In the United States, pension plans have traditionally paid attention primarily to domestic entities such as Congress, the Department of Labor, Internal Revenue Service and Pension Benefit Guaranty Corporation (PBGC) as the sources for potential rules that influence their operation. However, at least one international body has chosen to enter the debate over pension funds, and U.S. employers may wish to keep an eye on its activities for possible future impact on U.S. pension plans. The Organization for Economic Cooperation and Development (OECD) is an organization that seeks to foster good governance in market economies. This article reviews recent OECD activities and relates them to ongoing international pension developments arising from the European Union (EU) and International Accounting Standards Board (IASB) proposals for pension accounting.

International Body Enters Debate Over Governance and Funding of U.S. Pension Plans

International Body Enters Debate Over Gover

by David W. Powell

The Organization for Economic Cooperation and Development (OECD) is an organization founded in 1960 and comprised of approximately 30 countries, including the United States, the United Kingdom and a number of European and other countries, which seeks to foster good governance in market economies. For some years, OECD has been issuing pension guidelines, such as protection of the rights of members and beneficiaries, pension fund governance and managing pension fund assets. OECD was instrumental, for example, in encouraging the expensing of stock options.

Most recently, the Working Party on Private Pensions (WPPP) of the Directorate for Financial, Fiscal, and Enterprise Affairs (DAF) and the Insurance and Private Pensions Committee of OECD have promulgated a number of papers and guidelines concerning areas of key interest to many U.S. public and private plans. These include the areas of pension funding, licensing of plans by regulatory authorities and financial education of plan participants. In addition, WPPP holds meetings to periodically review these guidelines and further study these areas. This article will review these recent activities in more detail and their relationship to ongoing international pension developments, such as those arising from EU's efforts to regulate cross-border pensions and the International Accounting Standards Board's (IASB's) proposals regarding pension accounting.

Pension Funding

Recently, WPPP published its draft Guidelines on Funding and Benefit Security. These funding guidelines are available at the OECD Web site relating to DAF (www.oecd.org\daf).

These guidelines are intended to "lay down a framework for modernizing funding regulations in order to meet the goals of financial security of pension funds and adequate level of pensions" and are the first attempt at the international level to regulate pension funding. They reflect the views of delegates from OECD's 30 members as well as from three other countries (Brazil, Israel and Russia) and several international organizations that have observer status in WPPP.

The guidelines reflect many concepts familiar to U.S. plan sponsors. For example, they generally call for adequate funding of defined benefit plans on the basis of termination liability or ongoing liability and the use of reasonable actuarial assumptions reflecting appropriate factors. In addition, the guidelines call for insolvency guaranty schemes (e.g., PBGC insurance) to be provided. However, the guidelines also suggest several views not currently in line with common U.S. plan practices.

Funding Requirements Possibly Imposed on Public Sector Pension Plans

The funding guidelines state that they may also be applicable to the funded occupational plans of public sector employees. In the United States, plans of states, local governments, and their instrumentalities and political subdivisions are generally exempt from federal regulations, except for selected portions of the federal tax rules. Public sector plans are, in particular, not subject to the funding requirements of the Employee Retirement Income Security Act (ERISA) or the Internal Revenue Code. Governmental plans in the United States are generally funded in the manner determined by the applicable jurisdiction's governing body, or in some cases not funded at all. It is also common for funded public plans in the United States to be funded as a percentage of employee compensation, rather than an amount determined in relation to costs, experience or other actuarial factors, other than indirectly. These common practices would apparently not be permitted if rules similar to the funding guidelines were to be applied to public pension plans (which are much closer to the current ERISA funding requirements), as discussed below.

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Unfunded Private Occupational Plans

The funding guidelines state that they do not cover unfunded occupational (employment-based) plans, but that is because prior guidance (the Occupational Pensions Core Principles issued in 2001) recommends that such financing arrangements be prohibited. This recommendation appears to include unfunded supplemental executive retirement plans (SERPs), defined benefit plans offered to senior executives (top-hat plans) and excess benefit plans in the United States. The annotations to the funding guidelines acknowledge that these plans may be permitted, "but should not benefit from tax advantages." Specific reference is made in the funding guidelines to tax deductibility as such a tax advantage, but it is not clear whether this is intended to refer to the advantage of tax deferral or to deductibility when paid. The application of the principles of the funding guidelines to either defined contribution plans or excess plans covering all employees affected by the qualified plan limits (which may cover nonexecutives) is not specifically addressed.

Varying Actuarial Funding Standards

The goal of the draft funding guidelines is best summed up as follows: **The legal requirements of the country should require the identification and maintenance of a level of assets sufficient to meet accrued benefit obligations.** In this, the funding guidelines do not appear to go as far as the approach taken by EU in its 2003 Directive for Institution for Occupational Retirement Provisions (IORP), which says "in cases of cross-border activity . . . that the technical provisions be fully funded at all times," though IORP also contemplates that a member state may allow temporary underfunding in plans that do not cross borders. (Some EU member states, though, require overfunding.) A number of other interesting points concerning actuarial standards for pensions appear in the draft funding guidelines:

- Among the factors that should be taken into account is "the possibility of benefit adjustments." Though not clear, this could be read to include the possibility of voluntary early retirement window benefits, shutdown benefits and other future benefit increases.
- Legal requirements should not prevent funding methods that seek to dampen the short-term volatility of funding contributions. This would appear to be approving of current efforts by many companies to attempt to better manage their defined benefit plan contribution volatility.
- Funding rules should be countercyclical, providing incentives to build reserves against market downturn. Tax regulations should not discourage the buildup of sufficient reserves to withstand market conditions. The draft funding guidelines do not, however, address the impact of confiscatory taxes on pension reversions, which some in the United States view as having precisely that effect.
- In the case of "autonomous pension

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funds" operating without a guarantee from the sponsor, a term that would appear to include (but not be limited to) Taft-Hartley funds in the United States, the fund should be required to hold additional assets over and above what is necessary to fully fund the pension liabilities on a termination basis. This proposal, of course, could have controversial implications for employer contributions to such plans.
- The funding guidelines do not clearly address the reversion of excess pension assets, other than to say that in the event that assets exceed promised benefits upon termination, there should be rules in place as to the allocation of the funding excess or surplus between the plan sponsor and plan members and beneficiaries. In the United States, plans may allocate surplus assets to plan members on plan termination through additional benefits but generally strive to avoid having any such excess assets or a reversion to the employer due to the confiscatory taxes on such reversions.

Though not addressed in the funding guidelines, a related area under study by OECD is that of longevity risk, and the effect of changing demographics on the pension needs of employees and the funding of defined benefit plans and annuity products.

Funding Guidelines and Possible U.S. Effect

The Guidelines on Funding and Benefit Security are to be sent to the Insurance and Private Pensions Committee and then to the OECD Council for approval as a recommendation. The funding guidelines will not be of binding force on the OECD member states. Rather, the funding guidelines are intended to guide pension plan regulations of the member states. The precise manner of implementation is up to each country, and the funding guidelines recognize that the manner of implementation may vary from country to country. While the funding guidelines refer to themselves at one point as best practices, they also state that the aim is to meet the underlying objectives of each guideline.

Currently, the funding guidelines are in draft form, and because of the importance of the funding issue, a public consultation on the guidelines was held and comments were taken until September 15, 2006. For more information, see www.oecd.org/daf/pensions.

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Licensing Guidelines

Another area in which the OECD WPPP has begun to prepare draft guidelines is the licensing of pension plans and pension institutions. WPPP has been collecting data on the licensing practices of its member jurisdictions for some years, and has most recently summarized that data in a draft paper on Licensing and Registration Requirements for Private Pension Systems. The draft is still being circulated for comment by the countries that provided the information. That information has, however, been used to prepare, in conjunction with the International Organization of Pension Supervisors (IOPS), a draft set of Guidelines on the Licensing of Pension Entities. IOPS is an independent international body, essentially an association representing those involved in the supervision of private pension arrangements. IOPS has about 50 members and observers representing more than 40 countries worldwide. That does not include the United States, though OECD is a member of IOPS, and the United States is a member of OECD. OECD and IOPS have worked closely together in the past, and often meet in conjunction with each other.

The draft licensing guidelines are not yet available on the Web at this writing but are worth commenting on. The draft licensing guidelines particularly point out the great differences between pension regulation methods in different countries and the difficulty of coming up with relatively uniform standards in an area that is essentially legal, compared to the area of plan funding, which is to a great deal financial in nature and at least arguably more susceptible to cross-border rationalization. It is clear, for example, that the concepts of a pension plan document and a trust holding assets are by no means universal. In fact, the draft licensing guidelines point out significant differences, if not confusion, among countries over what the plan is, what the people and institutions running the plan are, and how they relate to each other. Some of this may be attributable to differences between common law and civil law legal systems. Some may be attributable to different concepts in different jurisdictions of how independent a plan is from the employer, and the role of labor in relation to business. As a result, the draft guidelines for licensing pension entities do not clearly distinguish between plans, those funding them and those administering them.

Other concepts in the current draft licensing guidelines include advance licensing of plans, required in much of the rest of the world but not the United States (other than in the area of annuity contracts by state insurance regulators, which may be more akin to how the rest of the world views pensions). Another concept in the guidelines that is common elsewhere, but not in the United States, is professional qualification criteria for those involved in governing the plan. What appears to be missing, at least from the current draft licensing guidelines, is the concept of regulation through the tax code and law regulating behavior by fiduciaries, such as ERISA, which can then be enforced by the plan members through a robust legal system, as opposed to making the plan a relatively independent body that seeks advance governmental approval for most actions (for example, setting an investment policy). Comments on these early drafts reflecting this U.S. regulatory approach are expected.

Because these licensing guidelines are being developed in conjunction with the pension regulators of IOPS, they may, at some point, have enforcement teeth, at least for IOPS member countries. Consequently, they are worth paying attention to. The licensing guidelines also cross reference the funding guidelines referred to above, so enforcement of those funding guidelines could be a by-product of the licensing guidelines.

Financial Education

OECD has been studying the area of financial education for a number of years, in part driven by the trend toward defined contribution plans in OECD countries. This is, of course, an area that has been a "hot topic" in the United States as well, and possibly the subject of legislation as this is written. OECD has been following the U.S. debate on this topic intently.

OECD has begun a financial education project. The first goal of the project is to develop and use information on the types of programs and their effectiveness to develop a methodology against which policymakers can compare strategies for improving financial literacy. The second phase of the project will be an in-depth survey of the financial literacy of individuals in a few selected countries. It is intended that the survey will provide guidance for countries on how to effectively address the issues of financial illiteracy. The next meeting of the project was held in New Delhi, India in September 2006, and a principal topic was the creation of national initiatives to advance financial literacy, particularly among vulnerable groups.

Financial institutions with an interest in investment education in the pension area may wish to stay apprised of OECD's global initiatives.

Accounting Changes to Come

OECD has long had an interest in the work of IASB in the pension area. IASB has recently begun to consider the application of so-called fair value accounting to pension assets, as well as to reconsider the accounting for pensions in general (currently prescribed in IAS 19). In the United States, the Financial Accounting Standards Board (FASB) has proposed to revise its rules for accounting for pensions, FAS 87, which is likely to have a significant impact on U.S. pensions. FASB and IASB are clearly working to bring together accounting standards for pensions. Some questions have been raised regarding the possible impact of fair value accounting on the management of pension portfolios, such as its possible favoring of bond portfolios over equity investments, a matter discussed at the recent meeting of WPPP in Geneva, Switzerland.

Conclusion

In pensions, as in business generally, the world is becoming a smaller place. Events happening at the global level can now affect U.S. pension rules and investments, even where no operations or investments are occurring outside the United States. With OECD, IOPS and other international bodies now taking a regulatory interest in those very areas, it is important to stay aware of current developments. It may even be a good idea to become involved in them. **B&C**

The views expressed in this article are the personal views of the author and not the views of OECD or any other body.

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