The Prudent-Person Rule in Relation to Investment Policy

Main classification: Guidance
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Justification

Who wrote this report?
This report was drawn up by the Prudent-Person Working Group of the Dutch Actuarial Association. The working group was set up by the Pensions Committee.

Aim of the working group and modus operandi
In accordance with the Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act, the certifying actuary must assess whether the investment policy of a pension fund complies with the prudent-person rule. General principles and more detailed criteria have been formulated for the implementation of this requirement in legislation and regulations which, to a certain degree, are open to various explanations and interpretations.

The aim of the working group is to develop proposals for guidance for the Dutch Actuarial Association in relation to the prudent-person rule. The guidance is intended primarily to support the certifying actuary, but must also contribute to ensuring that there is more clarity about the way in which the annual assessment by (certifying) members of the Dutch Actuarial Association is carried out on the basis of the prudent-person rule.

The working group started its activities in July 2010. The working group has had consultations with a number of relevant parties, so that the opinions and views of the market have been taken into account in the development of the guidance.

In 2011 the Dutch Actuarial Association organised three roundtable meetings at which experience in the practice of carrying out assessments based on the prudent-person principle was evaluated. On the basis of the responses received, the working group concluded that the report did not require any substantive amendments, but that the guidance could be clarified. For this reason, the structure within which the assessment takes place (the three-phase model) together with the assessment criteria are set out in an annex. In addition, a small number of textual amendments have been made. A brief response from the Dutch Central Bank was also taken into account.

Structure of the report
The report consists of the following parts:
1. Summary, conclusions and recommendations
2. Introduction
3. The certifying actuary in relation to the prudent-person principle
4. Conclusions of the working group

Annexes:
1. Assessment criteria in relation to the prudent-person rule
2. Formulation of the assignment of the Prudent-Person Working Group
3. The Pensions Act, including the Pension Funds (Financial Assessment Framework) Decree
5. Composition of the Working Group

Date 14 December 2011
Town/city Utrecht
1. Summary, conclusions and recommendations

The prudent-person rule in relation to investment policy is based on European regulations. In the Netherlands, the concept is enshrined in law in Section 135 of the Pensions Act and in Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act and is worked out in more detail in the Pension Funds (Financial Assessment Framework) Decree.

The Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act assign responsibility for the verification of compliance with the prudent-person rule to the certifying actuary. Neither the legislation, nor the pension directive provides a definition of the concept of a "prudent person". However, a number of principles have been formulated which have to be applied when interpreting the concept.

The principles, which are broad and have little concrete content, are an important reason for the profession, but also for people outside the profession, to formulate more concrete guidance. This is dealt with in more detail in the introduction (Chapter 2).

In order to arrive at a clear interpretation of what should be understood by a prudent investment policy, an overview of the relevant legislation was drawn up and discussions were held with various interested parties.

Chapter 3 pays attention to the most important points and aspects which emerged from these discussions. The most important legislation and regulations are included as Annexes 3 and 4 of this report.

The conclusions of the working group are explained in Chapter 4. Weighing up all the aspects, it was concluded that the assessment of compliance with the prudent-person rule focuses on whether the board of the pension fund, in the light of the pension fund's obligations, was able to arrive at the policy, which was agreed and implemented, in a manner which is reasonable. Not only the proposed policy must be assessed (ex ante) on the basis of the prudent-person rule, but it is also necessary to ascertain whether the actual development of this policy in the past year (ex post) was consistent with this.

For the purpose of this assessment, the working group has formulated assessment criteria, which are:

- of a quantitative, and not a quantitative, nature;
- transparent for all the parties involved.

The list of assessment criteria, which should be considered to be Guidance in accordance with the classification of regulations applied by the Dutch Actuarial Association, is included in Annex 1. The assessment criteria are intended to be exhaustive in the sense that they demarcate the area of work of the certifying actuary in relation to the prudent-person rule. It is up to the certifying actuary to decide how he or she wishes to use the list. Using this list, a questionnaire, for instance, could be drawn up which could be presented to the board as the basis for written answers. Following this, before the actuary makes his or her assessment, a further discussion could take place with the board or, alternatively, with the investment committee.
The working group makes the following **recommendations**.

1. The list of assessment criteria should be used as Guidance in assessing compliance with the prudent-person rule.
2. Where necessary, the certifying actuary should be advised/assisted by an investment expert. The certifying actuary should bear final responsibility for his or her assessment.
3. The questions derived from the list of assessment criteria should be put to one or more persons responsible for investment policy. It is important that the certifying actuary ensure that he or she receives all the information necessary to make the most thorough possible assessment.
4. The certifying actuary should document how he or she reached his or her assessment.
5. In the actuarial report, the certifying actuary should state clearly what was examined and how, and should provide a clear explanation or substantiation of his or her assessment.

It is important to note that the assessment of whether the standard method has been applied correctly by a pension fund and the assessment of whether the prudent-person rule has been applied to investments in a manner which is permissible must be considered in close relationship to each other. The certifying actuary, after all, has to assess whether the investment policy and the risk policy of the pension fund are such that the standard model, referred to in Annex 3 of the Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act can and may be applied. If this is not the case, the pension fund must determine the required net assets in consultation with the Dutch Central Bank on the basis of an internal model, which may be a standard model adjusted in relation to certain components. In the light of the aim of this report, the assessment of whether the standard test can be applied is only discussed in passing.

It is desirable that clear agreements be reached with the respective auditor regarding the audit of the basic data relating to the investments prior to the year-end reporting.

The Cooperation Agreement between the Actuary and Auditor of 16 December 2009 stipulates that the basic data also includes data relevant to the solvency test and the financial position, such as data relating to the investment portfolio.

"In relation to data pertaining to the investment portfolio, depending on the nature of the assessment these may include, for instance, the actual value of these investments or their composition based on the category of investment, the duration of fixed-interest investments, and the degree to which interest and currency risks, the credit spread *et cetera* are hedged."

In addition, it is stated in the agreement that the basic data do not have to be verified by the auditor in all cases. Furthermore, it is stated that it is important to reach mutual agreement on which data are relevant and the extent to which and the way in which the actuary or, alternatively, the auditor should include these data in their assessment activities.

It is also important to note that the declaration provided by the certifying actuary may not be construed as a declaration that the investment policy is secure and that the investments are of the right quality. Nor should the declaration be construed as confirmation that the investments match the liabilities precisely. This would go too far. The declaration made by the certifying actuary is important and is the result of a careful examination and assessment. However, no absolute value can be assigned to the certifying actuary's declaration.
2. Introduction

Section 135 of the Pensions Act stipulates that a pension fund must pursue an investment policy which is consistent with the prudent-person rule. The same criterion applies to occupational pension funds in accordance with Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act. In these sections of the respective acts, several general principles are mentioned with which the investment policy must comply. Further criteria have been set out in Section 13 of the Pension Funds (Financial Assessment Framework) Decree, which applies to pension funds which are subject to the Pensions Act or the Occupational Pension Schemes (Obligatory Membership) Act.

Declaration of the certifying actuary

In accordance with Section 147 of the Pensions Act and Section 142 of the Occupational Pension Schemes (Obligatory Membership) Act, the certifying actuary is required annually to assess compliance with the provisions of Section 126 up to and including Section 140 of the Pensions Act or, alternatively, Section 121 up to and including Section 135 of the Occupational Pension Schemes (Obligatory Membership) Act. The certifying actuary must therefore assess each year whether the investment policy of the pension fund complies with the prudent-person rule.

Problem definition

The general principles and further requirements set out in the above-mentioned sections of the applicable legislation and regulations have been formulated in such a way that there is considerable scope for further interpretation and elaboration. In addition, they give rise to the following questions:

• What did the legislator actually mean by the prudent-person rule?
• What exactly falls under the prudent person rule?
• Where does the responsibility of the certifying actuary end?
• To what extent is the certifying actuary in a position to assess compliance with the prudent-person rule? (Does he or she have sufficient information? Does he or she have sufficient expertise?)
• How does the certifying actuary reach his or her assessment?

These questions have yet not been answered with sufficient clarity. Without a clear framework, the certifying actuary can give his or own form to the prudent-person assessment. This is the case not only with regard to the scope of the assessment (what it includes), but also with regard to its depth (how far does the assessment go and to what level of detail).

In practice, this means that the certifying actuary perhaps goes further, or perhaps less far, than the statutory rules intend. The result may be that different and possibly even deviating assessments and outcomes occur. This lack of clarity is not desirable. In carrying out an assessment in accordance with the prudent-person rule, in principle every actuary should arrive at the same assessment. This is the reason why members of the Dutch Actuarial Association have appealed for the development of guidance for the certifying actuary in relation to the prudent-person rule.

The Executive Board of the Dutch Actuarial Association decided to develop a guidance working group under the responsibility of the Pensions Committee. This working group, under the name of the Prudent-Person Working Group of the Dutch Actuarial Association, drew up the following report.
3. The certifying actuary in relation to the prudent-person principle

The first section of this chapter discusses the legislative history and the statutory provisions in relation to the prudent-person rule. The second section provides a report on the interviews which have taken place with parties during the certification process in relation to the desired demarcation of the responsibilities of the certifying actuary in relation to verification of compliance with the prudent-person rule.

3.1 Legislative history and statutory provisions

The provisions of the Pensions Act, the Occupational Pension Schemes (Obligatory Membership) Act and the Pension Funds (Financial Assessment Framework) Decree in relation to the prudent-person rule are based on European legislation, such as the Pensions Directive (2003/41/EC).

This Pensions Directive was necessary in the European Commission's opinion because an internal market had already emerged in relation to almost all financial services, except pension funds. For instance, directives already existed for banks, investment institutions and insurers. Due to a good internal market, financial institutions can operate in other Member States and consumers of financial services are offered a high level of protection. The drawing up of a directive in relation to the prudential supervision of pension funds was regarded as an urgent priority because these are large financial institutions which play a central role in the integration, efficiency and equity of the financial markets. However, pension funds were not yet subject to coherent community legislation that enabled them to take full advantage of the opportunities of the internal market. The full title of the Pensions Directive is "Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision". In brief, this is referred to as the IORP Directive, where IORP stands for "Institutions for Occupational Retirement Provision".

Up until the moment at which the Pensions Directive came into force, only the provision of the Pension and Savings Funds Act [Pensioen- en spaarfondsenwet (PSW)] applied to pension funds in the Netherlands, which stipulated that the available assets of a pension fund had to be invested soundly. What was to be understood by a 'sound investment policy' was not set out clearly due to the complex of factors which play a role in this. For instance, in the Parliamentary Proceedings in relation to the Pension and Savings Funds Act (Memorandum of Reply to the Lower House of the Dutch Parliament), which resulted in the Act of 13 December 1972, the following was stated:

"The question as to whether a pension fund has invested soundly has to be considered separately for each pension fund against the background of the pension fund's financial structure, the nature of the liabilities and the pension fund's financial situation. In this regard, a more detailed description of the concept of 'sound' could perhaps result in an unintended limitation and consequently an unnecessary restriction of the pension fund's freedom to invest. Reference may also be made to the supervision exercised by the Dutch Insurance Supervisory Board which will give realistic substance to the provision."
For the supervisor, the concept of 'acting as a prudent person' serves as a guideline.

In the Pensions Directive, the general concept of a "prudent person" also serves as a guideline. This is the case not only in relation to investment policy, but also, for example, in relation to determining the technical provisions. The Pensions Directive does not give a definition of the concept of a "prudent person". The Directive only provides a number of principles which have to be applied when interpreting the concept. In the case of investments, the principles are stated in Article 18 of the Pensions Directive. In addition, in the preamble to the Pensions Directive a number of passages are also dedicated to the prudent-person principle. These passages and Article 18 of the Pensions Directive are included in the annex "Pensions Directive (2003/41/EC)" of this report. For the sake of completeness, Article 12 (Statement of Investment Policy Principles) has also been added.

**Scope of Article 18 "Investment rules"

It appears from the preamble and Article 18 of the Pensions Directive itself that pension funds must be free to determine their own optimal allocation of investments, taking into account the prescribed requirements with regard to security, quality and risk diversification.

The way in which the risks of any outsourcing are managed is not linked directly to Article 18. Article 13 of the Pensions Directive only prescribes that a Member State must also make provision for the powers and means to supervise outsourced activities.

Controlled and ethical operational management is also not linked directly to Article 18. Controlled and ethical operational management arises from Article 9 of the Pensions Directive as one of the conditions which a Member State may stipulate for the carrying out of the activities, but also from Article 12, as an element which must be included in the investment policy principles.

**Assessment by an expert

The Pensions Directive does not include any provision which requires assessment by an expert of the prudential criteria applied to the investments. A provision such as this, however, is included in Article 15(4) of the Pensions Directive insofar as this relates to the calculation and certification of the technical provisions ("The calculation of the technical provisions shall be executed and certified by an actuary or, if not by an actuary, by another specialist in this field, including an auditor, according to national legislation, on the basis of actuarial methods recognised by the competent authorities of the home Member State, according to the following principles ....").

**Pension and Savings Funds Act as of 1 January 2006

In anticipation of the Pensions Act and as a concession to the requirements imposed by the Pensions Directive, a number of provisions contained in the Directive were initially included in the Pension and Savings Funds Act. With regard to investments, the requirement (Section 9b of the Pension and Savings Funds Act) that the available funds of a pension fund be invested soundly remained unamended.
The provisions of the Pensions Directive were included in the new Section 9ba, as they are now contained in Section 13 of the Pension Funds (Financial Assessment Framework) Decree, supplemented by the general provision that "the assets shall be invested in the interests of the members, former members, pensioners and their surviving dependants who are entitled to pensions". This last sentence is also contained (in a slightly more concise formulation) in the text of Section 135 of the Pensions Act.

In the Explanatory Memorandum to the bill, the following was stated, for instance, in relation to the prudent-person rule in relation to investments:

"The prudent-person rule has been chosen as the point of departure for the supervision of investments. As was stated above, what is important in this regard is that the investments must comply with the principles of security, quality and risk diversification. In doing so, an important choice was made at the European level in favour of qualitative supervision of investments rather than quantitative restrictions on investments, which have characterised the financial supervision of pension funds in many other Member States for so many years.

The interpretation of the concept of a 'prudent person' does not derogate essentially in practice from the interpretation given to the term "soundly" in Section 9b of the Pension and Savings Funds Act in past years by the Dutch Central Bank. It is expressly not the intention to give a stricter interpretation to the concept of "prudent person" than that given to the concept of "sound investment". Qualitative rules make it possible to deal better and with greater care with individual circumstances (in relation to investments) than is possible in the case of fixed quantitative criteria. The interests of members and pensioners are served much better by doing so. The other side of the coin is that supervision based on qualitative criteria is more difficult than supervision based on fixed quantitative criteria....

....No use was made of the power, contained in Article 18(5)(1) of the Directive to introduce rules relating to the topics referred to in the first and second clauses, including quantitative rules, provided these are justified from a prudential point of view, which reflect all the pension schemes administered by pension funds and occupational pension funds. Up until now, the Netherlands has not imposed any quantitative restrictions on the investments of pension funds and does not intend to do so now. For the rest, Article 18(5) need not be implemented since legislation in the Netherlands does not include provisions which are contrary to the prohibitions contained in clauses (a), (b) and (c)."

The following statement is also included in the Explanatory Memorandum in relation to the amendment of the Pension and Savings Funds Act with regard to the actuarial declaration:

"At present the calculations in accordance with Sections 9c and 10b(3) of the Pension and Savings Funds Act and Section 5(4) of the Pension Funds (Financial Statements) Decree are audited and certified by an actuary. In accordance with Article 15(4) of the Directive, the calculations may also be assigned to an auditor or "another specialist in this field". No use was made of this option."
In a manner which is consistent with the present situation, it was decided that the calculations should be assigned to the actuary within the context of his activities in relation to the actuarial report. Since "the Directive must be implemented with as few policy changes as possible, a choice was not made in favour of an independent actuary. In the Pensions Bill a choice will be made in favour of assigning the respective activities to an independent actuary."

This amendment to the Pension and Savings Funds Act did not yet make provision for an assessment by the actuary in accordance with the criteria stipulated by the Act in relation to investments.

**Pensions Act as applicable since 1 January 2007**

The statutory requirements with regard to investments which are important in relation to the actuarial declaration are described in Section 135 of the Pensions Act and Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act respectively. They are worked out in more detail in Section 13 of the Pension Funds (Financial Assessment Framework) Decree.

The requirements with regard to controlled and ethical operational management are included in Section 143 of the Pensions Act. Outsourcing is dealt with in Section 34 of the Act. Whether compliance with both of these sections, which relate to prudent investment, falls within the scope of the actuarial declaration is not immediately clear from this.

As was also applicable to the Pension and Savings Funds Act, the texts in relation to prudent investment have been taken almost verbatim from the EU directive. In the light of the principle prescribed by law that pension funds must invest on the basis of the prudent-person rule, the government has limited as little as possible the freedom which pension funds have to invest at their own discretion. As in the case of the Pension and Savings Funds Act, no use is therefore made of the possibility of including quantitative rules with regard to investments in the Pensions Directives.

**Actuarial declaration**

The role of the certifying actuary has been extended significantly compared to the actuary's statutory tasks, as applicable up until the introduction of the Pensions Act. The certifying actuary is not only required to form an opinion on the technical provisions (Section 126 of the Pensions Act), but also on aspects which are governed by Section 127 up to and including Section 140 of the said Act, in other words including the assessment of compliance with the statutory requirements with regard to investments.

Due to the absence of an explanation of the task of the actuary in relation to investments, a framework has not been provided for these. For instance, it is not immediately clear whether the actuary can limit himself or herself to his or her specialism (financial risks) or whether he or she also has to take into account non-financial risks in assessing whether the investment policy pursued guarantees "the security, the quality, the liquidity and the profitability of the portfolio as a whole". In addition, insofar as is known, the Netherlands is the only country in the EU which requires the actuary to declare whether the prudential requirements which apply to the investment policy pursued have been met.
Position of the Dutch Central Bank

The Dutch Central Bank has also not provided a more detailed interpretation of the concept of a 'prudent person' in relation to Section 135 of the Pensions Act and Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act respectively.

However, the Dutch Central Bank has published a 'Policy rule on key principles for assessing the risk management for alternative investments'. In this policy rule, reference is made primarily to Section 34 (outsourcing) and Section 143 (controlled and ethical operational management) of the Pensions Act. The prudent-person principle plays a role in relation to whether alternative investments are, in fact, permitted at all. A distinction is made here between the prudent-person principle in relation to the choice of investments and the organisational embedding of this. During the actuarial afternoon organised by the Dutch Central Bank on 25 November 2010 for representatives of a large number of actuarial firms, the Dutch Central Bank stated explicitly that an assessment of 'controlled and ethical operational management' is not included in the tasks of the certifying actuary.

3.2 Demarcation of the responsibilities of the certifying actuary

It may be deduced from the above that considerable (or greater) responsibility was assigned to the certifying actuary with regard to the assessment of compliance with the prudent-person principle with the introduction of the Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act. Although this was perhaps not intentional, this responsibility is far greater than under the Pension and Savings Funds Act. In any event, the certifying actuary's responsibility has come to the fore more explicitly. However, the scope of this responsibility is debatable. The working group was of the opinion that to answer this question it was necessary to exchange views with a number of parties involved in the certifying process. For this reason, discussions were held with the Reporting Committee of the Dutch Association of Company Pension Funds (OFP)/Dutch Association of Industry-wide Pension Funds (VB), as representatives of the pension fund is to be assessed, with the Dutch Central Bank as the supervisor with Association of Investment Professionals (VBA) and with a representation of auditors within the framework of the Netherlands Institute of Chartered Accountants (NBA). In addition, the working group asked three lawyers of the actuarial consultancy organisations (Mercer, Aon Hewitt and Towers Watson) about their views on what the legislator meant with regard to the assessment by the certifying actuary of compliance with the prudent-person rule.

The working group used the contents of these discussions as input for the report. It must be emphasised that the conclusions which the working group drew from the discussions have not (yet) been presented to the participants in these discussions. The conclusions from the discussions, as included in this report, are therefore a reflection of the working group's interpretation of these discussions.

Views of the lawyers

The lawyers involved arrived at the following conclusions:

- The prudent-person rule must be interpreted broadly and sooner represents a process-related principle than a substantive principle;
- The prudent-person rule not only applies to the policy itself, but also to the implementation of the policy in the past year;
It is important that the board arrives at its decisions on the basis of a carefully determined policy, which should also include a risk management model. An assessment based on this norm therefore focuses on whether the board was able to arrive at its policy and the decisions it took in a reasonable manner, partly in the light of the pension fund's liabilities;

This means that aspects of risk monitoring (in a more general process-related sense) and the administrative organisation and internal control (insofar as these relate to the management of investments) have to be taken into account;

The emphasis of the certifying actuary's assessment lies on assessing the risks of the investment policy and the actual investments in the light of the pension liabilities in the short and long(er) terms.

According to the lawyers, the assessment by the certifying actuary in accordance with the prudent-person rule does not include in-depth risk analyses, such as the FIRM analysis and the assessment of the quality of individual investments.

Statement of Investment Policy Principles
In addition to the provisions of or pursuant to the Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act respectively, in the opinion of the lawyers the Statement of Investment Policy Principles is an important basis for the assessment in accordance with the prudent-person rule based on the documentation of policy-related aspects. It should be noted that the Statement of Investment Policy Principles is not always important and that it will also be necessary to include the investment policy set out in the Actuarial Technical Operating Memorandum and the possible elaboration of an investment plan in the audit. The actual policy (implementation) will therefore have to be assessed in relation to the investment policy. The investment policy will then have to be assessed against the investment policy principles.
Discussion with the Reporting Committee of the Dutch Association of Company Pension Funds (OFP)/Dutch Association of Industry-wide Pension Funds (VB)

In the working group’s opinion, the following emerged from the discussions with the Dutch Association of Company Pension Funds (OFP)/Dutch Association of Industry-wide Pension Funds (VB):

• The certifying actuary should only consider the financial risks;
• The assessment of processes, the monitoring of policy by the board and the auditing of implementation by the board is already carried out by the auditor and the internal supervision department;
• The assessment based on the prudent-person rule should only be an *ex ante* assessment and not also an *ex post* assessment;
• Transparent norms are required in relation to the way in which the certifying actuary reaches his opinion on compliance with the prudent-person rule. These norms should be determined in consultation with the supervisor, the auditor and the "parties audited";
• These norms should then be shared broadly because pension funds must know what the certifying actuary will assess and how he or she will do so;
• Broad agreement should be reached with regard to the scope of the assessment;
• As far as possible, the Dutch Actuarial Association should already be communicating with "external parties". The press and public expect this in the light of the financial situation of many pension funds.

Discussion with the Dutch Central Bank

The working group drew the following conclusions from the discussion with the supervisor, the Dutch Central Bank:

• The assessment based on the prudent-person rule is a logical, statutory task of the certifying actuary due to the activities which the actuary already has to carry out in relation to the auditing of the required net assets;
• The *ex ante* audit of the investment policy (and the process by which this is formulated), of the degree of freedom and of the management measures taken is far more important than the *ex post* audit or the audit of monitoring or processes;
• The emphasis ought to lie on the solvency test. The certifying actuary must make a careful assessment of whether the standard test is sufficient on the basis of the investment policy, the investment risks and the management measures taken.
  - If this is the case, a considerable part of the prudent-person test would already have been completed;
  - If this is not the case, then a considerable part of the prudent-person test would already have been completed and the conclusion would have been drawn that the investment policy, degree of freedom and management measures taken require an adjusted (internal) test;
  - By means of an *ex post* assessment of the annual solvency test, differences will emerge between the policy approved and the policy implemented.
• During the interview, however, it was not really clear whether Section 34 of the Pensions Act (outsourcing) and Section 143 of the Pensions Act (controlled and ethical operational management) fall within the actuary’s task.
During the actuarial afternoon organised by the Dutch Central Bank on 25 November 2010 for representatives of a large number of actuarial firms and large pension administrators, the Dutch Central Bank stated explicitly that an assessment of the ‘controlled and ethical operational management’ is not included in the tasks of the certifying actuary.

- Direct investment in real estate is not regarded by the Dutch Central Bank as a regulated market because the price of real estate is not determined by numerous parties.
- At the pension afternoon, referred to above, further details were provided of the areas to which the certifying actuary should pay attention, in the opinion of the Dutch Central Bank. These are:
  - valuations
  - collateral management
  - concentration risk
  - assignment and strategy in relation to the life to maturity of the liabilities
  - making the right risk estimates
  - regulated markets
  - liquidity (both on the balance sheet and in relation to products)
  - additional risks in relation to derivatives
  - effective limitations/degrees of freedom
  - is the policy followed in the implementation.

Discussion with the representatives of auditors
In the working group's opinion, the following conclusions emerged from the discussion:

- The auditor also takes aspects relating to the investment policy and investment process into account in his or her audit of the administrative organisation and internal control. However, the auditor's audit focuses on whether the annual reporting gives a true and fair impression of reality and, in principle, not on whether the board of the pension fund, in the light of the pension fund's obligations, was able to arrive at the policy, which was agreed and implemented, in a manner which is reasonable;
- In addition, the question arises as to whether and, if so, to what extent the auditor has a role or wishes to have a role in auditing the basic data, such as cash flows and credit spreads, which are the data input for the pension fund's calculation of the required net assets.

Discussion with representatives of the Association of Investment Professionals (VBA)
In the working group's opinion, the following conclusions emerged from the discussion:

- The certifying actuary should limit himself or herself in his or her assessment of the investment policy. The question is whether the certifying actuary can issue a declaration that the investment policy is prudent. Even if investment analysts/advisers are involved in this, a declaration such as this incurs a certain degree of risk.
- The composition of government bonds has to be considered critically, even though Section 135(3) of the Pensions Act states that the requirement with regard to diversification does not apply to government bonds.
- The point of departure for certification must be whether there is a clear objective in relation to pensions and a clear financial policy.
• One should try to ensure that the terminology is as concrete as possible: terms such as "the board is aware of" and "unnecessary risk" are generally (too) vague.

• The question is whether the certifying actuary would like to and/or is able to form an opinion of the sub portfolios.
4. Conclusions and recommendations of the working group

The following conclusions can be drawn from the views of the lawyers and the opinions of the parties with which the working group held discussions:

The certifying actuary will have to assess whether:

- the board of the pension fund, in the light of the pension fund's obligations, was able to arrive at the policy, which was agreed, in a manner which was reasonable;
- the pension fund implemented the investment policy in the past year in a manner which was consistent with the agreed investment policy.

In order to arrive at a sound assessment of the investments and to carry out a sound audit of the level of the required net assets, it is important that the data relating to the investments are reliable. The working group assumes that, on the basis of the Co-operation Agreement, the responsibility for the correctness of the investments lies with the auditor. The auditing of this must be included in the audit of the basic data, just as this applies to the data file. If there are any points in the Co-operation Agreement which are not clear (enough), these will have to be clarified.

The working group sees it as its task to analyse what the actuary should regard as his or her responsibilities. In doing so, the working group subscribes to the principles described above.

In elaborating these, the working group has drawn up an exhaustive list of assessment criteria which are:
1. qualitative by nature and not quantitative;
2. transparent for all the parties involved.

Notes to the list of assessment criteria:

The working group decided to draw up a list of qualitative assessment criteria. The advantage of such a list (which covers all provisions in relation to the prudent-person rule) is that it also clearly indicates the boundaries of the actuary's area of work. This is the reason that the list is referred to as 'exhaustive'.

In its further elaboration of the assessment criteria, the working group paid careful attention to what, in its opinion, did and did not belong to this area of work. Everything which is not included in this list is therefore expressly not the subject of assessment by the certifying actuary.

The working group is aware that some components may perhaps fall outside of the audit (and may therefore, for example, also fall outside the auditor's audit) as a result of this choice. If this leads to undesirable situations in the future, in consultation with other parties, such as auditors and the Dutch Central Bank, a decision on how to deal with this grey area can be taken on the basis of new insights.

Qualitative by nature and not quantitative

At the European level, an important choice was made to take qualitative supervision of investments as the point of departure and not the application of quantitative restrictions. An exception to this is the requirement that not more than 5%/10% is invested in the sponsoring undertaking/group. This reflects Dutch legislation and regulations. The criteria set out in Section 13 of the Pension Funds (Financial Assessment Framework) Decree also contained qualitative yardsticks.
There is a temptation nevertheless to define quantitative yardsticks (for instance, "no more than 50% of the equity portfolio should be invested in a particular region" or "investment must occur in at least two main categories"). However, the working group has adhered to the open norm applied by the legislator. After all, the legislator wished to guarantee the freedom of investment of pension funds (in other words, without political involvement) and did not wish to prescribe when an investment should be deemed prudent and when not. This depends on numerous factors, such as the situation in the world, the nature of the pension fund, the available expertise, the relationship to other investments, the relationship to existing liabilities etc.

Applying quantitative criteria may result in the wrong conclusions being drawn. For instance, the rule "investments must occur in at least two main categories" may perhaps seem reasonable as a minimum diversification requirement. In theory, however, a pension fund may only have nominal liabilities, which can be matched perfectly by an investment portfolio which consists solely of fixed-interest securities. The requirement that no more than 50% of the equity portfolio must be invested in a particular region seems plausible, on the one hand, but, on the other hand, is nevertheless arbitrary and offers the actuary false certainty. All the boundaries which can be identified are arbitrary to some degree.

For this reason, the working group decided only to formulate qualitative assessment criteria (unless quantitative assessment criteria have explicitly been included in the legislation and regulations).

**Transparent for all the parties involved**

On the basis of the assessment criteria formulated, what falls within the area of responsibility of the certifying actuary and what does not is clear to all parties. Whatever is not mentioned does not fall within the actuary’s responsibility. An assessment of whether the board has sufficient expertise is not directly part of the certifying actuary’s task.

The working group has attempted to formulate the criteria as clearly as possible. A point which requires attention is the definition of ‘regulated markets’. The Pensions Act does not provide a definition although the Financial Supervision Act does. This definition has been included in full in the list of assessment criteria.

With regard to investments mainly in regulated markets, the working group assumes that what is meant by this is a share of at least 75% to 80%.

With the aid of this list, the actuary can make an *ex ante* assessment of whether the pension fund has pursued a reasonable investment policy and how this policy was formulated and an *ex post* assessment of whether the pension fund adhered to the agreed investment policy.

To assess how the investment policy was formulated the minutes of board meetings and the discussions with the investment committee are an important source. More insight can also be obtained by including correspondence between the pension fund and the Dutch Central Bank. In order to make a careful assessment the actuary will have to make use, where necessary, of the knowledge of experts, such as investment consultants. The certifying actuary bears final responsibility for his or her assessment.

The way in which the board has given form to its investment policy and whether this was done prudently can be assessed by asking the right questions in the discussion with the board or the investment committee and, where necessary, asking further questions.
The minutes of the investment committee (or board meetings) can serve as a starting point for this. A guideline for this discussion is the list of assessment criteria.

The portfolio manager and the board must adhere to the agreed policy. Whether this actually happened must be assessed retrospectively (ex post). This assessment is also part of the prudent-person assessment. To facilitate this assessment, the following **plausibility test** can be applied by the actuary to the pension fund’s assets. The point of departure for the test is the assets at the beginning of the year. On the basis of the strategic mix and the returns realised on the various components of the portfolio an estimate can be made of the yield (delta capital) realised during the year. On the basis of the permissible bandwidths, a minimum and maximum yield can also be calculated. If the yield realised remains within the boundaries, this gives an indication that investments occurred on the basis of the investment policy. If the yield realised falls outside this bandwidth, further examination of the investments is required.

It is up to the actuary to decide what further use he or she wishes to make of the list. For instance, the actuary may draw up a questionnaire on the basis of the list and present this to the board. The answers could be discussed in a telephone conference or during a face-to-face meeting. Another option would be to discuss the criteria one by one during a meeting with the board or the investment committee.

In the working group’s opinion, the certifying actuary is sufficiently able to assess compliance with the prudent-person rule on the basis of the general principles stated and the assessment criteria which are formulated after consulting the board.

It should also be noted that the assessment of whether the prudent-person rule has been applied in a permissible way to investments is closely related to the assessment of whether the standard model has been applied correctly by the pension fund in determining the required net assets. Many aspects play a role in this assessment, which are also included in the list of assessment criteria. In this regard, it is important to ascertain whether an adequate assessment has been made of the risk profile of the pension fund on the basis of the standard model. If there are ‘additional risks’, the board may/will have to add a buffer to the required net assets. In this case, consultation will also take place or will have taken place with the Dutch Central Bank on the use of a (partially) internal risk model.

**Recording and discussing the findings of the certifying actuary**

The findings and recommendations are set out by the certifying actuary in the actuarial report. The certifying actuary should explain clearly how he or she reached his or her assessment. In addition, the certifying actuary should state what was examined and how this was done. The conclusions in the report should be accompanied by a clear explanation or substantiation. The actuarial report should be discussed with the board. It is preferable that the certifying actuary is present at the board meeting at which the report is discussed.

If investments occur in non-regulated markets, the report should include a statement in this regard, explaining whether this is consistent with the risk policy and the measures which were taken in this regard to limit the risks.

In the actuarial declaration itself, the actuary will state whether or not the pension fund has complied with the section on the prudent-person rule. Although there may be scope in this declaration for an explanatory text, this must be functional. As far as possible, explanatory texts should be included in the report. In addition, the
certifying actuary must take into account the fact that the declaration is included in the annual report while the actuary’s report is not.

**Addenda**
1. Report on the Prudent-Person Rule in Relation to Investment Policy
2. Formulation of the assignment of the Prudent-Person Working Group
3. The Pensions Act, including the Decree in Relation to the Financial Assessment Framework
5. Composition of the Prudent-Person Working Group
Annex 1. Guidelines for the Application of the Prudent-Person Assessment Criteria to Investment Policy

Aim

This document will serve as Guidance in relation to auditing of the investment policy of pension funds with retained risk or which are reinsured on the basis of a capital-sum contract in accordance with the prudent-person principle. Pension funds which are fully reinsured do not normally have to be assessed on the basis of the prudent-person rule.

The legislation refers to the prudent-person rule in relation to "investments in the interests of persons with entitlements or rights to pensions", to "sufficient security, quality and liquidity of the portfolio as a whole", to "investments mainly on the regulated markets" and to "investments which are consistent with the nature and duration of the expected pension benefits". Apart from whether the words "sufficient", "mainly" and "consistent with" allow much scope for differences of interpretation and implementation, it will only be possible to answer the question of whether these criteria have been met in retrospect.

It is important to note that the declaration provided by the certifying actuary may not be construed as a declaration that the investment policy is secure and that the investments are of the right quality. Nor should the declaration be construed as confirmation that the investments match the liabilities precisely. This would go too far. The declaration made by the certifying actuary is important and is the result of a careful investigation and assessment. However, no absolute value can be assigned to the declaration of the certifying actuary.

The assessment by the actuary is based on the following structure (a three-phase model):

- How did the pension fund arrive at its investment policy (what choices were made and what assumptions were applied)?
- Has the investment policy been recorded properly (was a broad study carried out and were the right policy considerations made)?
- Was the investment policy carried out as intended and is the policy monitored adequately?

The assessment according to the prudent-person rule must be carried out in the light of the total financial structure of the pension fund. If the pension fund has a strong financial basis, it is possible to incur greater risk. If the financial structure changes, the risks must also be adjusted in line with this (a moving boundary). In brief, was the board of the pension fund in accordance with criteria of fairness and equity and in the light of the pension fund’s obligations able to arrive at the policy which was agreed? If these criteria have been met and if the buffer is in line with the risk to be taken, then the policy is prudent.

For this purpose, a list of qualitative assessment criteria has been developed, the intention of which is to provide guidance for the actuary. This list also demarcates the boundaries of the certifying actuary’s area of work and is therefore intended as an exhaustive list.

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1 In accordance with the bill amending the Pensions Act and several other acts (Pensions (Miscellaneous Provisions) Act 2012) insurance based on a capital-sum contract will no longer be permissible.
In the working group's opinion, the certifying actuary must be sufficiently able to assess compliance with the prudent-person rule on the basis of the general principles stated and the assessment criteria which have been formulated, after consulting the board.

It is up to the actuary to decide what further use he or she wishes to make of the list. For instance, on the basis of this list the certifying actuary may compile a questionnaire which he or she may present to the board or the investment committee, or the criteria could be discussed one by one at a meeting.

In order to make a sound assessment, the actuary may make use of the knowledge of experts, such as an investment consultant. The certifying actuary bears final responsibility for his or her assessment.

**Required documents**

When requesting the required documents, the following documents, amongst others, could be considered:
- Annual Report and Annual Accounts;
- Actuarial and Technical Operating Memorandum
- Statement of Investment Policy Principles
- Investment Plan/Investment Mandate
- ALM Study/Continuity Analysis/Risk Budgeting Study/Risk Management Plan (if available);
- Reports by the portfolio manager/custodian;
- Reports to/communication with the Dutch Central Bank;
- Minutes of the Investment Committee;
- Minutes of the Board meetings
- Internal Actuarial Report;
- Recovery Plan;
- Assurance Report/ Declaration in relation to the auditor's basic data

**Areas of attention in relation to Section 135 of the Pensions Act**

**Investments in the pension fund's own sponsor/group sponsor**
- Limited to 5% of the total investment portfolio in the case of the sponsoring undertaking.
- Limited to 10% of the total investment portfolio of the pension fund's sponsoring group.
- Considerable diversification is taken into account in relation to investments in a group of sponsoring undertakings.

**Investments in the interests of persons with pension entitlements and rights to pensions**
- The investment policy has been adopted on the basis of a sound study, for instance an ALM study or a risk budgeting study. In this regard, attention has also also been paid to the bandwidth and degrees of freedom.
- In relation to this study, realistic and feasible assumptions were applied and sensitivity analyses were carried out within the framework of existing legislation and regulations.
- In the study of the investment policy, the structure of liabilities was taken into account explicitly with regard to both the nominal pension liabilities and the supplement policy.
- On the basis of this study and the board’s decisions, it can be concluded in the light of the pension objectives that no more risk is incurred than is necessary (for...
instance, an unnecessarily high probability of underfunding) and that the board has made a deliberate decision in a resolution of the board for the risk-return profile chosen (risk attitude). This may appear, for instance, from the continuity analysis which is carried out periodically, including the consistency test.

**Market valuation**
- The investments have been valued on the basis of their market valuation, as set out in the annual report of the pension fund and the Actuarial and Technical Operating Memorandum.
- If market valuation is not possible (for instance, in the case of illiquid investments), the alternative valuation methods applied must be stated. The valuation method is verifiable.
- The auditor has issued an unqualified report in relation to these annual accounts.

**Criteria arising from Section 13 of the Pension Funds (Financial Assessment Framework) Decree**

**Sufficient security and quality of the portfolio as a whole**

**Concentration risk**
- The board has made a deliberate choice in relation to the size of the contracts entered into with third parties and the counterparty risk, as well as the monitoring of this.
- The board has insight into the spread across countries, regions, companies and rating categories at the mandate, investment fund and portfolio levels.

**Debtor risk**
- The spread of (corporate) bonds across various rating classes within the pension fund and/or the mandate is known or can be requested. The strategic position in credit instruments is based on sound research, for instance a study of market valuations/valuation models, a risk-budgeting study or, alternatively, a portfolio construction study. The decision-making in relation to the study shows that a deliberate choice was made to incur any debtor risk.
- The board takes into account risks associated with asset loans.
- Guidelines have been drawn up in relation to collateral management and these are adhered to.

**Recovery situation**
- In the case of a recovery plan, the pension fund, in accordance with Section 16 of the Pension Funds (Financial Assessment Framework) Decree, has not deliberately increased the pension fund’s risk profile relative to the policy or the strategy prior to the emergence of the reserve deficit.

**Governance**
- The board has given sufficient arguments for the rationale and implementation of the choices made in the investment policy and has recorded these choices in writing (decisions, minutes and/or reports, mandates).
- The pension fund has an investment plan or a similar document which sets out the main principles according to which it invests and which makes use of degrees of freedom in this regard.
- The pension fund has a Statement of Investment Policy Principles. The investment plan is consistent with this statement.
- There is a clear mandate (for instance, described in the investment plan and the Statement of Investment Policy Principles accompanying this), in which the
objectives and restrictions on investments (including the risk yardsticks and bandwidths for the rebalancing policy and tactical policy) are described.

- The investments spread across the main categories and subcategories are in accordance with the investment plan and/or the mandate. The pension fund monitors the implementation of the investment plan and/or the mandate (including the risk yardsticks) on the basis of periodic reports.
- The decision-making with regard to any deviation from the investment plan and/or mandate takes place with due care.

Transparency of the investment funds

- The investment funds also have agreed investment guidelines on the basis of which the risks incurred by the investment funds are managed.
- The annual accounts of the investment funds have received an unqualified auditor's report.
- The reports are made available in a timely fashion.
- The realised return on investments is verifiable and the risk incurred is consistent with the investment policy.

Sufficient liquidity of the investment portfolio as a whole

- The board has an insight into the expected liquidity requirement, both with regard to the pension liabilities and with regard to the investment liabilities. In this regard, the relationship between the pension fund's liquidity and liabilities and, for instance, collaterals, calls and derivative positions must be taken into account in relation to the investments.
- The board takes into account the risks arising from any mismatch between the required liquidity and the available short-term liquidity.
- The extent of investments in illiquid investment categories is limited to a prudent level.

Investments are consistent with the nature and duration of the expected pension benefits

- In determining the investment policy, the 'expected cash flows' are taken into account (for instance, by means of an ALM study and a risk-budgeting study).
- The board has deliberately chosen not to match/to match partially/to match fully the projection of nominal or real cash flows and understands the consequences which this is expected to have on the pension outcomes and financing.
- In determining the investment mix, the relationship between investment risks and the maturing of the pension fund must be taken into account.
- The pension fund is aware of the risks accompanying Liability Driven Investments (LDI).

Regulated markets

- Investments which are traded on non-regulated financial markets are limited to a prudent level.

Financial derivatives

- Derivative positions have only been taken to reduce the risk profile or to facilitate portfolio management.

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2 The definition of 'regulated markets' in accordance with the Financial Supervision Act is: a multilateral system which brings together or facilitates the bringing together of numerous intentions of third parties to buy and sell in relation to financial instruments—within this system and in accordance with non-discretionary rules of the system—in such a way that an agreement arises from this in relation to financial instruments which are admitted for trading in accordance with the rules and the systems of the said market, and which operates in a regular fashion and in accordance with applicable rules in relation to the granting of licences and continuous supervision.
• The risk profile of the derivative positions has been estimated adequately and has been incorporated into periodic reports.

Counterparty risk
• A deliberate choice has been made in relation to the size of the contracts entered into with third parties and the counterparty risk incurred in the event that the option of central clearing has been chosen.
• Counterparty risk has been reduced as far as possible on the basis of standard agreements generally accepted in the financial world and collateral.

Proper diversification
• The investments in equities and bonds, according to regional sector or, alternatively, according to company or country, are based on sound research, such as an ALM study and/or a risk-budgeting study.
• The actual spread within the portfolio and within the investment categories, for instance according to country, region, sector and creditworthiness, is known in sufficient detail or, alternatively, can be requested.
• The concentration risk has been limited to a prudent level.
Annex 2. Formulation of the assignment of the Prudent-Person Working Group

Introduction
Section 135 of the Pensions Act stipulates that a pension fund must pursue an investment policy which is consistent with the prudent-person rule. The same criterion applies to occupational pension funds in accordance with Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act. In these sections of the respective acts, several general principles are mentioned with which the investment policy must comply. Further criteria have been set out in Section 13 of the Pension Funds (Financial Assessment Framework) Decree, which applies to pension funds which are subject to the Pensions Act or the Occupational Pension Schemes (Obligatory Membership) Act.

Declaration of the certifying actuary
In accordance with Section 147 of the Pensions Act and Section 142 of the Occupational Pension Schemes (Obligatory Membership) Act, the certifying actuary is required annually to assess compliance with the provisions of Section 126 up to and including Section 140 of the Pensions Act or, alternatively, Section 121 up to and including Section 135 of the Occupational Pension Schemes (Obligatory Membership) Act. The certifying actuary must therefore assess annually whether the investment policy of the pension fund complies with the prudent-person rule.

Problem definition
The general principles and further requirements set out in the above-mentioned sections of legislation and regulations have been formulated in such a way that there is considerable scope for further interpretation and elaboration. The following questions, in particular, arise from this:

- What did the legislator actually mean by the prudent-person rule?
- What exactly falls under the prudent-person rule?
- Where does the responsibility of the certifying actuary end?
- To what extent is the certifying actuary in a position to assess compliance with the prudent-person rule? (Does he or she have sufficient information? Does he or she have sufficient expertise?)
- How does the certifying actuary reach his or her assessment?

At present, these questions have not been answered with sufficient clarity. Without sufficiently clear answers to these questions, each certifying actuary may give form to the prudent-person assessment in his or her own way. This applies not only to the scope of the assessment (what it includes), but also to its depth (how far the assessment goes and to what level of detail).

This means that in practice certifying actuaries go further or, alternatively, go less far than is intended in accordance with the statutory rules. The result may be that different and possibly even deviating assessments and outcomes occur. This lack of clarity is undesirable since, in principle, when carrying out an assessment in accordance with the prudent-person rule each actuary should arrive at the same assessment.

This is the reason why members of the Dutch Actuarial Association have appealed for the development of guidance for the certifying actuary in relation to the prudent-person rule.
Prudent-Person Working Group of the Dutch Actuarial Association
The Dutch Actuarial Association therefore set up a Prudent-Person Working Group consisting of Eric van den Ende (GBF), Eugene Rebers (APG, replaced as of November by Karin Aarssen), Arjen Hussem (PGGM), Rein van Dam (Mercer), Carel Hammer (Hewitt), Arie Herlaar (AON), Yvo Hauet (Sprenkels & Verschuren) and Ruud Kruijff (Towers Watson). The working group is supported by Robert de Vries of the Office of the Dutch Actuarial Association & Dutch Actuarial Institute.

Formulation of the assignment
The assignment issued to the Prudent-Person Working Group is as follows:

Assignment
In accordance with Section 147 of the Pensions Act and the Occupational Pension Schemes (Obligatory Membership) Act, the certifying actuary must assess whether the investment policy of a pension fund meets the prudent-person rule. A few general principles are stated in Section 135 of the Pensions Act and Section 130 of the Occupational Pension Schemes (Obligatory Membership) Act. Further requirements are formulated in Section 13 of the Pension Funds (Financial Assessment Framework) Decree which, as in the case of the Pensions Act, are to a certain degree open to various explanations and interpretations.

Substantive matters
The Prudent-Person Working Group must develop proposals for guidance which the Dutch Actuarial Association can issue to its (certifying) members in relation to the prudent-person rule. This guidance is intended to support the certifying actuary in carrying out the annual assessment of the investment policy of a pension fund in accordance with the prudent-person rule. In addition, this guidance must result in a situation where the annual assessment in accordance with the prudent-person rule is carried out by the (certifying) members of the Dutch Actuarial Association in a clear manner without wishing to limit the individual responsibility of the certifying actuary. The guidance must deal with the following topics:

- the framework for assessment in accordance with the prudent-person rule;
  - the legislator's intention;
  - the scope of the prudent-person rule;
  - the scope of the certifying actuary's responsibility;
- the assessment criteria for the certifying actuary which arise from the regulations;
  - the assessment criteria which arise from Section 135 of the Pensions Act and Section 13 of the Pension Funds (Financial Assessment Framework) Decree;
  - the degree of detail expected of the certifying actuary in his or her assessment based on the assessment criteria;
  - the question of whether the certifying actuary (partly) based his or her assessment on the examination and opinion of another expert (for instance, an auditor and/or an investment consultant) who is not involved with the respective pension fund;
  - the relevant minimum expertise which the certifying actuary should have;
- the criteria which the report of the certifying actuary must meet within the framework of the prudent-person rule;
  - the degree of detail;
- the type of findings (according to their nature and importance) that should be stated in the actuarial report or, alternatively, in the actuarial declaration.
**Approach (to follow up) and schedule of activities**

The working group wishes to complete its final product—a draft report for guidance for (certifying) members of the Dutch Actuarial Association—at the latest on 8 November 2012 in order to discuss the proposal at the General Meeting of Members on 10 November 2012. The aim is to create support and obtain input. To complete the assignment within the stipulated period, the working group will hold a monthly meeting in the period from July to November 2010.

In addition, a number of meetings are planned with stakeholders, including the Dutch Association of Industry-wide Pension Funds (VB)/Dutch Association of Company Pension Funds (OFP) (Reporting Committee) and the Royal Netherlands Institute of Registered Accountants (NIVRA); discussions are also being held with a number of pension lawyers of actuarial firm’s with regard to the scope of the prudent-person check. Consultation is taking place with the Dutch Central Bank in which the Dutch Central Bank can share its views with the working group regarding the prudent-person assessment. The advantage of this is that the working group will be able to take account of the views of the Dutch Central Bank in developing the guidance and can avoid possible delays in the further process of communicating with interested market parties.

In principle, the final acceptance of the guidance has been included on the agenda of the General Meeting of Members of 8 December 2010. The possibility cannot be excluded that the study will continue after the matter has been discussed in the General Meeting of Members if the situation gives cause for this (for instance, because the working group was not in a position to complete the assignment in sufficient detail due to lack of time or because the assessment of the input by the members requires more time).
Annex 3. The Pensions Act, including the Pension Funds (Financial Assessment Framework) Decree (relevant provisions)

Article 135 Requirements with regard to investments
1. A pension fund shall pursue an investment policy which is consistent with the prudent-person rule and which, in particular, is based on the following principles:
   a. the securities shall be invested in the interests of those persons entitled to pensions and with rights to pensions; and
      Explanatory Memorandum:
      Substantively nothing has changed relative to the Pension and Savings Funds Act with regard to the investments by pension funds. This bill also contains no quantitative restrictions. However, in accordance with Directive 2003/41/EC, a number of qualitative provisions apply. However, these are entirely in line with the obligation to invest soundly, which already exists in the Pension and Savings Funds Act and has been worked out in more detail by the supervisor.
      The prudent-person rule focuses on the situation as a whole. Within this it is certainly possible that individual investments incur a higher risk. The purpose of this may be to realise a higher return on that part, which may be used, for instance, to finance the granting of supplements. Perfect matching of assets and liabilities, if not impossible, is in any event difficult and expensive. However, insufficient matching also carries a price tag. This is one reason that capital buffers are required in accordance with the bill for remaining, unmatched risks ....

   b. investment in the sponsoring undertaking shall be no more than 5% of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group as the sponsoring undertaking shall not be more than 10% of the portfolio. When the institution is sponsored by a number of undertakings, investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification;
      Explanatory Memorandum: ....
      The percentages mentioned relate to the total liabilities. This means that if a pension fund has reinsured 80% of its liabilities and has retained 20% of its risk, the aforementioned boundaries of 5% and 10% respectively apply. The pension fund may then invest in the contributing company in respect of a quarter or half respectively of the capital invested by the pension fund on which risk is incurred...
      For the sake of clarity, it is emphasised that a prudent investment policy, where the assets are invested in the interests of persons entitled to pensions and persons with rights to pensions (see subsection (a) of this section), may make it necessary to impose further restrictions on investment in the pension fund's own sponsor than the boundaries stipulated in accordance with this section. (Proceedings of the Lower House of the Dutch Parliament, 2005-2006, 30 413, No. 3259).
      For the sake of completeness, it is emphasised that in accordance with clause (1)(a) of Directive 2003/41/EC, attention is only given to the interests of persons entitled to pensions and persons with rights to pensions and, in contrast to Article 94(2), consideration is not given to the position of the employer.

   c. the investments are valued on the basis of their market valuation.

2. Further rules shall be introduced by or pursuant to an order in council to guarantee a prudent investment policy.

3. The requirements included in subsection (1), preamble and clause (b), and the rules stipulated in accordance with the second subsection with regard to the
diversification of assets shall not apply to investments in government bonds.

Explanatory Memorandum:
Directive 2003/41/EC stipulates that the Member States may decide that the stipulated criteria with regard to the diversification of assets (clause 2(e)) and in relation to investments in the pension fund’s own sponsor (clause 1(b)) do not have to apply to government bonds. The Netherlands has not made use of this option.

……

Article 145 Actuarial and Technical Operating Memorandum

1. The pension fund shall adopt an actuarial and technical operating memorandum, which shall, in any event, include a description of the way in which the provisions of or pursuant to Sections 25, 95, 126 up to and including 137, and 143 are implemented. The actuarial and technical operating memorandum shall also include a Statement of Investment Policy Principles and a description of the management instruments.

2. Rules shall be introduced in relation to the actuarial and technical operating memorandum by or pursuant to an order in council.

3. In so far as risks are transferred, reinsured or underwritten, the description, as referred to in the previous subsection, may remain limited to a reference to the provisions in this regard in the respective agreements.

4. The Statement of Investment Policy Principles shall be revised every three years and, in addition, without delay after every important amendment to the investment policy.

……

Article 147 Schedules

1. A pension fund shall ensure that the financial year coincides with the calendar year.

2. A pension fund shall provide the supervisor periodically and by the deadlines specified for this purpose with schedules which the supervisor requires for the proper performance of its task, as referred to in Section 151.

3. The schedules shall only include:
   a. ....
   h. actuarial schedules, certified by an authorised actuary, including an actuarial report accompanied by a declaration by an actuary;
   i. ...

4. In his declaration, as referred to in subsection (3)(h), the actuary shall confirm that he is satisfied that the pension fund has complied with Section 126 up to and including Section 140. He is authorised to provide an explanation of his declaration or to make a reservation in respect of any matter.

Explanatory Memorandum: The text of this subsection is based on Section 2:99 of the Financial Supervision Bill. The declaration referred to here relates to certification by the actuary of the actuarial report.

……
Article 170 Obligation on the part of the auditor and actuary to provide information and to give notification

1. An auditor who carries out the audit of the schedules, referred to in Section 147(5), shall notify the supervisor as soon as possible of any circumstances of which he has taken cognizance while carrying out the audit and which:
   a. is contrary to this act;
   b. jeopardises compliance with obligations which the pension fund has accepted; or
   c. results in a refusal to issue a declaration with regard to the truth and fairness thereof or which gives rise to reservations.

2. Subsection (1), preamble and parts (a) and (b), shall apply *mutatis mutandis* to the actuary who carries out the audit of the schedules, as referred to in Section 147(4).

Pension Funds (Financial Assessment Framework) Decree
Paragraph 5 Investments and loans

Section 13 Requirements with regard to investments

1. The assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

   Explanatory Memorandum:
   The first subsection provides a further general elaboration of the principle of investment in accordance with the prudent-person rule. The prudent-person rule is not defined by the directive. Section 135(1)(a) of the Pensions Act and Section 130(1)(a) of the Occupational Pension Schemes (Obligatory Membership) Act contain what are perhaps the most essential criteria: the assets must be invested in such a way that the security, quality, liquidity and profitability of the portfolio as a whole is guaranteed. In this regard, it should be noted that in the case of pension funds the profitability of the portfolio is not guaranteed, as is stated in this description, which is derived from the Directive. In addition, the assets must be invested exclusively in the interests of the members and persons entitled to pensions. In this regard, reference can also be made to recital 31 of the Directive: "Institutions are very long-term investors. Redemption of the assets held by these institutions cannot, in general, be made for any purpose other than providing retirement benefits. Furthermore, in order to protect adequately the rights of members and beneficiaries, institutions should be able to opt for an asset allocation that matches the precise nature and duration of their liabilities. These aspects call for efficient supervision and an approach towards investment rules allowing institutions sufficient flexibility to decide on the most secure and efficient investment policy and obliging them to act prudently. Compliance with the "prudent person" rule therefore requires an investment policy geared to the membership structure of the individual institution for occupational retirement provision."

2. Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits.

   Explanatory Memorandum:
   The provisions of subsection (2) mean that investments must be matched as far as possible to future liabilities. Perfect matching of investments to the (duration of the) expected future pension benefits, however, is difficult to realise. The market does not offer sufficient investment opportunities for this. In so far as this is possible, this would also be very expensive. Partly due to this incomplete matching, [...] capital buffers are required in accordance with Section 132 of the Pensions Act. It is not the intention of the provisions of subsection (2) to impose quantitative restrictions on investments. All that is intended is that in selecting investments the nature and duration of the expected benefits are taken into account.
3. The assets shall be predominantly invested in regulated markets. Investments in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels.

Explanatory Memorandum in relation to the Pension and Savings Funds Act, 1 January 2006:
The term "regulated market" is a term which is also used in Article 1(13) of the Investment Services Directive (OJEC L 93/22), but even this directive does not provide a more detailed description. In this regard, it is ultimately at the discretion of the supervisor whether the requirements arising from the prudent-person rule have been met.

4. Investments in derivatives are permitted insofar as these contribute to a reduction in the risk profile or facilitate effective portfolio management. The pension fund shall avoid excessive risk in relation to one and the same counterparty and in relation to other derivative transactions.

Explanatory Memorandum:
Derivatives are investment products whose value is derived from the underlying asset. The concept of a 'derivative' is worked out in more detail in Addendum B to the Prudential Rules (Financial Supervision Act) Decree, which is based on Annex IV of the (revised) Banking Directive (Directive (EC) No. 2006/48 of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJEC L 177).

5. The assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole.

6. Valuation at market value, as referred to in Section 135(1)(c) of the Pensions Act and Section 130(1)(b) of the Occupational Pension Schemes (Obligatory Membership) Act, shall be understood to mean: the amount for which an asset can be traded or a liability can be settled between well-informed parties who are willing to participate in the transaction and are independent of each other.

Explanatory Memorandum:
The valuation of investments at their market value is based on Section 4 of the Actual Value Decree, which is based on Section 2:384 of the Netherlands Civil Code. The concept of market value excludes the purchase price.

Pensions Directive 2003/41/EC

Whereas

(1) ....

This Directive thus represents a first step on the way to an internal market for occupational retirement provision organised on a European scale. By setting the "prudent person" rule as the underlying principle for capital investment and making it possible for institutions to operate across borders, the redirection of savings into the sector of occupational retirement provision is encouraged, thus contributing to economic and social progress.

...

(31) Institutions are very long-term investors. Redemption of the assets held by these institutions cannot, in general, be made for any purpose other than providing retirement benefits. Furthermore, in order to protect adequately the rights of members and beneficiaries, institutions should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities. These aspects call for efficient supervision and an approach towards investment rules allowing institutions sufficient flexibility to decide on the most secure and efficient investment policy and obliging them to act prudently. Compliance with the 'prudent person' rule therefore requires an investment policy geared to the membership structure of the individual institution for occupational retirement provision."

(32) Supervisory methods and practices vary among Member States. Therefore, Member States should be given some discretion on the precise investment rules that they wish to impose on the institutions located in their territories. However, these rules must not restrict the free movement of capital, unless justified on prudential grounds.

(33) As very long-term investors with low liquidity risks, institutions for occupational retirement provision are in a position to invest in non-liquid assets such as shares as well as in risk capital markets within prudent limits. They can also benefit from the advantages of international diversification. Investments in shares, risk capital markets and currencies other than those of the liabilities should therefore not be restricted except on prudential grounds.

.....

HAVE ADOPTED THE FOLLOWING DIRECTIVE:

Article 1 ....

Article 12 Statement of Investment Policy Principles
Each Member State shall ensure that every institution located in its territory prepares and, at least every three years, reviews a written statement of investment-policy principles.
This statement is to be revised without delay after any significant change in the investment policy. Member States shall provide that this statement contains, at least, such matters as the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities.

**Article 18 Investment rules**

1. Member States shall require institutions located in their territories to invest in accordance with the "prudent person" rule and in particular in accordance with the following rules:

(a) In addition, the assets must be invested exclusively in the interests of members and persons entitled to pensions. The assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;

(b) The assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits;

(c) The assets shall be predominantly invested on regulated markets. Investment in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels;

(d) Investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The pension fund shall avoid excessive risk in relation to one and the same counterparty and in relation to other derivative transactions.

(e) The assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole.

Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration;

(f) Investment in the sponsoring undertaking shall be no more than 5% of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group as the sponsoring undertaking shall not be more than 10% of the portfolio.

When the institution is sponsored by a number of undertakings, investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification.

Member States may decide not to apply the requirements referred to in points (e) and (f) to investment in government bonds

2. The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.

3. Member States shall not require institutions located in their territory to invest in particular categories of assets.
4. Without prejudice to Article 12, Member States shall not subject the investment decisions of an institution located in their territory or its investment manager to any kind of prior approval or systematic notification requirements.

5. In accordance with the provisions of paragraphs 1 to 4, Member States may, for the institutions located in their territories, lay down more detailed rules, including quantitative rules, provided they are prudentially justified, to reflect the total range of pension schemes operated by these institutions.
In particular, Member States may apply investment provisions similar to those of Directive 2002/83/EC.
However, Member States shall not prevent institutions from:
(a) investing up to 70% of the assets covering the technical provisions or of the whole portfolio for schemes in which the members bear the investment risks in shares, negotiable securities treated as shares and corporate bonds admitted to trading on regulated markets and deciding on the relative weight of these securities in their investment portfolio. Provided it is prudentially justified, Member States may, however, apply a lower limit to institutions which provide retirement products with a long-term interest rate guarantee, bear the investment risk and themselves provide for the guarantee;
(b) investing up to 30% of the assets covering technical provisions in assets denominated in currencies other than those in which the liabilities are expressed;
(c) investing in risk capital markets.

6. Paragraph 5 shall not preclude the right for Member States to require the application to institutions located in their territory of more stringent investment rules also on an individual basis provided they are prudentially justified, in particular in the light of the liabilities entered into by the institution.

7. In the event of cross-border activity as referred in Article 20, the competent authorities of each host Member State may require that the rules set out in the second subparagraph apply to the institution in the home Member State. In such case, these rules shall apply only to the part of the assets of the institution that corresponds to the activities carried out in the particular host Member State. Furthermore, they shall only be applied if the same or stricter rules also apply to institutions located in the host Member State.
The rules referred to in the first subparagraph are as follows:
(a) the institution shall not invest more than 30% of these assets in shares, other securities treated as shares and debt securities which are not admitted to trading on a regulated market, or the institution shall invest at least 70% of these assets in shares, other securities treated as shares, and debt securities which are admitted to trading on a regulated market;
(b) the institution shall invest no more than 5% of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital-market instruments issued by the same undertaking and no more than 10% of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital market instruments issued by undertakings belonging to a single group;
(c) the institution shall not invest more than 30% of these assets in assets denominated in currencies other than those in which the liabilities are expressed. To comply with these requirements, the home Member State may require ring-fencing of the assets.
Annex 5.

Composition of the Working Group on the Prudent-Person Rule in Relation to Investment Policy

R. Kruijff AAG (Ruud), Chairman
K. Aarssen AAG RBA (Karin), member of the Working Group in November/December 2010
R. van Dam AAG (Rein)
E.F. van den Ende AAG (Eric)
C.F. Hammer AAG (Carel)
Y. Hauet AAG RBA (Yvo)
A.C. Herlaar AAG (Arie)
A. Hussem AAG (Arjen)
E. Rebers (Eugene), member of the Working Group until November 2010