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# GUIDELINES ON IMPLEMENTATION OF THE PRUDENT PERSON PRINCIPLE FOR INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION (IORPs) IN RESPECT OF ACTUARIAL PRACTICE

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# GUIDELINES ON IMPLEMENTATION OF THE PRUDENT PERSON PRINCIPLE FOR INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION (IORPs) IN RESPECT OF ACTUARIAL PRACTICE

## Introduction

The EU Directive on Institutions for Occupational Retirement Provision (IORPs), published in September 2003, mentions the Prudent Person Principle. While the Prudent Person in the Directive is mainly linked to asset management, the Groupe Consultatif sees the need for a Prudent Person guideline also in respect of the articles dealing with actuarial responsibilities, asset liability management and solvency questions. The following guidance is intended principally to assist actuaries working in the EU and to whom the Directive applies. However, it may also be helpful to actuaries in other circumstances (some of which are identified in the Appendix).

The essential element of the Prudent Person Principle is that investments held to meet the liabilities should be appropriate to the nature of the liabilities. To be able to achieve this requires sound and responsible management where all the financial and actuarial risks are carefully monitored, controlled and explained.

The Groupe Consultatif sees the need for guidelines for actuarial practice especially in respect of the following articles in the EU Pension Directive dealing with actuarial responsibilities:

- Art. 12: Statement of investment policy principles
- Art. 13: Information to be provided to the competent authorities
- Art. 15: Technical provisions
- Art. 16: Funding of technical provisions
- Art. 17: Regulatory own funds
- Art. 18: Investment rules

Although these guidelines suggest certain tools and methods to be applied by actuaries, the Groupe Consultatif is aware that differences in pension environment between member states may require other solutions when dealing with the IORP Directive. However, if there are sound reasons for a different approach, they could still be helpful in determining whether or not including some of the suggested elements here is appropriate.

The Groupe Consultatif proposes a twofold approach for actuaries to implement the Prudent Person Principle for the pension environment in which they are working. The intention is not to replace existing guidelines (such as the 1992 Code of Professional Conduct for Actuaries in EU countries, or the 2003 IAA Guidelines of Actuarial Practice for Social Security Programs), but to supplement these to address the Prudent Person Principle. For information purposes, both of these existing guidelines are included as an Annex.

The first part of the approach describes a number of qualitative and organisational measures to implement in order to promote adequate and financially sound management of IORPs as defined in the EU Pension Directive.

The second part covers various technical elements to be considered by the actuary within the organisation framework. It is the opinion of the Groupe Consultatif that a capital adequacy test provides a useful instrument in addition to the qualitative guidelines to determine whether the investment strategy and decisions are still within acceptable boundaries of the Prudent Person Principle.

The objective is to guarantee the transparency, the validity and the efficiency of the plan. That means setting up:-

i) clearly defined minimum requirements for information to participants and supervisors;
ii) monitoring of risks;
iii) adherence to the structure and governance framework of the IORP; and
iv) observance of responsibilities and rights of all the stakeholders.

## A. Qualitative and Organisational measures

By describing how key processes within the IORP are organised, the way risk management is set up, the investment strategy, the mandates for asset managers and the control processes (both internal and external) for investment activities, the IORP acts in a structured way to achieve a sound investment process and controllable risks. This could be achieved in the form of a document where the IORP describes its organisation, governance structure, financial setup, the valuation basis for its liabilities and the investment policy. The Groupe Consultatif recommends the adoption of such a document by the Board of the IORP and would in particular encourage actuaries working for IORPs within the responsibilities set out in the Directive to adhere to this guideline where possible and reasonable.

This document, given here the working title Actuarial & Operational Memorandum (AOM), could be split into two parts:

i) Actuarial: pensions plans, reinsured risks, valuation basis, contributions and Cost of Living Adjustment policy.

   a. what are the liabilities? how mature are they? how do they behave?
   b. how to measure them?
   c. Funding Agreement

   Depending on local legislation and practice for the sponsor, the trustees may have to agree their own funding rules. In essence this approach to funding is the equivalent of the application of the Prudent Person Principle to investments.

   When determining the AOM, the primary areas of debate between sponsor and trustees relate to -

   - how the balance of powers between the sponsor and the trustees which are laid down in the documentation of a Plan fall to be interpreted;
   - on whose behalf the actuary is acting - as advisor to the trustees, or the sponsor, as the case may be; and finally,
   - what ultimate protections apply if the sponsor goes bankrupt or voluntarily forecloses the Plan.

ii) Organisation: internal control structure, administration and eligibility.

   There are a number of separate, but inter-related areas of application of organisational measures:

   a. Who is accountable for decisions about benefit improvements, investment policy and funding? Who needs to be consulted, etc?

      In this respect it is important that role and responsibilities of Trustees are well defined. Though differences in legislation can lead to different responsibilities, generally it is the duty of Trustees to see that the IORP is operated in accordance with the requirements of its governing document for the benefit of its beneficiaries.

   b. Funding agreement and targets;

   c. Risk management in general -

      o What is the risk that the liabilities will grow unexpectedly? How can this risk be controlled? Who is bearing the risk? To what extent are risks shared between sponsor, IORP and members?

- What happens to the assets under various liability risk scenarios? or vice versa?
- What are the principles that determine how the dependency between assets and liabilities is managed?
- Importantly, which risks can be controlled or at least monitored regularly, and which can only be observed? Investments: strategic asset mix, accepted deviations from strategic mix, asset manager structure, risk measurement, risk control, performance evaluation, and valuation of assets;
- Setting up a capital adequacy test: for this item we refer to Section B below.

## B. <u>Technical elements which constitute a capital adequacy test</u>

The introduction of a capital adequacy test is not intended to result in stricter rules as to technical provisions being imposed. What it is intended to provide is a consistent set of tools to measure and manage the risk profile of the IORP.

Both long-term and short-term perspectives should be addressed in the set-up of the capital adequacy test as follows:

i) A continuity test on long-term solvency, safety capital or any similar buffer against volatility as used in different jurisdictions.

   This test tries to establish whether the risks in terms of capital solvency will, in the long term, remain within the risk exposure norms applicable at the time. This test should be set up to answer the probability of the IORP going bankrupt, the timing and the size of the deficit in such an event.

ii) A minimum required solvency check primarily of the technical provisions intended for financial obligations and, secondly of the available assets designated as at the balance sheet date for coverage of the said obligations.

   This check is intended to make sure that the level of relevant technical pension provisions is at least equal to the current value of those obligations within the economic environment. The current value of the assets used for the coverage of technical provisions must be at least equal to the current value of the financial obligations. Thus this test makes sure as far as possible that, should there ever be a need to transfer obligations, this transfer can be carried out without having to reduce the future obligations.

The capital solvency requirements will depend on an organisation's intended risk profile. This will be expressed first and foremost in the continuity test. Stress testing techniques will help significantly in understanding and managing the underlying financial risks. It supports the IORP in choosing the appropriate level of aversion or adoption of risk both for the long and the short run

The following features should be taken into consideration:

***<u>Pension liabilities</u>***

In particular the following features of pension liabilities should be taken into account:

- The method to determine the discount rate of liabilities (e.g. fixed income term yield rates, any fixed value used);
- Duration;
- Conditions for payment (guaranteed, at discretion of employer or pension fund management body, subject to available funds etc);
- Extent of protection against changes in monetary value both before and after retirement (e.g. by revaluation at a fixed rate, in line with price inflation, earnings inflation or an individual's pay);
- Reinsured risks;

- Funding policy and contribution rates/policy agreed between sponsor and IORP.

In selecting actuarial assumptions regard should be given to the nature of the liabilities and the appropriate investments to match them. In particular -

- Allowance should be made for expected changes in relevant biometric risks;
- Margins should be included for adverse deviation;
- Calculations should comply with relevant legislation and professional guidance and should use recognised actuarial methods and assumptions;
- Calculations should be carried out by an actuary;
- In choosing the discount rates to use, the actuary should have regard to fixed income term yields.

***Pension assets***

In particular the following features of different categories of investments should be taken into account

- Duration;
- Extent of credit risk, in particular distinguishing between government and corporate issues;
- Expected volatility (e.g. market sector);
- Currency.

***Target Funding***

In order to meet adverse developments the IORP should develop a policy of setting the Target Funding by taking into account the following features:

- The possibility of additional funding if the capital adequacy test fails to achieve its required solvency level;
- The degree of volatility allowed in investment results, which is reflected in the asset allocation decision;
- The trade-off between more stable results against a lower contribution rate;
- The Target Funding level where the above defined policies are at their optimum.

## Conclusion

The Prudent Person Principle as set out in the EU Pension Directive aligns with the principles of good professional practice. In this respect, the Groupe Consultatif recommends –

- that the member associations of the Groupe Consultatif encourage the actuaries in their association working for IORPs to follow the principles of this guideline when appropriate;
- further work in this area going forward.

## APPENDIX

### Explanatory Note to the Guidance on Implementation of the Prudent Person Principle

#### *Initial considerations to context of this guideline*

The Groupe Consultatif recognises that although, through various EU Directives, the clear intention is to move towards a common basis for providing occupational retirement solutions, there are still significant differences between the various territories within the EU which may remain in place for a long time in the future. Any guidelines created will need to take this into account. In addition, it should be noted that IORPs can differ in size significantly. Therefore this paper should be considered as a guideline but not a mandatory standard of practice. For small institutions its recommendations might be too comprehensive to handle in practice. It is the responsibility of the actuary to propose to the IORP those recommendations that seem appropriate considering its size, risk profile, and the local regulatory framework applicable.

Though this guideline could also apply to actuarial work done for non-funded or insured pension plans and even for other lines of business, it has been drafted explicitly to address actuarial responsibilities in relation to the EU Directive on IORPs and to the corresponding (draft) legislation adopted by member states.

In some countries the regulatory framework sets requirements (e.g. stress testing) which go beyond the recommendations of this guideline. The Groupe Consultatif welcomes such comprehensive evaluations. However, actuaries who operate in states not subject to such regulations cannot be forced to adopt similar tests in their country. But this guideline should enable them to evaluate their responsibilities and work in relation to the current EU Directive. Moreover, this guideline provides a non-mandatory recommended policy for the whole IORP as an organisation, with a focus on actuarial matters.

#### *Investment Policy*

When considering what investment policy to follow, a prudent trustee will necessarily have regard to the financial strength of the sponsor, and to its expressed commitment to continuing to run the Plan. In those relatively few countries where the Plan members rank highly compared to other creditors in the event of the sponsor's liquidation, perhaps these issues are less crucial. In the majority of countries, it is crucial however, not least because the economic scenarios that yield poor or negative investment returns often coincide with those that are poor, for the business prospects of the sponsor itself.

By using an actuarial framework, the trustees can determine the level of investment risk a Plan could, or perhaps should, take on. Risk is, of course, neither good nor bad: the issue is how it is utilised. Nor can risk be eliminated, but typically it is shared or transferred between parties (and not always to their knowledge).

It is important to highlight two points:

- the cost of liabilities is determined by the benefit design;

- in a funded Plan, the accounting and cash flow (funding) impacts are certainly influenced by how the assets of the Plan are invested. Matching the liabilities will produce higher contributions with a high degree of certainty. To the extent that one mismatches (i.e. holds assets of shorter duration than one's liabilities), then the contributions required may be higher or lower depending on whether the investment managers called the market correctly. Typically, a trustee can take risk when that trustee is comfortable that the Plan is not going to terminate in the short term.

***Interdependence of Assets and Liabilities***

When evaluating the interdependence between assets and liabilities there are several methods to integrate those risks into one Asset Liability Management model.

It is considered best practice to use actuarial modelling to investigate the balance of risk and reward for a range of possible strategic asset allocations between different asset classes, before deciding on the asset allocation.

It is considered best practice to state the investment principles, including asset allocation benchmark, on which the assets will be managed, and to monitor or report on the adherence to this principle.
It is normally appropriate for a diversified portfolio of assets to be held.

It is regarded as not prudent to hold more than a small proportion of assets in the stock or bonds of the sponsoring employer or group in which the sponsoring employer participates.

It is not considered prudent to hold more than a modest proportion of assets in the stock or bonds of any single enterprise or business grouping of enterprises.

It is considered best practice to measure the investment performance achieved relative to appropriate market indices and survey data, both over short term and long term intervals.