DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS

OECD GUIDELINES ON FUNDING AND BENEFIT SECURITY IN OCCUPATIONAL PENSION PLANS

Recommendation of the Council

These guidelines, prepared by the OECD Insurance and Private Pensions Committee and the Working Party on Private Pensions, were adopted by the OECD Council on 10 May 2007.

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RECOMMENDATION OF THE COUNCIL ON GUIDELINES ON FUNDING AND BENEFIT SECURITY IN OCCUPATIONAL PENSION PLANS

THE COUNCIL,

Having regard to Articles 1, 3 and 5(b) of the Convention on the Organisation for Economic Cooperation and Development of 14 December 1960;

Having regard to the Recommendation of the Council on Core Principles of Occupational Pension Regulation [C(2004)41], to which this Recommendation is complementary;

Considering that the funding of private pension plans is central for benefit security;

Considering that regulations should encourage prudent levels of funding so as to meet the retirement income objectives of the pension plan;

Considering that the Guidelines presented in the Annex to this Recommendation are based on previous work carried out in this area by the Insurance and Private Pensions Committee and its Working Party on Private Pensions and are complemented by the annotations set out in Appendix II, which may be reviewed as necessary from time to time by the Insurance and Private Pensions Committee;

Considering that the Guidelines address regulatory concerns that arise in the funding of occupational, private pension plans;

Noting that these Guidelines are intended to apply to occupational, private pension plans;

Noting that these Guidelines may also apply to funded, non-occupational plans and funds;

Noting that the Guidelines identify good practices for the regulation of pension funds, where "regulation" is understood to include a broad variety of instruments, e.g. laws; tax requirements; standards set by supervisory authorities; codes of conduct developed by professional associations; collectively bargained agreements and plan documents;

Recognising that evolutions of the structure and operation of private pension plans may call for further updating and adaptation of these Guidelines;

On the proposal of the Insurance and Private Pensions Committee and its Working Party on Private Pensions;

I. RECOMMENDS that Member Countries invite public authorities to ensure an adequate regulation of funding and benefit security in occupational pension plans, having regard to the contents of the Annex to this Recommendation, of which it forms an integral part.

II. INVITES Member Countries to disseminate these Guidelines among pension funds.

III. INVITES non-Members to take account of the terms of this Recommendation and, if appropriate, to adhere to it under conditions to be determined by the Insurance and Private Pensions Committee.

IV. INSTRUCTS the Insurance and Private Pensions Committee and its Working Party on Private Pensions to exchange information on progress and experiences with respect to the implementation of this Recommendation, to review that information and to report to the Council not later than three years following its adoption and, as appropriate, thereafter.

GUIDELINES ON FUNDING AND BENEFIT SECURITY IN OCCUPATIONAL PENSION PLANS

I. Funding of occupational pension plans

1.1 Occupational pension plans should be funded.

1.2 Occupational defined contribution plans should be funded through the establishment of pension funds, pension insurance contracts or the purchase of other authorised retirement savings products from financial institutions.

1.3 Occupational defined benefit plans should in general be funded through the establishment of a pension fund or through an insurance arrangement (or a combination of these mechanisms). Additional protection may be provided through the recognition of creditor rights to the pension fund or the plan members and beneficiaries and, in some cases, through insolvency guaranty schemes that protect pension benefits in the case of insolvency of the plan sponsor or the pension fund.

1.4 Private unfunded plans should generally be prohibited. The establishment of an insolvency guaranty scheme should in general be required for occupational defined benefit plans that are financed through the book reserve system.

1.5 Insolvency guaranty schemes should rely on appropriate pricing of the insurance provided in order to avoid unwarranted incentives for risk-taking (moral hazard). The level of benefits guaranteed should also be limited.

II. Measurement of occupational pension plan liabilities

2.1 Legal provisions[1] *should be in place requiring the determination of occupational pension plan liabilities corresponding to the financial commitments or obligations which arise out of the pension arrangement. The ongoing liability is normally defined as the accrued benefit rights of pension plan members and beneficiaries excluding future service but taking into account the projected benefits to be received under estimated retirement, mortality, and early leaver (also known as membership termination or job separation) patterns. The termination liability takes into account the pension benefits accrued if the plan were to be terminated at the time of the valuation.*

2.2 Any definitions of ongoing and termination liability should reflect any benefit indexation factors prescribed by law or plan terms (unconditional indexation) that apply from membership or plan termination to the annuity starting date and, if relevant, after the annuity starting date, provided that these factors are predictable. These definitions should also reflect benefits that become vested upon plan termination.

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1. Throughout this document, legal provisions are defined in a broad sense. They may include the main body of the pension law, related laws (e.g. trust law), tax requirements, standards set by pension and financial sector supervisory authorities, codes of conduct developed by professional associations (e.g. a pension fund association), collectively bargained agreements, or plan documents (e.g. trust documents).

2.3 These legal provisions should require the use of appropriate calculation methods, including actuarial techniques and amortisation rules that are consistent with generally recognised actuarial standards and methods.

2.4 The legal provisions (referencing generally recognised actuarial standards and methods) should require the use of prudent actuarial assumptions which are considered appropriate for the calculation of the pension plan's liabilities. These assumptions would include, among others, the mortality table (representing the assumed level of mortality of plan members and beneficiaries as at the date at which the plan's liabilities are calculated), future trend in mortality (representing permanent changes in mortality that are assumed to occur after the date at which the liabilities are calculated) and retirement and early leaver patterns at different ages (taking into account the actual retirement and early leaver behaviour of those covered by the plan).

2.5 The legal provisions (referencing generally recognised actuarial standards and methods) should require the use of prudent discount rates for determining liabilities that are consistent with the methodologies used in the valuation of assets and other economic assumptions. These legal provisions (or the actuarial profession) should provide guidance as to the factors that may be considered in determining the discount rate for ongoing and termination liabilities.

2.6 The calculation of pension liabilities should take place at least once every three years, while a certification or report of the adjusted development of the liabilities and changes in risks covered should be required for the intervening years. All actuarial valuations should be carried out by an actuary, or by another equivalent specialist, who has had appropriate training and experience in the field of pensions.

2.7 As part of the process of defining its funding policy, the governing body of the pension fund should seek the advice of the actuary or other relevant specialist regarding the assumptions and methods to be used in calculating pension liabilities and funding levels. This advice should be provided in a clear and timely fashion.

III. Funding rules for occupational pension plans/funds

3.1 The legal provisions require the identification and maintenance of a level of assets that would be at least sufficient to meet accrued benefit payments. The targeted funding level may be based on the termination or the ongoing liability. It should also take account of the plan sponsor's ability and commitment to increase contributions to the pension plan in situations of underfunding, the possibility of benefit adjustments or changes in retirement ages, as well as the link between the pension fund's assets and its liabilities.

3.2 Approved funding methods (also known as actuarial cost methods) for the ongoing liability should attempt to prevent sharply rising cost curves over time by spreading the actuarial (or accrued) liability over the expected career path of plan members. In order to ensure adequate funding levels over time, ongoing funding methods should take into account factors such as future salary growth, mortality, disability, early leaver (separation) and other relevant events.

3.3 In addition to normal costs (the present value of benefits that have accrued on behalf of the members during the valuation period), contributions should reflect other factors, including, to the extent appropriate to the accrual of benefits under the plan, work before a plan's inception, plan amendments that increase liability attributable to past service, deviations of actual results from assumptions (experience gains and losses), and the effects of changes in assumptions (actuarial gains and losses). These supplemental costs should be amortised as even currency units or at a minimum as even percentages *of payroll. Amortisation periods should in general not be longer than the expected future period of service of active plan participants.*

3.4 The legal provisions should not prevent funding methods that seek to dampen the short term volatility in firms' funding contributions. Prudent amortisation of supplemental costs over time might help achieve a smoother contribution schedule and more stable funding levels.

3.5 These legal provisions set out the different mechanisms and the recovery period for correcting a situation of underfunding, taking into account the sources of underfunding and the type of underfunding (ongoing or termination basis). Funding rules may grant some reprieve on contribution obligations only under restricted circumstances and to defined limits. Temporary reductions of contribution obligations may be considered with a clear waiver procedure managed by the pension regulator.

3.6 Funding rules should aim to be countercyclical, providing incentives to build reserves against market downturns. They should also take market volatility into account when limiting contributions (or their tax deductibility) as a certain funding level is reached. Tax regulations should not discourage the build-up of sufficient reserves to withstand adverse market conditions and should avoid restricting the full funding of the ongoing or termination liability. Temporary suspension of contribution obligations may be appropriate in circumstances of significant overfunding (calculated on an on-going basis).

3.7 Funding rules should take into account the extent to which the autonomous pension fund itself as opposed to the plan sponsor or the plan members is directly responsible partly or wholly for the commitments represented by the pension liabilities. Where the pension fund itself underwrites the pension liability without any guarantee from the plan sponsor or members, it should be required to hold additional assets over and above those necessary to fully fund the pension liabilities on a plan termination basis. This capital requirement or solvency margin should be determined taking into account the nature and size of assets held and liabilities due that are the responsibility of the pension fund and the extent to which benefits may be reduced.

IV. Winding-up

4.1 The allocation of plan assets and the responsibility for underfunding in the event of plan termination should be clearly established. In the event that assets exceed promised benefits on a termination basis, there should be rules in place as to the allocation of the funding excess or surplus. In the event that assets are insufficient to cover promised benefits, there should be rules concerning the benefit payment allocation.

4.2 Whenever plan benefits are guaranteed by sponsoring employers, the creditor rights of pension plan members and beneficiaries (either directly, via the pension fund, or, where relevant, via insolvency guarantee schemes) should be recognised in the case of bankruptcy of the plan sponsor. Priority rights relative to other creditors should be required for at least due and unpaid contributions.

ANNOTATIONS TO GUIDELINES ON FUNDING AND BENEFIT SECURITY IN OCCUPATIONAL PENSION PLANS

I. Funding of occupational pension plans

1. Benefit security in both defined benefit and defined contribution occupational plans calls for the funding of pension benefits, that is, the identification and accumulation of assets to be used exclusively to meet pension commitments and related expenses (for example, the cost of pension plan administration).

2. Different methods of funding exist in occupational plans. For defined contribution plans, where sponsoring employers do not make any benefit or performance commitments, the legal separation of pension plan assets from those of the employer should be mandatory. The assets may be held in a pension fund or they may be managed directly by financial institutions through pension insurance contracts or other authorised products.

3. For occupational defined benefit plans, plan assets should normally be legally segregated from the plan sponsor through a pension fund or an insurance arrangement (a pension insurance contract) in order to ensure a minimum level of protection against the possible insolvency of the sponsor. Countries sometimes buttress these funding requirements with priority creditor rights in the case of insolvency of the sponsor and, more occasionally, with insolvency guaranty schemes that protect benefits against the insolvency of the sponsor. In most countries, insolvency guarantee schemes only insure benefits promised in a pension plan up to a specific ceiling.

4. In occupational defined benefit pension plans financed through the book reserve system benefits should be protected against the risk of default of the plan sponsor through an insolvency guaranty scheme. In practice, only certain defined benefit plans offered by some companies to specific workers (e.g. senior executives, so-called “top hat” schemes) are sometimes managed on an unfunded basis without such schemes. Such plans may be permitted but should not benefit from tax advantages. Plans that benefit from tax deductibility (and which are normally expected to cover most of the sponsoring company’s workers) should not be run on an unfunded basis without insolvency insurance.

5. Insolvency guaranty schemes may be privately or publicly managed. In general, it is important that such schemes rely on appropriate pricing of the insurance provided in order to avoid unwarranted incentives for risk-taking (moral hazard). These arrangements also function most effectively when the underwriting entity has priority rights for missed or unpaid contributions in the case of insolvency of the plan sponsor.

6. Insolvency guaranty schemes (and in some cases, bankruptcy priority) may also be required for defined benefit plans financed via pension funds, in order to provide an additional layer of protection against bankruptcy of the plan sponsor. The need for such schemes should be evaluated taking into consideration the effectiveness of funding and investment rules in mitigating the consequences of sponsor bankruptcy on benefit security and the potential impact of such schemes on the plan sponsor’s ability to raise capital and, consequently, on its ability and willingness to continue to support the pension plan. It is important also that insolvency guaranty schemes rely on appropriate pricing of the insurance provided, taking into account, inter alia, the extent of under/overfunding and the default risk of the sponsoring entity.

7. Plan sponsors may also contract directly with insurance companies to purchase policies to cover their pension commitments. In defined benefit plans, such policies may include savings products providing rate of return guarantees, annuities, and survivors' insurance. In general, however, for those countries in which final salary benefits accrue with respect to future salary increases, insurance companies do not provide instruments to fully insure final salary benefit promises for plan members that are still accruing benefits (annuities are the relevant policies for those who have retired)[1]. Such plan formulas, therefore, would normally call for the establishment of a pension fund to meet commitments that are not covered by the insurance policy.

II. Measurement of occupational pension plan liabilities

8. The legal provisions usually define one or more measures of ongoing liability to be used in determining annual contribution requirements to occupational pension plans. Ongoing liabilities are normally valued by presuming that the plan remains in place and by treating current members and beneficiaries of the pension plan at the time of valuation as a closed group. An actuarial cost method is then consistently applied to allocate an appropriate part of the total projected cost of the pension plans to the period ending on the valuation date (the "accrued liability") and subsequent years (the "normal costs"). One such method is the projected unit credit method, which includes any assumed future salary increases and excludes future service. Alternative measures of ongoing liabilities may include also prospective benefits that are accrued from future service. The reporting of the total projected cost of the pension plan, net of projected future contributions, should be required if measurement of the accrued liability and normal cost alone, may fail to disclose future deficits to be funded by plan members and beneficiaries. In calculating ongoing liability plan sponsors and pension entities should take into account the particulars of all plan benefit formulas and rights using appropriate assumptions and discount rates (see below).

9. A clear measure of termination liability (also called winding-up liability) that reflects the country's laws about the rights of participants if the plan were to be terminated on or about the time of valuation (accrued rights) may also be required. These rights often correspond to the rights of workers (early leavers) who leave plan coverage (separation) before retirement with a vested benefit payable at the plan's annuity starting date. The termination liability is calculated with reference to current salaries (and indexation if required). The concept of termination liability can be important for minimum funding rules (see below).

10. The legal provisions (referencing generally recognised actuarial standards and methods) also need to provide guidance concerning the appropriate range of actuarial assumptions for the measurement of ongoing liabilities. There will normally be distinct assumptions with respect to early leaver (separation) and disability during active service, mortality, salary or wage growth (including any indexing requirement), expected income from assets, and, if relevant, future increases in benefits (e.g. unconditional indexation). Guidance is required in order to promote the adoption of prudent assumptions that encourage adequate funding levels. Separate guidance should be provided for the determination of assumptions for calculating the termination liability where required.

11. The legal provisions (also referencing generally recognised actuarial standards and methods) should also provide guidance on longevity after benefits become payable (retirement age or annuity starting date). Specific guidance is needed with respect to the use of mortality tables that are up to date and relevant to the population covered. The pension regulator may require that any standard tables used (e.g. those from census/statistical offices or tables based on annuity transactions of life insurance companies)

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1. German Pensionskassen, although treated as insurance undertakings under the Insurance Supervision Law, do provide such instruments.

are appropriately adjusted to take account of any systematic differences in longevity characteristics between pension plan retirees and beneficiaries and the population covered by those standard tables. The legal provisions should require that retirement assumptions take into account the actual retirement and early leaver (also known as membership termination or job separation) behaviour of those covered by the plan.

12. The legal provisions (also referencing generally recognised actuarial standards and methods) should also require that the discount rates used to calculate pension liabilities are prudently chosen taking into account the plan liabilities' risk and maturity structure. Those used for the calculation of ongoing liabilities usually differ from those used in calculating termination liabilities, but both normally take into account the market yield of high-quality corporate or government bonds. Discount rates used for calculating the termination liability may alternatively be based on the yields implicit in annuities sold by market providers for benefits equivalent to those offered by the pension plan. When choosing discount rates, due attention should be paid to the maturity and risk profile of the pension plan's liabilities.

13. Regular monitoring of the plan's pension liabilities is important to ensure that any imbalances in funding levels are identified at an early stage and hence corrective measures can be implemented on a gradual manner. Valuations should take place at least every three years, but the regulator may deem it necessary to require more frequent valuations on plans that may be more prone to funding imbalances. Such intervening valuations may be limited to a certification or report reflecting the adjusted development of the liabilities and changes in risks covered. The calculation of pension liabilities should be carried out by an actuary or by another equivalent specialist in this field. Actuaries have specific reporting and whistleblowing responsibilities that are outlined in the pension fund governance guidelines [DAFFE/AS/PEN/WD(2001)2/REV5]. In particular, they should be required to disclose to the governing body in a clear and timely manner the actuarial assumptions and methods used for calculating pension liabilities and funding levels.

III. Funding rules for occupational pension plans/funds

14. The legal provisions (referencing generally recognised actuarial standards and methods) should provide guidance concerning appropriate actuarial funding methods to allocate a pension plan's actuarial (or accrued) liability over time, balancing the security of members' benefits and the plan sponsor's ability to pay. These provisions should require a regular contribution obligation (normal cost) derived from such allocations either based on the ongoing or the termination liability.

15. The target funding level should take into account the plan sponsor's ability and its commitment to raise contributions if the plan were to become underfunded, as well as the extent to which benefits can be adjusted or the retirement age changed. The relationship between the fund's assets and its liabilities, and in particular, the extent of matching between their respective future cashflows, should also be taken into consideration when choosing a target funding level.

16. The periods chosen for the amortisation of funding costs arising from work before a plan's inception, plan amendments that increase liability attributable to past service, and experience and actuarial gains and losses should be chosen so as to keep plan contributions on a path consistent with the plan's normal cost. By spreading these funding costs over time (as even currency units or at a minimum as even percentages of payroll), the short term volatility of funding contributions can be reduced. In general, however, amortisation periods should not be longer than the expected future period of service of active plan participants. Long amortisation periods should be discouraged as they can lead to low funding levels, below the plan termination liability, even when ongoing funding methods are based on projected benefits.

Short amortisation periods may be envisaged for experience and actuarial gains and losses in order to rapidly correct underfunding.

17. The amortisation periods for liabilities related to work for plan sponsors prior to plans being adopted should balance prudential interests and allowing sponsoring employers to provide retirement benefits to workers who were employed by the firm sponsoring the plan before the plan's inception. Similarly, with respect to changes in the law that require sponsors to recognise or accelerate the recognition of liabilities, legally established amortisation periods should balance prudential interests, the effects on sponsors' reported earnings and cash flows, and the willingness of sponsors to establish and maintain occupational pension plans.

18. Corrective measures in the case of underfunding should take into account the source of the underfunding and the type of underfunding (ongoing or termination basis). In particular, it should firstly be established whether the underfunding is due to changes in the valuation of the assets or liabilities or to a failure to collect the required contributions from the sponsoring employer or/and plan members. The latter should be addressed through appropriate channels, including judicial procedures where relevant.

19. Funding rules should also set out the different mechanisms permitted for correcting underfunding, such as the payment of a lump-sum by the plan sponsor, an increase in future contributions by the sponsor or/and plan members, and adjustments in future benefit accruals and other benefit parameters such as the retirement age. Funding rules should also provide for recovery periods for correcting underfunding, taking into account the source and type of underfunding. The chosen recovery period needs to balance the goal of benefit security of accrued benefits and that of plan continuity.

20. Exemptions to funding requirements may also be granted on a discretionary basis by the pension regulator, but only under defined circumstances with a clear waiver procedure managed by the regulator. The procedure should have the option to require any sponsor granted a waiver to collaterise the waived contributions with secured liens on company assets or otherwise provide security on behalf of the pension plan and, if relevant, any public or private insolvency insurer or guaranty fund.

21. Funding rules should aim to be countercyclical, providing incentives for the build-up of reserves against market downturns. They should also avoid putting in danger the employer's continuation of the sponsoring of the plan. The building of reserves is all the more important when the spreading of experience and actuarial gains and losses are restricted. Asset price and discount rate volatility can then cause wide swings in funding ratios and funding requirements. Tax regulations, which set ceilings on contributions or their tax deductibility when a certain funding level is reached, should not discourage the build-up of sufficient reserves to withstand adverse market conditions and should avoid restricting the full funding of the ongoing liability. When setting such ceilings it is of paramount importance to consider the potential volatility of discount rates and asset values.

22. Optimally, sponsoring employers should be permitted to more rapidly recognise and amortise unfunded liabilities and make deductible contributions that exceed annual contribution obligations. Such provisions may include more rapid amortisation of unfunded liabilities attributable to past service or acceleration recognition of the future liabilities over a worker's remaining expected service with the sponsoring employer.

23. In some countries, the pension fund itself may be directly responsible for ensuring that assets are sufficient to meet liabilities without any guarantee from the sponsoring employer or members. This is the case for accrued liabilities in some countries. Where autonomous pension funds underwrite directly some of the pension liabilities without an employer or member guarantee, they should be subject to a capital requirement over and above the level of assets necessary to fully fund the pension liabilities on a plan

termination basis. Such pension funds act to a certain extent in a similar way to life insurance companies. Solvency rules regarding pension funds should therefore also take into account the specific role and functions of other institutions providing occupational retirement benefits.

IV. Winding-up

24. In the event that a plan is terminated and promised benefits exceed assets, there should be rules to allocate available assets to members and other beneficiaries in accord with accrued rights. There should also be rules concerning the responsibility of plan sponsors for any unfunded liabilities. In the event that assets exceed promised benefits on a termination basis, there should be rules in place as to the allocation of the funding excess or surplus between plan sponsors, plan members and other beneficiaries. In some jurisdictions, however, excess assets may only be returned to the plan sponsor while in others they may be shared only among members and other beneficiaries. There is also a need for clarity in allocating plan assets to cover benefits due to current pensioners and active workers when assets are insufficient to cover promised benefits.

25. Bankruptcy and company insolvency laws should provide priority position for due and unpaid contributions at the time of plan termination. The position should equal at least the position of due and unpaid taxes at the time of plan termination. Where insolvency guaranty schemes are present, the underwriting entity normally becomes a preferential creditor of the insolvent sponsor.

26. Priority rights may also be appropriate for underfunded pension commitments (with reference to the termination liability) that are the responsibility of the plan sponsor. The need for granting such rights will depend on various factors, such as the extent to which there are in place insolvency guaranty arrangements that may help recoup any funding gap in the case of plan terminations as a result of bankruptcy of the plan sponsor. Due consideration should also be given to the likely impact of such rights on a plan sponsor's ability to raise capital and, consequently, on its ability or willingness to continue to support the pension plan.