide guidance regarding the reasonable range of discount rates for determining liabilities. The regulator should provide guidance concerning any other factors that may be considered in determining the discount rate for ongoing liability on the one hand, and the discount rate for terminal liability on the other.

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<sup>8</sup> The regulator should avoid language that would preclude a plan sponsor from engaging in forecasting pension costs to the sponsor in which the rights of and contributions attributable to new workers are also considered.

- 4.16 The legal provisions (referencing generally recognised actuarial standards and methods) provide guidance on longevity after benefits become payable (retirement age or annuity starting date). Relevant sources may include census/statistical offices, as well as information based on annuity transactions of life insurance companies. However, the pension regulator may wish to take account of any systematic differences in longevity characteristics between pension plan retirees and beneficiaries and the purchasers of annuities from life insurance companies.

### **Funding Rules for defined benefit plans**

#### ***Essential Criteria***

- 4.17 The legal provisions require the identification and maintenance of a level of assets that is sufficient to cover ongoing plan liabilities. Legal provisions are in place for determining contribution requirements with respect to ongoing liabilities.
- 4.18 These legal provisions set out flexible methods for correcting a situation of underfunding – that is, where the value of pension assets is less than the value of the pension liabilities with appropriate distinctions concerning the source of underfunding. Additional legal provisions may be necessary to assure that additional funding is available in the event of the winding-up of a pension plan.

#### ***Advanced Criteria***

- 4.19 With respect to defined benefit plans other than book reserves, the legal provisions (referencing generally recognised actuarial standards and methods) provide guidance concerning appropriate actuarial funding methods to allocate a pension plan's ongoing potential liability over time. The method provides for an annual contribution obligation (normal cost or annual service cost) derived from such allocations.
- 4.20 Approved funding methods attempt to prevent sharply rising cost curves over time by spreading costs over the expected career path of plan members as even percentages of payroll or at a minimum even currency units. To assure adequate funding over time at prudent levels, funding methods should take into account factors such as salary growth, separation and other relevant events.
- 4.21 In addition to normal cost or annual service cost, legal provisions require that funding obligations reflect other factors, including work before a plan's inception, plan amendments that increase liability attributable to past service, deviations from expected results under ongoing assumptions (net experience gains and losses), and the effects of changes in ongoing assumptions (actuarial gains and losses).
- 4.22 Funding rules allow for separate amortisation of liabilities related to work for plan sponsors prior to plans being adopted and of liabilities resulting from plan amendments that retroactively increase benefits based on past service under the plan. The amortisation periods for these liabilities should balance prudential interests and allowing sponsoring employers to provide retirement benefits to workers who were employed by the firm sponsoring the plan before the plan's inception. Similarly, with respect to changes in the law that require sponsors to recognise or accelerate the recognition of liabilities, legally established amortisation periods should balance prudential interests, the effects on sponsors' reported earnings and cash flows, and the willingness of sponsors to establish and maintain defined benefit plans.

- 4.23 The legal provisions require that rules are in place to spread net experience gains and losses arising from changes in actuarial assumptions. The periods should be chosen so as to keep plan contributions on a path consistent with the plan's normal cost or annual service cost.
- 4.24 In some countries the legal provisions also require that periodic contributions on an ongoing basis are not less than amounts necessary to assure minimum funding levels determined with reference to terminal liability. Such measures might include relatively rapid amortisation of underfunding on a terminal liability basis. Any such rapid amortisation rules should be flexible enough to take account of the source of the underfunding.
- 4.25 Flexibility for temporary suspension of contribution obligations may be considered in the legal provisions, but only under defined circumstances (such as business hardship) with a clear waiver procedure managed by the pension regulator. The procedure should have the option to require any sponsor granted a waiver to collateralise the waived contributions with secured liens on company assets or otherwise provide security on behalf of the pension plan and, if relevant, any public or private insolvency insurer or guaranty fund.
- 4.26 Optimally sponsoring employers should be permitted to more rapidly recognise and amortise unfunded liabilities and make deductible contributions that exceed annual contribution obligations. Such provisions may include more rapid amortisation of unfunded liabilities attributable to past service or acceleration recognition of future liabilities over a worker's remaining expected service with the sponsoring employer.

### **Winding Up**

#### ***Essential Criteria***

- 4.27 There are legal provisions in place regarding the allocation of plan assets and the responsibility for underfunding in the event of plan termination.
- 4.28 The legal provisions recognise the creditor rights of pension plan members and beneficiaries in the case of bankruptcy of the plan sponsor.

#### ***Advanced Criteria***

- 4.29 In the event that assets exceed promised benefits on a terminal basis, there should be rules in place as to the allocation of the surplus. In the event that promised benefits exceed assets, there should be rules to allocate available assets to members in accord with accrued rights and with general principles of equity.
- 4.30 The legal provisions should seek to have the country's bankruptcy and company insolvency laws provide priority position for due and unpaid contributions at the time of plan termination. The position should equal at least the position of due and unpaid taxes at the time of plan termination. Priority rights may also be considered for underfunded pension commitments with reference to the terminal liability.

### **Core Principle 5: Asset Management**

Investment by pension funds should be adequately regulated. 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. Investment abroad by pension funds should be permitted, subject to prudent management principles.

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.

### ***Discussion***

The investment of pension fund assets is one of the core activities of a pension entity. In the case of defined benefit plans, the goal of the investment function is to help the governing body generate the highest possible returns consistent with the liabilities and liquidity needs of the pension plan, 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 investment goals and the risk tolerance of plan participants. In participant-directed defined contribution plans, this function is in large part carried out by plan or fund members themselves, albeit with varying degrees of intervention and responsibility for oversight or monitoring remaining with the pension entity. In all these cases, it is critical that the investment function be responsibly implemented, managed and regulated.

Investment regulation should be based on prudential principles such as diversification, dispersion, and maturity and currency risk management. A prudent person rule can be included in the legal provisions to embody these principles. Under this rule, the pension plan or pension entity's governing body or another responsible party will have broad authority to invest the pension assets in a prudent fashion in light of the particular needs of the plan or fund. In addition, the authorities may restrict, the ability of the governing body or responsible party explicitly by quantitative regulations, for instance by asset class. Quantitative limitations, which for example, inhibit adequate diversification or impede maturity matching should be avoided.

Additionally, separate regulatory considerations may arise in individual account type plans or funds where members are able to direct their own investments (typically among a specified array of choices). These types of plans or funds may require distinct regulation addressing the unique concerns that may arise in those circumstances. These, too, are addressed in the guidelines. Notwithstanding the different concerns that arise under the prudent person and quantitative approach to regulation, and the unique concerns associated with member direction of investment, the bulk of the guidelines below apply in all cases.

As noted in the introduction, where a pension fund is invested in certain insurance vehicles or collective investment schemes (CIS), such as unit investment trusts or mutual funds, the regulation of the underlying vehicle may be the responsibility of a different regulator subject to principles and guidelines in addition to (or in lieu of) those in this document. Nonetheless, in such cases it is critically important to recognise that the responsibility to regulate the pension entities' investment decisions and processes will remain with the pension regulator.

## **Valuation of pension assets**

### ***Essential Criteria***

- 5.1 The legal provisions establish a proper and disclosed basis for valuing pension assets.

### ***Advanced Criteria***

- 5.2 The legal provisions require pension assets to be valued on a basis that is adequate for accounting and reporting purposes. For actuarial and funding determination, rules may permit methods of smoothing asset values over time.

## **Prudent Person Standard**

### ***Essential Criteria***

- 5.3 The governing body of the pension plan/fund and other appropriate parties is subject to a standard of prudent behaviour such that the investment of pension assets is undertaken with care, skill, prudence and diligence.

### ***Advanced Criteria***

- 5.4 The standard of prudent behaviour applied to the governing body and other appropriate parties should include:
  - A duty of loyalty, i.e., an obligation to make investment management decisions in the best 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.
- 5.5 The legal provisions establish principles related to diversification, dispersion, and maturity and currency risk management pursuant to which assets should be invested.

## **Portfolio limits**

### ***Essential Criteria***

- 5.6 The legal provisions may include maximum levels of investment by category to the extent that they are consistent with the principles of diversification, dispersion, and maturity and risk management pursuant to which assets should be invested. The legal provisions shall 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.
- 5.7 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.
- 5.8 Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the pension fund to excessive risk concentration.

- 5.9 Investment abroad by pension funds should not be prohibited.

#### ***Advanced Criteria***

- 5.10 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 fund assets are permitted to exceed the maximum levels under certain conditions, such as within specified time limits or upon prior supervisory authorisation.
- 5.11 In accordance with the principle of dispersion, maximum levels (ceilings) may be established for the investment in a given asset, in a single issue, in securities of the same issuer (single or group issuer) as a proportion of a pension fund's total portfolio.
- 5.12 Legal provisions also should include a prohibition or limitations (maximum levels or ceilings) on self investment by those undertaking investment management of pension assets. 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 maximum ceiling of 10 percent of the pension assets on:
  - The ability of pension fund managers to invest pension assets in shares or other instruments of their own company and affiliated companies; and
  - The ability to invest pension assets in the shares or other instruments of the employer sponsoring the pension plan or fund and affiliated companies of the employer.
- 5.13 Similarly, legal provisions should include maximum limits (ceilings) 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.

#### **Investment policy**

##### ***Essential Criteria***

- 5.14 The governing body or the party responsible for the investment management of pension assets is required to set forth and actively observe an overall investment policy.

##### ***Advanced Criteria***

- 5.15 The investment policy should establish clearly the investment objectives and the modalities for achieving those objectives. The investment objectives should satisfy the principles of diversification, dispersion, maturity and currency matching and they should identify the strategic asset allocation (the long-term asset mix over the main investment categories), the performance objectives of the fund, and the means of monitoring and modifying such allocations and performance objectives.
- 5.16 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.
- 5.17 Legal provisions are in place regarding the use of derivatives. The requirements consider the risks in the use of derivatives and other similar commitments.

- 5.18 The legal provisions require that the governing body has in place an appropriate policy for the use of derivatives and similar commitments. This policy, which may be part of the overall investment policy of the pension fund, should be reviewed periodically.

#### **Core Principle 6: Rights of members and beneficiaries and adequacy of benefits**

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.

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).

Appropriate disclosure and education should be promoted as regards respective costs and benefits characteristics of pension plans, 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 individual pension plans.

#### **Discussion**

The key distinctions among pension programmes that may affect the precise nature and scope of rights and protections are first, whether the pension programme is mandatory or voluntary; second, whether the pension programme is intended to be the primary or only a supplementary source of retirement income; third, whether and to what extent the programme is subsidised by the state; and fourth, whether the plan design is defined benefit or defined contribution, and if defined contribution, whether plan members themselves direct their own investments. In the case of pension plans voluntarily established by employers for their employees, countervailing labour market constraints, including the role of collective bargaining and the extent to which certain rights may impose additional costs or unwarranted burden on employers, must also be taken into account. Put more directly, there is a risk that overly proscriptive member rights and protections may lead to a decrease in pension plan formation or upset the balance of collective bargaining over such issues. These concerns must be taken into account and be balanced against the need for such rights and protections.

In addition to these distinctions, one may distinguish between substantive rights and procedural rights, although the line between the two may not always be clearly drawn. Substantive rights would include, among other things, certain fundamental rights of non-discriminatory access, participation and coverage in an employer's pension plan, as well as benefit accrual and vesting rules. To the extent that a right is characterised as substantive, the nature of the pension plan (voluntary/mandatory, primary/supplementary, defined benefit/defined contribution, etc.) will be reflected in the expansive or limited nature of the right granted. By contrast, procedural rights are more universal in character, less dependent on the nature of the pension plan, and are, therefore, less likely to vary substantially in degree or quality. These procedural rights would include, for example, certain juridical rights, such as the right to a transparent and fair process

whereby member and beneficiary claims and grievances may be timely heard and appealed and adequate redress obtained.

One basic right that should be granted to members and beneficiaries regardless of the type of plan is the right to disclosure about relevant information concerning the pension plan and fund. Members and beneficiaries who have regular access to clear descriptions of their rights and responsibilities accruing to plan or fund membership – and who understand those rights and obligations – will serve an important monitoring function to assure the appropriate governance of the plan or fund. Disclosure and education is also appropriate to help members and beneficiaries understand (1) the extent to which their plan or fund may provide them with a satisfactory level of income in retirement, (2) the extent to which they and/or the pension plan or fund bear the risks and responsibilities of providing and protecting their expected retirement income, and (3) the decisions that they may need to make regarding the form and timing of benefit payment at retirement. This transparency is critical to the efficient and sound workings of all occupational pension plans, regardless of plan or fund type. Beneficiaries should also be able to obtain upon request relevant information regarding their benefits and rights.

### **Access to plan participation, equal treatment and entitlements under the pension plan**

#### ***Essential criteria***

6.1 Employees have non-discriminatory access to the private pension plan established by their employer. Specifically, regulation aims at avoiding exclusions from plan participation that are based on non-economic criteria, such as age, gender, marital status or nationality. In the case of mandatory pension plans, those plans that serve as the primary means of providing retirement income, and those that are significantly subsidised by the state, regulation also aim at avoiding other unreasonable exclusions from plan participation, including exclusions based on salary, periods of service and terms of employment, (e.g., by distinguishing between part-time and full-time employees or those employed on an at-will and fixed-term basis). Regulation of voluntary and supplementary pension plans also aims towards similarly broad access, although the extent of such access may take into account factors including the voluntary nature of the arrangement, the unique needs of the employer establishing the pension plan, and the adequacy of other pension benefits.

6.2 Employees are equally treated under the plan rules with respect to portability rights, disclosure requirements, governance and redress mechanisms, and other rights associated with the plan.

6.3 If establishing rules for benefit levels and accrual or contribution rates, regulators may take into account the extent of integration of occupational plans with other public or mandated sources of retirement income and the adequacy of the totality of the benefits provided.

6.4 Employees are protected from retaliatory actions and threats of retaliation by their employer or pension plan representatives with respect to pension benefits and the exercising of rights under a pension plan. For example, they should be protected from terminations of employment carried out with the intent to prevent the vesting of an accrued benefit under the pension plan. Similarly, individuals exercising their rights under a pension plan, including but not limited to their filing of a claim or appeal or their initiation of administrative or judicial action, should be protected from retaliatory action, such as termination of employment, suspension, discipline, fine or any other type of discrimination.

## **Benefit Accrual and Vesting Rights**

### ***Essential criteria***

6.5 Regulations promote the protection of benefits that an employee accrues by participating in an occupational pension plan, prevent the retroactive reduction of the value of benefits previously accrued in the plan and provide that plan members obtain timely notice regarding any reduction in the rate of future benefit accruals in the pension plan.

6.6 Accrued benefits vest immediately or after a period of employment with the employer sponsoring the plan that is reasonable in light of average employee tenure. Benefits derived from member contributions to the pension plan should be immediately vested.

6.7 Practices that substantially undermine or eviscerate benefit accrual and vesting rights are not permitted.

6.8 Vested benefits of those individuals who have severed employment with an employer are protected and not subject to forfeiture, regardless of reasons for severance, except in the limited case of dismissals resulting from acts of gross malfeasance that are clearly defined.

6.9 Vested benefits are protected from the creditors of the plan sponsor and plan service providers (including any financial institutions or other entities managing the pension plan or plan assets or acting as a custodian of pension fund assets associated with the plan) – at a minimum by the legal separation of plan assets. Vested benefits are also protected when the plan sponsor or a plan service provider changes ownership due to merger, acquisition, sale, or other corporate transaction, or files for bankruptcy. Similarly, the extent to which vested benefits are protected from the creditors of individual plan members and beneficiaries is addressed.

### ***Advanced criteria***

6.10 Vesting periods range from immediate vesting to five years, although in some cases it may be longer.

6.11 Excessive back-loading of benefits (deferring benefit accrual through the design of the benefit formula) is discouraged.

6.12 Severed employees, whether separated from service voluntarily, through mutual agreement or at the will of the employer, are assured that at least the nominal value of their vested benefit in a pension plan is protected.

## **Pension portability and rights of early leavers**

### ***Essential criteria***

6.13 Individuals who are changing jobs are able, upon request, to move the value of their vested account balance in a defined contribution plan from their former employer's pension plan either to the plan of their current employer (where permitted) or to a similar, tax-protected environment provided by an alternative financial instrument or institution. Where feasible, a similar portability right is available to individuals in defined benefit plans. There may be diminished need for individual portability rights where there are industry-wide and other types of multiple-employer pension plans.

6.14 Individuals have the right to timely execution of the request to transfer the value of their vested benefit accruals.

6.15 With respect to defined benefit pension plan benefits, the actuarial and interest rate assumptions used in valuing an individual's vested benefit accrual that is to be transferred are fair and reasonable. These assumptions are made readily available to the individual transferring the value of his accrued benefit.

6.16 Portability rights are available to members of a pension plan when they separate from service with an employer, regardless of whether the separation is voluntarily, involuntary or by mutual agreement.

6.17 Portability rights are not inhibited by the assessment of unreasonable charges or fees, such as excessive transaction charges or excessive back-end fees. At a minimum, members and beneficiaries are informed of the presence of any such charges or fees.

6.18 Individuals are not required to exercise their portability rights and, generally, are permitted to leave their vested benefits in the pension plan of their former employer.

#### ***Advanced criteria***

6.19 If defined benefit plans do not index the vested benefit amounts of early leavers for wages or inflation, former plan members are able to transfer their benefit accumulations elsewhere.

#### **Disclosure and availability of information**

##### ***Essential criteria***

6.20 Members and beneficiaries in pension plans, as well as potential plan members, have a legal right to ready access or disclosure to basic information about the pension plan, including adequate information regarding their rights of access, anticipated contribution and/or benefit accrual rates, vesting schedules, other rights and obligations, the names and manner of contacting responsible parties for plan administration and governance, and claims processes or procedures.

6.21 Plan documents, annual accounts, and annual financial and actuarial reports, if not automatically disclosed, are made readily available to plan members and to beneficiaries where relevant for copying for no more than reasonable charge or fee.

6.22 Members and beneficiaries are notified in timely fashion if required employer and member contributions have not been made to the pension plan.

6.23 Timely, individualised benefit statement is provided to each plan member (and to beneficiaries where relevant). The frequency and type of information included on the benefit statement will depend on the type of pension plan. The information included enables the plan member to identify current benefit accruals or account balances and the extent to which the accruals or account balances are vested. For pension plans with individual accounts, the information includes the date and value of contributions made to the account, investment performance, earnings and/or losses, and, for member-directed accounts, a record of all transactions (purchases and sales) occurring in the member's account during the relevant reporting period. This information and other similarly personal data is maintained and delivered in a manner that takes full account of its confidential nature.

6.24 Individuals are provided adequate information about the rules associated with the portability of their vested benefit accruals, especially where the transfer of these assets may entail a loss of certain benefits or rights that were associated with the pension plan in which the benefit originated.

6.25 Disclosure materials are written in a manner expected to be readily understood by the members and beneficiaries to whom they are directed.

6.26 Consideration is given to adequate forms of delivery of disclosure materials, including delivery by post, delivery at the workplace, and via email or websites, where feasible.

6.27 Amendments or changes to the pension plan that will significantly impact members and beneficiaries, their rights and their benefits are disclosed to them in timely fashion and in a manner expected to be readily understood by them.

### ***Advanced criteria***

6.28 Certain information is automatically provided to members (or beneficiaries, depending on the case) at certain times or following particular events, such as on joining the plan or when material changes are made to the plan. Depending on the type of plan, the information that is automatically provided to members includes:

- Information regarding the governing body of the plan or fund, including the names and responsibilities of the governing body members and information regarding how to contact the plan or fund;
- An explanation of the nature of the benefit promised under the plan rules, including an identification of the risks borne by the average member (such as the investment risk inherent in defined contribution arrangements) and those borne by the plan sponsor or financial companies managing the fund.
- Information about the consequences of leaving plan coverage before pension rights may be vested, the effects of inflation or real wage growth on the value of vested terminated benefits;
- In defined contribution plans, members should be regularly informed (at least annually) on the investment returns and plan or fund management fees charged to their individual accounts or shares of the pension fund.
- Where members have the right to direct the investment of individual accounts, the disclosures should provide adequate information upon which each member can make sound investment decisions. In particular, plan members should be informed of the nature of the financial instruments available to them as investment choices and the role of cost and fees in the rate of return on investments selected.
- Where members have a choice among forms of benefit distribution, they should be informed of these forms of benefit in order to enable them to select a form of benefit appropriate to their financial situation. In the case where lump-sum benefits are offered, plan members should be informed, for example, of the options they have in order to transform this lump-sum into other retirement products, such as annuities purchased from insurance companies;
- Information sufficient to enable members to understand the recourse available to them in order to protect or assert their rights under the pension plan. This information should include

procedures to present a claim for benefits and to seek remedies to redress claims which the member considers to be wrongfully denied and a mechanism to address plan or fund activity inconsistent with legal provisions or with plan or fund by-laws.

6.29 Other information, made available to members and beneficiaries on a timely basis upon request, includes:

- Information regarding the funding of plan obligations and investment management of plan assets, including, where appropriate, information regarding the extent and reasons behind funding deficiencies (calculated on a terminal and on-going liability basis), the fees and costs associated with the investment of assets, descriptions of fund investment objectives and the historical performance of plan or fund asset managers measured against market benchmarks;
- In defined benefit plans, information on any provision that may have been made for insolvency insurance or other arrangement made to collateralise pension liabilities. This disclosure should include the rights of participants against an insolvency insurer or other guaranteeing party and against the sponsoring employer in bankruptcy; and

6.30 In communicating with its members, the pension plan aims to do so in a way that will be understood, providing information that is sufficiently accurate and comprehensive to enable members to understand the nature of the plan or fund and their rights and obligations.

#### **Additional rights in the case of member-directed, occupational plans**

##### ***Essential criteria***

6.31 Where members direct their own investments in an occupational pension plan, they have the right to a number and diversity of investment choices sufficient to permit them to construct an appropriate investment portfolio in light of their own individual circumstances and in the context of the particular pension programme.

6.32 Members should be provided with complete information regarding investment choices that is standardised and readily compared. At a minimum this information should include disclosure of all charges, fees and expenses associated with each investment choice, as well as historical investment performance data.

6.33 Members managing their own individual accounts have the right to timely and fair execution of their investment decisions and to written confirmation of these transactions. The right (or responsibility) to make and execute investment decisions should not be inhibited by the assessment of any unreasonable charges or fees.

6.34 Members and beneficiaries who are required to manage their own individual accounts should be provided sufficient opportunity to acquire the financial skills or education and other assistance that they need in order to make appropriate investment decisions in their pension plans.

##### ***Advanced criteria***

6.35 The range of investment options include both higher-risk and lower-risk options (which may include an option guaranteeing the amounts of the employee's own contributions paid in), and an option suitable for the typical plan member.

## Entitlement process and rights of redress

### *Essential criteria*

6.36 Members and beneficiaries (and individuals claiming the right to be deemed a member or beneficiary under a pension plan) shall be entitled to a fair process or procedure in which their entitlements, rights and benefits under the pension plan may be claimed or asserted.

6.37 The claim process or procedure should be expeditious and transparent. It should be easy to understand and have only reasonable or no cost to the individual claimant.

6.38 The process should include independent administrative or judicial recourse if initial claims of rights or benefits are denied by the pension plan administrator, fiduciary, or employer. This process should provide for adequate remedial measures to redress the loss of rights or benefits suffered by the member or beneficiary whose claim has been found to be valid.

### *Advanced criteria*

6.39 Plan members and beneficiaries should have access to informal redress channels. Occupational pension plans may have internal dispute settlement procedures and independent arbitrators may be appointed to deal with complaints related to occupational pension plans.

### **Core Principle 7: Supervision**

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.

### *Discussion*

The supervision of private pensions is based on the relevant regulation from two aspects. First, the operation of the supervised institutions and plans is defined by the relevant laws and decrees. Second, the structure and responsibility of the supervisory authority itself is determined - in most cases - by the legislation.

The principal responsibility of the supervisory authority is to take appropriate action so that occupational pension plans and pension funds are managed and administered in a way that promotes the interests of plan members and beneficiaries. The supervisory authority should have the power to extend its activity to all aspects of occupational pension plans and pension entities that are covered by the regulatory framework.

The supervisory structure, as well as the responsibility and functional duties of the supervisory authorities is affected by the following structural and regulatory issues:

- level of compulsion on participation in private pension plans (mandatory vs. voluntary system)
- institutional structure of the private pension provision (e.g. institutions that can provide and manage pension plans/funds)
- type of pension plans (e.g. DB vs. DC, funded vs. unfunded)
- type of pension funds (e.g. closed vs. open)
- legal and governance structure of pension funds (e.g. internal versus external governing bodies)
- regulatory approach (e.g. prudent man vs. quantitative regulation)

In addition, the supervisory framework of private pension systems is also influenced by general economic, administrative, and social issues of the respective country, such as:

- the role of the state in society and the economy,
- the development of financial markets and the private pension system,
- the size and structure of the private pension market (e.g. number and size of funds).

While the frequency and intensity of the supervision will vary depending on the factors outlined above, the basic tools at the disposal of the supervisor are common. These include the supervision of the establishment of pension plans and pension entities, the regular off-site monitoring of the reports sent to the authority, on-site inspections, and sanctioning and other remedial action.

### **Organisation**

#### ***Essential Criteria***

- 7.1 Legal provisions clearly and objectively state the responsibilities of the pension supervisor.
- 7.2 These legal provisions grant the pension supervisor operational independence from both political authorities and commercial interference in the exercise of its functions and powers.
- 7.3 The legal provisions grant the pension supervisor adequate powers, legal protection, and proper resources and staff, and the capacity to perform its functions and exercise its powers.
- 7.4 The legal provisions require that the pension supervisor adopts clear, transparent, and consistent regulatory and supervisory processes. Where appropriate, the rules and procedures of the supervisor are published and updated regularly. These legal provisions allow the pension supervisor to consult, as appropriate, with the pensions sector when determining its approach to supervision and regulation.

- 7.5 The legal provisions require that the staff of the pension supervisor observe the highest professional standards including appropriate standards of confidentiality.
- 7.6 If its own capacities are insufficient, the legal provisions allow for the pension supervisor to outsource to third parties (e.g. auditors, actuaries) supervisory tasks such as on-site inspections and off-site monitoring
- 7.7 Third parties are subject to the same confidentiality requirements as the pension supervisor and have legal liability for the services rendered. If required, the pension supervisor must have the ability to take actions against these third parties either directly or through the appropriate professional body.
- 7.8 The pension supervisor is empowered to exchange information with other relevant agencies, taking into account data protection standards.

### ***Advanced Criteria***

- 7.9 The legal provisions require that, where applicable, the pension supervisor addresses complaints by the pension plan members and beneficiaries and by the governing body of pension plans and funds through a clearly specified appeal procedure and to respond in a timely manner to such requests.
- 7.10 The legal provisions address inappropriate dealings between the members of the supervisory staff and the staffs of plans, funds and pension entities (e.g. as regards the acceptance of gifts or invitations).
- 7.11 The legal provisions address conflicts of interest situations that affect the pension regulatory and supervisory staff, identifying potential situations and stating procedures for dealing with them (e.g. prohibition of dealing in shares or investments in the pension entities that they regulate).

### **Authorisation**

#### ***Essential Criteria***

- 7.12 The pension supervisor has the authority to inspect and, where necessary, require the revision of the founding documents of pension plans, pension entities, and pension fund managing companies.
- 7.13 The pension supervisor has the authority to execute a fit-and-proper test of the members of the governing body of pension funds in order to assess whether the person is qualified for the task. The supervisor has the authority to disqualify members of the governing body on the basis of this test.
- 7.14 The pension supervisor has the authority to reject a proposed member of the governing body on the basis of a fit and proper test.

## **Reporting / off-site supervision**

### ***Essential Criteria***

- 7.15 The pension supervisor has authority to review and, where necessary, require the revision of the funding evaluation of defined benefit plans and the audited financial statement of pension funds that must be prepared on a periodic basis. The nature of this requirement should take into account information already required by other financial regulators.
- 7.16 The pension supervisor has the authority to review and, if it does not comply with current legal provisions, require the revision of the investment policy as set forth by the governing body of the pension fund.
- 7.17 The supervisor has the authority to review from time to time the actual investment strategies of pension funds and assess the extent to which their investment policies have been implemented.

### ***Advanced Criteria***

- 7.18 The pension supervisor has the authority to require, when appropriate, that the governing body reports changes in the governance structure, in the distribution of responsibilities, and in the actual nature of the operational and oversight tasks to be carried as part of the administration of pension plans.

## **On-site inspection**

### ***Essential Criteria***

- 7.19 The pension supervisor has the authority to undertake on-site inspections of a pension plan and fund, which include at least the activities listed below:
  - evaluation of the governance and internal control system, including internal audit, reporting and monitoring;
  - compliance with the contribution and benefit schedules as stated in the legal provisions and the pension plan's charter;
  - compliance with funding and investment regulations, including the plan's investment policy and any relevant plan rules;
  - analysis of the pension fund operations and relationships with external service providers and other parties (e.g. pension consultants, asset managers, and custodians).
- 7.20 If its own capacities are insufficient, the pension supervisor has the authority to delegate on-site examinations to external auditors, or other qualified parties. It must have sufficient powers to investigate and gather information deemed necessary to carry out its supervisory function.
- 7.21 The pension supervisor has the authority to carry out limited inspections, investigating only areas of specific concern.

## **Sanctions, intervention, and other remedial actions**

### ***Essential Criteria***

- 7.22 The pension supervisor should be provided with comprehensive investigatory and enforcement powers including:
  - regulatory and investigative powers to obtain data, information, documents statements and records from persons involved in the relevant conduct or who may have information relevant to the inquiry;
  - power to seek orders and/or to take other action to ensure compliance with these regulatory, administrative and investigation powers;
  - power to impose administrative sanctions and / or to seek orders from courts or tribunals;
  - power to initiate or to refer matters for criminal prosecution.
- 7.23 There are procedures in place for the governing body of pension plans and pension funds to appeal to the pension supervisor for decisions taken by the latter that affect them and which they consider inconsistent with the legal provisions.
- 7.24 The pension supervisor has the authority:
  - - to require a change in the organisational or governance structure of a pension entity if it is deemed necessary to ensure their proper functioning.
  - - to request the replacement of members of the governing body that are not carrying out their duties in accordance with the legal provisions.
  - - in the case of external service providers, as appropriate, to request their replacement or report them to their own professional body.
- 7.25 The pension supervisor has the authority to intervene in the management of a pension plan on the basis of supervisory analysis that shows the likely insolvency of the plan.