The development of the 'prudent man' concept in relation to pension schemes

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Abstract The duty to invest pension fund assets prudently is a fundamental obligation for trustees and those who administer and run schemes. What do we really mean by this 'duty of prudence?' The different interpretations given to the concept of 'prudence' across Europe reflect a host of different factors — differing approaches of civil and common law jurisdictions; differing economic environments; differing concepts of risk and different investment cultures. The European Commission has recently issued a draft Pensions Directive which tries to bring some coherence to this concept of prudence across Europe. In this paper, we explain that there are two very different approaches. The first is a purely quantitative approach which is the traditional European, civil code approach. The alternative is the common law USA/UK concept of qualitative prudence. There is, however, an intermediate route which is to identify prudence in terms of the behaviour of the investor and meeting the standards of good 'due process'. This is the route that the European Commission and its new draft directive have taken.

Keywords: *the 'prudent man' concept; pension schemes; European Commission; First Draft Pensions Directive 1999*

Introduction

The requirement to deal with trust assets as a 'prudent man of business' has been developed in a number of common law jurisdictions both through the courts and incorporated into statute — for example, in the UK and the USA. For the civil law jurisdictions, however, the responsibility of 'prudence' was traditionally less specific. It was, however, inherent in the philosophy behind the long list of investment restrictions with which pensions investment had to comply.

In 1997, however, the European

Commission proposed as part of its liberalisation package, that in place of requirements on pension funds to invest or not invest in any particular category, there should be permitted any investment based only on a *prudent man* principle. There should be no requirement to localise assets in any Member State, unless justified on *prudential grounds*. This is the reason why the recently issued working documents from the European Commission, which set the outline for the new Pensions Directive, continue to focus on prudence.

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Table 1

Country	Restrictions
Denmark	A maximum of 40% may be invested in 'high risk assets' — these include domestic equities, foreign equities and unlisted securities. Also 80% currency matching requirement. In case of EU currency, up to 50% of liabilities can be covered by assets denominated in ECU. No self-investment.
Germany	Maximum 30% EU equity, 25% EU property, 6% non-EU shares, 6% non-EU bonds, 20% overall foreign assets, 10% self-investment limit.
Spain	5% limit in securities issued by any one enterprise. 90% of assets must be invested in quoted securities, bank deposits, property or mortgages. 1% must be in current accounts or money market.
France	At least 50% to be invested in EU government bonds, less than 33% in loans to sponsors.
Italy	No pension law for self-administered schemes but investment policy determined by the board of directors are usually restricted to government bonds, bank deposits, insurance policies and property.
Sweden	Majority to be held in bonds, debentures and loans.

Under the direction of Commissioner Monti, the Commission, prior to its 1999 Communication, has recently been re-examining these issues against a background of the two models of 'prudence' currently in use in the international pensions world. The two models the Commission has to consider are:

- Model A: A prudent person is someone who makes a *prudent investment*.
- Model B: A prudent person is someone who *behaves prudently*, not dependent on the reality of the investment outcome.

Model A: The Prudent Investment

This is the approach of a range of European countries who have sought to have investment restrictions which are justifiable on a prudent basis (see Table 1).

There has been some 'voluntary' movement away from this system of rigidity in recent years. For example, under German law, the Insurance Supervisory Law requires the *PensionsKasse* to be invested as safely

and as profitably as possible. There must be constant liquidity and an adequate mixture and diversification of capital, but recently the investment possibilities have been extended allowing the insurance company a more international strategy. Equally, under Belgian law, there exists a general principle ensuring diversity and an adequate spread of investments which can be brought into play to justify a deviation from the series of more specific rules governing permitted categories of investment and liquidity requirements.

What is the logic for this approach? Essentially *that prudence is equal to safety*. In each of the countries referred to above, the primary focus is on security, assessed by reference to a fixed standard. This approach obtains support from other Directives. The Capital Movements Directive which requires freedom of movement of capital, has an escape clause in it which *allows* Member States to have restrictions if (among other things) they are justified by *prudential reasons*. The Third Life Assurance Directive sets a prudential standard for insurance business which requires technical provisions for the risks carried,

on the basis of the rules laid down in that Directive and a solvency margin on the liability side, together with currency matching.

These ideas of prudence focus on *judging the investment itself*. The overall risk of a pension portfolio as a whole should not go beyond a given level, taking account of the objective of the pension fund — to make the defined benefit scheme as cheap as possible for the contributing company and to make the defined contribution scheme as generous as possible to maximise investment returns.

This leads on to the 'quantitative' approach to being a prudent person — the idea that the investment itself can be tested as to whether or not the decision was prudent at the time. In summary, the 'tests' applicable under this Model are:

- testing the investment category
- testing the asset classes
- testing the outcome of making the investment itself.

There are, however, problems with this model. The first is the purely investment point that some analysts consider it too restrictive. Of course, analysts are divided on this, often according to their own risk culture. Another is that it cannot always provide an answer to whether the investments do indeed satisfy a prudence test. Take, for example, currency matching which has, to some extent, been the 'Achilles heel' of European pensions reform. While European legislation imposes an 80 per cent matching requirement in insurance companies in the name of prudence, since exchange risks are similar in concept to other market risks, international diversification may itself be prudent in terms of the Capital Movement Directive.

Model B: Prudent person rule

The alternative approach is that applied by countries who have a concept of a 'prudent person'. The test then is the *behaviour* of that prudent person. The process of making the investment decision is the key test of prudence.

This is the test which is applied in the UK, the USA and to some extent the Netherlands. The country with the longest history of a statutory prudent man rule is the United States. The USA is a good case study as its history mirrors the European developments we are seeing today.

The US legislation used to require conformity with an authorised 'list' of investments. In the middle of the 19th century it developed a prudent person principle. As in the UK, the USA had a general principle that a person should act with the 'care, skill, prudence and diligence of a prudent man in a like capacity ...'. This covered both trustees and investment managers and other fiduciaries. Then in the 1970s, Congress decided — just as the Commission is trying to do now — to codify and set out in statute the rules for a prudent person. One of the reasons for Congress deciding to shift to an overriding statutory provision was that they wanted the courts to interpret the rule *bearing in mind the special nature of pension plans* (House Conference Report 93–1280).

Testing who is and is not a prudent person has been developed both in the USA and the UK through the courts. Rulings have included that evidence of prudence includes evidencing:

- *there has been a thorough consideration of the issues*. In a US case of *Howard v. Shay* (1996), fiduciaries sold off a block of assets having received a professional valuation. The courts held that the valuer should have been properly and fully questioned by the

fiduciary. Further evidence of a lack of prudence was that the transaction was carried out the day after the valuation was received — evidence, it was held, of a lack of thorough investigation.

- *there has not been 'blind' reliance on experts.* In the same case and several subsequent, the courts have held a fiduciary cannot use an expert's advice to 'whitewash' actions. The expert's qualifications need to be researched and the court has held that if there was any doubt, a second opinion should be obtained.
- *the investigation is everything.* The decision as to whether an investment is prudent is based on what the trustee knows or *should have known*. It is really an 'if only' test. The thoroughness of the investigation is not only based on actual actions taken, but also on what the fiduciary would or *should have done* if only they had been thorough enough to investigate the full facts.

So if we compare the tests to be applied under Model B to those under Model A, they are to:

- test the behaviour of the investor
- test the fiduciaries
- test the process of decision making.

The advantage of this kind of rule is that it is flexible — the only standard is what it is reasonable to do in the particular circumstances. Prudence is a standard that measures a course of conduct. It is not about the investment result, but about the process of getting to that result.

The disadvantage with a fully flexible prudent person rule is that its very flexibility leaves it open to be tested in the courts. Because the courts are themselves not investment experts, they will tend to adopt as their standard the

investment theories, customs and conventions generally exercised by the investment community. Critics then argue that more cutting edge techniques can be rejected in favour of a narrower interpretation of risk and safety.

The Netherlands have a prudent man test which concentrates on 'due process'. The concept is one of a 'solid' or proper investment — and, for example, part of the required standard for this is preparing a clear well-founded investment policy with a requirement to set out an investment plan. So although it is the outcome of the investment that is tested, the 'due process' is a key part of their prudence requirement. The European Commission has been strongly influenced by this approach.

Model C: the Commission's model

Rather than prudence being a specific measurable level of risk that a pension fund can bear (Model A), or in contrast a subjective test of prudent person's behaviour (Model B), the European Commission has moved the debate into the arena of consumer protection and supervision:

'The primary object of prudential regulation is to protect consumers — or in this case members pension schemes' (1998 Commission Communication).

This moves the prudence debate from one which measures investment against a pension fund's objectives, to one of consumer protection, regulation and control. It is a model of prudent person *management*, not prudent investment risk. Prudence becomes about proper management and supervision, not about restrictive investment. Moreover, where there is prudent management, there must be prudent managers — the 'prudent person' test by the back door.

Model C: prudent management test

The European Commission originally suggested six 'badges' of prudent management:

- *separation of assets* of the pension fund and of the sponsoring company
- *authorisation* by a competent authority (with sanctions)
- *competency*: strict criteria regarding the responsibility, competence and integrity of managers
- *control*: supervisory authority's power to intervene must be defined — this is to include both internal controls and external
- *transparency*: periodic statements to members
- *reporting* to supervisory authorities and explanation of investment strategy.

European Parliament proposed additional 'badges' — for example, the involvement of contributors and sectoral interests which were not accepted by the Commission. The Commission also proposes PAYGO and book reserve systems remain outside these prudential requirements, although it is hard to see the logic behind this.

Once this protective framework is in place, then as much flexibility as possible is to be encouraged. Prudent management is intended to be a 'qualitative' approach. But it is not as flexible as the classic 'prudent person' rule. Prudential management can be dealt with by a 'checklist' approach — does the member state require separation of assets? Is there authorisation by a competent authority? Does the supervisory authority have power to intervene? Is there transparency with members? These afford simple 'yes' or 'no' answers, rather than any 'Model B' subjective test of behaviour.

The key tests under this model are:

- testing the responsibility, compliance and integrity criteria for managers
- testing the level of supervision
- complying with local prudential rules
- use of diversification and modern ALM techniques.

The disadvantage, like any checklist approach, is that it is not fully flexible — the checklist may need to change over time. The pure qualitative model is to look behind these 'badges', at the way the people operating these badges think and how they come to their decisions.

The European Commission has opted for this 'hybrid' approach focusing on due process in its First Draft Pensions Directive of December 1999. For example, draft Article 7 of that draft requires that European pension schemes must be subject to authorisation. Authorisation under that Article will be granted where a scheme can establish:

- it is run by persons 'of good repute with appropriate professional qualifications or experience
- that there are rules regarding the functioning of the scheme
- evidence that liabilities are properly valued or certified
- evidence for defined benefit schemes of a commitment to regular financing
- evidence of information to members on benefits and risks.

A concern for consumer protection in the context of prudence is a strong theme of the draft, requiring an increased level of reporting and information to be given to members (Articles 8 and 9) and fully funding requirements (Article 12). However, flexibility is increased in the area of investment rules whereby 'Member States shall not require institutions to invest in particular categories of assets' (Article 14).

This does all have the advantage of being flexible. It is too early to say whether the draft will become a Directive in its current form. However, the key to

the success of this approach will be to ensure that a degree of flexibility is not lost during the political debate on the implementation of the directive.