

OECD turns its attention to possible further regulation of DC plans, impact of accounting standards

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The views expressed in this article are solely those of Mr. Powell as a private practitioner and are not the views of the OECD, WPPP, IPPC, the Private Sector Advisory Committee to the IPPC, or any governmental agency.

Market turmoil brings DC Plan Investments heightened attention at recent meeting

At the recent Working Party on Private Pensions (WPPP) meeting of the Insurance and Private Pensions Committee (IPPC) of the Organization for Economic Cooperation and Development (OECD) in Paris, the agenda focused on largely on defined contribution plans and the current economic turmoil. This should be of interest to employers and service providers to DC plans everywhere, whether engaged in cross-border business activity or not, as this

appears to signal the beginning of a long schedule of work in this area by the OECD. Though often thought of primarily as a data-gathering entity, the OECD also reviews private pension systems in member countries, analyses policy and technical issues, and formulates pension policy recommendations. As those who follow it have observed, the OECD has become increasingly active in the pension area.

Clearly, the trend throughout the OECD member countries has been toward defined contribution (DC) plans and away from defined

benefit (DB) plans, largely because of the issues with funding of defined benefits, including funding issues in social insurance programs such as Social Security in the US. Having in recent years issued significant guidelines on pension funding and regulation, defined contribution regulation is a natural progression for the IPPC, but the most recent meeting also covered a great deal of concern about the financial turmoil in the markets and whether it warranted further adjustment to regulatory systems and the permitted investments by DC plans.

Currently, some major countries already limit equity investments by DC plans and the OECD has begun to discuss whether such limits should be considered in some form in other countries where equity investment by DC plans is common.

Regulatory approaches which were discussed at the IPPC meeting included (1) quantitative portfolio ceilings (limits on equities), (2) minimum return/minimum replacement restrictions (investment policies based on probability thresholds, length of contributions and the accumulation period), (3) short term investment restriction based on value at risk (VaR) (generally steering investors to investments with no more than

30% equities), and (4) limitations based on replacement rate expected shortfall. Generally, all methods make very low or very high exposure to equities look unattractive. But it was also observed that regulatory methods that effectively force sales of equities in market downturns (as, apparently, Finnish laws provided) could be counterproductive. Of course, also drawing some criticism were restrictions on foreign investment, which are generally inconsistent with the purposes of the OECD.

Of course, the next question raised by proposals to limit investment in equity by plans is where the monies should be invested instead. It was noted that corporate debt is subject to risks as well, not only of default risks, but liquidity and interest rate risk, all of which can affect the value of the instrument prior to maturity. Debt instruments are not immune from the issues of fair value accounting and the convergence of US Generally Accepted Accounting Principles (GAAP) to International Accounting Standards (IAS), discussed below. Some countries already require a partial investment by DC plans in government-issued interest-bearing instruments, which creates different concerns of unfunded liabilities at the government level,

akin to the Social Security funding controversy in the US. Another disconcerting example is that of Argentina (not an OECD country), which recently passed legislation to convert private pension investments to a governmental obligation, described by some in the financial press as an asset seizure, though one of its purported purposes was to protect the value of the pensions from further market drops.

Another area being examined by the IPPC was the relationship between DC investment and longevity. The use of annuity distributions from DC plans was discussed, including the use of deferred annuities, (e.g., commencing only at age 85). Currently, efforts are being made by some insurance companies in the US to foster annuity payouts from DC plans, but the products have been fairly complex and raised technical regulatory issues. Some country representatives noted that we really don't have much data on the self-managed payout phase from DC plans.

Interestingly, the role of pension investment in private equity, hedge funds and other alternative investments and their possible role in or impact by the current market turmoil did not receive much attention at the IPPC meeting,

perhaps because OECD reports indicate that only a nominal amount of overall pension assets are held in alternative investments.

Concerns expressed regarding IAS Accounting Standards for pensions

Not unrelated to the concerns raised by recent market turmoil, the IPPC has also been discussing the impact of IAS 19, the international standard of accounting for DB pension plans, which, similar to Financial Accounting Standard (FAS) 158 currently in the US, essentially requires current recognition of assets and liabilities at their fair value (although how IAS 19 would have them presented in the financial statements is still being finalized). Both standards have been fairly controversial.

At the recent meeting, a number of country representatives and other parties expressed concern that current recognition of losses and gains makes it appear that pension liabilities are more risky than other liabilities of the employer, which may not necessarily be the case. Further, it was observed that, in some countries, defined benefit liabilities may be reduced in some circumstances, while in other countries, the employer may not be accountable for all of the liabilities.

Several WPPP members expressed a view that there was little future for DB plans under the new accounting rules. Related to accounting valuation is pension funding, where the market turmoil has also raised concerns that the additional funding required could cause the loss of jobs, and result in lenders to employers requiring remedial measures such as pension freezes as pension liabilities hit employer balance sheets.

Calls for disclosure of Environmental, Social and Governance considerations in Plan Investment Policies.

Several additions were proposed for the Guidelines for Pension Fund Governance of the WPPP, previously issued in 2002 and formally adopted in 2005. Apparently due to comments by certain advocacy groups, among them is a new rule that the governing body of the plan "should disclose if, and if so how, environmental, social and governance considerations are taken into account in the investment policy." Some business interests are likely to be concerned with the extent and effect of that disclosure. In the U.S., there are already significant issues surrounding how what is referred to as socially responsible investing fits with the fiduciary principle to

act prudently and in the exclusive interest of plan participants and beneficiaries. That the actions of pension regulators in many countries are guided by these OECD guidelines (generally through the International Organization of Pensions Supervisors, or IOPS), means this addition would carry some weight.

Cross-Border pensions still lurking.

Though a presentation was made on the subject of tax and other barriers to cross-border pension plans at the July, 2009, WPPP meeting, this subject did not appear on the agenda for the December meeting, possibly due to the need to devote time to the impact of the market turmoil. However, with the European Union taking small steps in that direction with its Directive on Institutions for Occupational Retirement Provision, the increasing globalization of business generally, and given that the purpose of the OECD includes the promotion of efficient and open market-oriented financial systems, it is possible that the matter will continue to be brought up. Notably, IOPS has also been studying cross-border pensions, but its activities in the area have generally not been public.

What does the future hold for pensions at the OECD?

While the most recent meeting of the WPPP did not result in many concrete conclusions, that is to be expected for an organization that is deliberative and comprised of so many countries and economies with such varied pension systems. However, it is also clear that, as a senior WPPP member said, a "new period of work" focused on DC plans is opening for the WPPP. In the coming year, for example, the WPPP has indicated it will study the number of investment options for a DC plan to offer, the types of options, the design of the default option, changes and information disclosure, among other topics. The OECD has been at the forefront of pension regulation in the past, and apparently intends to continue to be so. Observing its activities may prove both useful and important.◆