GOVERNANCE OF PENSION PLANS

THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT
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TABLE OF CONTENTS

TABLE OF CONTENTS 2

CHAPTER 1 3

INTRODUCTION 3

CHAPTER 2 4

GOVERNANCE OVERVIEW 4
- Introduction 4
- Governance Structure 5
- Pension Deal 6

CHAPTER 3 7

PENSION GOVERNANCE PRINCIPLES 7

PRINCIPLES 7
- 1. Risk and Power Sharing 7
- 2. Core Competencies 9
- 3. Information Flows 9
- 4. Performance Evaluation 10

CHAPTER 4 11

APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION FUNDING ACTIVITIES 11

DESCRIPTION OF PENSION FUNDING ACTIVITIES 11

APPLICATION OF PRINCIPLES TO PENSION FUNDING ACTIVITIES 11
- Risk and Power Sharing 11
- Core Competences 11
- Information Flows 12
- Performance Evaluation 12

CHAPTER 5 13

APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION INVESTMENT ACTIVITIES 13

DESCRIPTION OF INVESTMENT ACTIVITIES 13

APPLICATION OF PRINCIPLES TO INVESTMENT ACTIVITIES 13
- Risk and Power Sharing 13
- Core Competencies 13
- Information Flows 15
- Performance Evaluation 15

CHAPTER 6 17

APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION ADMINISTRATION ACTIVITIES 17

DESCRIPTION OF PENSION ADMINISTRATION ACTIVITIES 17

APPLICATION OF PRINCIPLES TO PENSION ADMINISTRATION ACTIVITIES 17
- Risk and Power Sharing 17
- Core Competencies 18
- Information Flows 18
- Performance Evaluation 18

CHAPTER 1
INTRODUCTION

In recent years, governance has emerged as an important issue to Canadian federal and provincial pension plan policymakers. To some extent, this growing interest reflects the increasing emphasis placed on governance by federal and provincial financial service regulators. At the same time, the interest has been prompted by pension funds and other institutional investors becoming more active in the governance of the major corporations in which they have invested. Recently, the Senate Standing Committee on Banking, Trade and Commerce announced that it will study the influence of pension funds and other institutional investors on the capital markets.

In response to these developments, the ACPM, as the national voice of pension plan sponsors, established a working group to review pension plan governance issues on behalf of its members. The result of this review by the Association is this report, which sets out key principles applicable to the governance of pension plans. In many respects, these principles complement the work on governance undertaken by the Pension Investment Association of Canada and other organizations. However, the ACPM has attempted to develop principles applicable to pension plans of all sizes, in both the public and private sectors.

The following assumptions underline the Principles set out in this document:

- An effective system of governance is required to assist fiduciaries in exercising the independent judgement that is required of them.

- The effectiveness of any governance system lies in its ability to address key issues simply. The ACPM Principles clearly set out the responsibilities and accountabilities of those involved in the governance of pension plans.

- Effective governance provides reasonable oversight, but is not so onerous as to discourage the establishment of pension plans or the devoting sufficient time to oversee them.

Governance principles should be practical and of use to pension plans of all types and sizes. Often, governance discussions focus on large plans, which have significant resources. One cannot discount the importance of these plans or ignore their unique challenges, but good advice is just as vital to the myriad of small to mid-size plans as well.

An effective system of governance must not inhibit the plan administrator from developing and responding flexibly to changing circumstances. One size does not fit all. Each plan administrator must be free to develop its own approach within a broad set of principles.

The ACPM recognizes that each pension plan and its governance is unique. We assume that each plan will gain an understanding of a broad set of principles and will seek appropriate expert advice for adaptation and implementation. It is very important that each plan administrator be free to develop its own approach within broad principles. We firmly believe that guidelines on pension governance should not be mandated nor legislated.

CHAPTER 2
GOVERNANCE OVERVIEW

Pension Governance refers to the processes and structures used to direct and manage the affairs of the pension plan, in accordance with the best interests of the pension plan participants. The processes and structures define the division of power and establish mechanisms for ensuring accountability.

All pension plans have a pension governance structure. This governance structure should reflect and support the underlying nature of the "pension deal". The concepts of governance structure and pension deal are described in this chapter.

Introduction

A pension plan is an arrangement that provides retirement income if such arrangement is both registered under the federal Income Tax Act of Canada and a provincial or federal pension standards statute. Pension fund refers to the assets of the pension plan.

Sponsor usually refers to the entity that established the pension plan in the first place. However, the original sponsor may be different than the current sponsor as a result of corporate reorganizations, purchase and sales or labour negotiations. The plan sponsor is usually, although not always, the administrator. Typically, although not always, the sponsor of a corporate pension plan is the board of directors of that corporation. Normally the plan sponsor, either directly or indirectly, has the power to control the provisions of the pension plan, including the design of plan benefits, an important governance responsibility. In reality this power may be constrained, however, by the requirements of collective bargaining, or by pension benefits standards or other legislation, for example.

There will be a governing body or board in connection with a pension plan. Board refers to the governing body of an organization or corporation that sponsors, establishes, administers, or participates in the pension plan. The term "board of directors" is most often used in connection with for-profit corporations. "Board of trustees", on the other hand, is the most common way to describe the governing body of multi-employer pension plans or pension plans which are jointly governed. Finally, "board of governors" is a term often used when describing public or quasi-public pension plans (e.g., university pension plans). Note that these are general rules and there are exceptions.

There will also be an administrator of the pension plan. Administrator, as legally defined in all pension jurisdictions except Manitoba, Quebec and Newfoundland, refers to the body which is ultimately responsible for the pension plan. This may be an employer or employers, a board of trustees as in a multi-employer pension plan or a special body authorized by an Act of a Legislature. In most cases, the employer who established the pension plan (i.e., the plan sponsor) is the administrator.

The board will typically delegate certain authority and responsibilities to a pension committee or to a number of committees. A pension committee refers to the body of persons to whom a board has delegated all or some of its pension authority and responsibilities. Typically, it is a subcommittee of a board. Members of a pension committee are liable as both agents of the administrator and as fiduciaries of the plan beneficiaries.

Fiduciary refers to anyone acting in a capacity which affects the financial interests of pension plan beneficiaries. At common-law, a fiduciary relationship exists when the fiduciary has scope for the exercise of discretion or power and can exercise this power or discretion to affect a beneficiary's interests. The beneficiary is vulnerable to the fiduciary holding the discretionary power. Members of the board or pension committee are clearly fiduciaries when acting as administrator. So are trustees and investment managers. However, other professional advisors and agents may also be fiduciaries depending on the circumstances.

Trustee refers to a term often used in the context of pension plans to mean different things. Some use the term to distinguish between the administrator of a pension plan and the person who may be responsible for administering the pension fund. For example, under the Ontario Pension Benefits Act, a pension fund can only be administered by a government, an insurance company, a trust in Canada, a special body authorized by an Act of the Legislature, the Government Annuities Branch, or a combination of any of these. Others refer to "trustee" in the context of "board of trustees", and still others use the term generically to describe any fiduciary connected with a pension plan. Even the entity having custody of the pension funds is often referred to as trustee. Throughout this Paper, the term "trustee" will only be used when necessary to distinguish between the entity responsible for administering the pension *plan* (i.e., the administrator) and the entity responsible for administering the pension *fund*. In all other cases, appropriate terms will be used, as applicable.

Governance Structure

It is not possible to describe a "one size fits all" model for pension plan governance, but it is possible to articulate principles, or guidelines, which will promote effective pension plan governance, in large or small corporations. The following are principles applicable to pension plan governance structures. Note that the use of the term "pension committee" is inclusive of a governance structure which uses a number of committees.

- Total pension plan responsibility (investment, funding, administration, plan design) should be vested in a single body to ensure broad and effective governance.

- The pension committee should be dominated by board members or their independent nominees, not management who are responsible for operations.

- Pension committee members, who perform an important fiduciary duty, should be chosen to ensure an appropriate mix of skills and interest.

- The pension committee should establish an overall strategic plan for the operation of the pension plan, taking into account the liabilities and commitments inherent in the pension plan and the earning potential of the plan assets. This includes establishing investment policies and objectives.

- The pension committee needs to identify responsibilities, assign accountabilities for their fulfilment, and establish monitoring and feedback procedures to ensure accountabilities are being fulfilled.

- The pension committee needs to establish a means to measure its own effectiveness and to report this back regularly to the board.

Pension Deal

Effective governance requires knowledge of the whole pension plan and a clear understanding of the pension "deal". Who is accountable and who is at risk? The following are questions that every member of a pension plan governance structure should ask.

- Who is the plan sponsor?
- employer, union, joint trusteeship

- What sort of pension plan is it?
- defined benefit, defined contribution, hybrid

- Who is covered by the pension plan?

- What is the benefit commitment?
- benefit formula and ancillaries
- implicit commitments or practices (e.g. ad hoc inflation increases, periodic upgrades)

- Who can change the pension plan?
- unilateral authority, collective bargaining, jointly trusteed

- What is the nature of the risk?
- defined benefit, defined contribution
- unfunded liabilities, investment performance

- Who bears the risk?
- employer, shared, member

- Who is entitled to plan surplus?
- surplus withdrawal, contribution holidays
- is the plan text clear

- Where is the pension plan authority stated?
    - plan text, trust agreement, legislation
    - is it clearly stated

CHAPTER 3
PENSION GOVERNANCE PRINCIPLES

ACPM believes that there are four pension governance principles which should be applied to the main activities of pension plan governance. The four principles are,

1. risk and power sharing,
2. core competencies,
3. information flows, and
4. performance evaluation.

Principles

1. *Risk and Power Sharing*

> *"Risk and Power Sharing" refers to how the decision-making responsibilities are structured within the pension governance structure. All responsibilities should be identified and assigned appropriately. A key governance concept is that whoever is accountable for a plan's decision-making is at risk. Whoever bears the legal and financial risk should have the power to influence the relevant decision-making.*

The administrator (usually the plan sponsor) has overall responsibility to prudently manage the pension plan and pension fund and to ensure that the pension promise is kept for all beneficiaries. Since the administrator cannot do everything, it must set up a pension governance structure and delegate aspects of pension management and operations.

An effective pension governance structure should assign tasks in accordance with the appropriate knowledge, experience, and time availability. Effective pension governance encompasses both plan oversight and administration, (governing and operating responsibilities).

Governing responsibilities include establishing mission and vision, making policy, setting strategy and high-level monitoring. Operating responsibilities refer to implementation of mission, vision, policy, and strategy, as well as lower-level monitoring. Generally, management's role consists of assisting and supporting the governing decision-makers and translating their decisions into operational plans for execution by staff and others. Staff, as well as outside advisors, ensure day-to-day operating responsibilities are carried out.

To the extent possible, the pension governance structure, accountabilities and relationships should be clearly documented.

2. *Core Competencies*

> *"Core Competencies" refers to the appropriate knowledge, skills, experience, time availability, and interest that are required by all those accountable within the pension governance structure.*

Those responsible for pension plan governance come from many walks of business life. They may find that they are dealing with issues that are outside the scope of their normal expertise. These decision-makers must understand pension finance, relevant investment principles, and governance. In many cases, expertise is available internally through the finance, treasury, and human resources areas of the plan sponsor. If, however, specific expertise is not internally available, qualified external advisors should be recruited. Also, consideration needs be given to the training of key decision-makers.

Decision-makers should understand the nature of the pension promise, actuarial principles, and asset/liability management. They should be aware of the various risks they face, the tools they have at their disposal to manage these risks, and the potential consequences and implications of risk management. They should recognize, and disclose, any conflicts of interest they may have. Finally, effective pension governance requires a basic knowledge of the regulatory or other constraints facing the pension plan. This includes the Income Tax Act, Pension Benefits Standards Acts, and actuarial and accounting standards. It also includes the plan text, trust document and, if applicable, associated union contracts.

This does not mean that decision-makers are required to understand all the intricacies of the day-to-day operations of managing and investing a pension plan and pension fund. The key concept is that each decision-making body should have or obtain the appropriate knowledge to make informed decisions.

3. *Information Flows*

> *"Information Flows" refers to the flow of information to decision-makers to ensure they receive the information they need to discharge their fiduciary obligations, especially relating to supervising and monitoring. Information must be accurate, complete, appropriate, consistent, timely, and easily understood.*

Information flows are sometimes a weak link in the pension governance system. Multiple sources of information, the complex nature of that information, and the different uses to which it is put, make effective communication a challenge. However, it is critical that systems are put in place to ensure that all levels of the pension governance process receive appropriate, timely and understandable information to enable them to discharge their responsibilities effectively. It is also critical that the administrator receive information to be able to monitor that delegated responsibilities are being effectively fulfilled.

4. *Performance Evaluation*

> *Objective performance measures need to be established for all key decision-makers. They should be regularly evaluated by the administrator against such standards to assess their performance. Further, the standards themselves should be regularly reviewed.*

The goal of performance evaluation is to determine the effectiveness of the pension governance structures and operations in meeting the pension promise and in discharging the responsibilities of the administrator and other fiduciaries.

Before performance can be evaluated, performance measures must be established. These measures need to be quantified wherever possible and related to appropriate time periods. These measures typically fall into one of two main categories - financial measures (i.e., those related to investment performance and funded status) and service delivery standards. Measures and standards must be established for all key decision-makers, including the administrator, pension committee members (if any), senior management and staff of employer, custodian, investment managers, benefit administrators (if third-party administrators are involved) and professional advisors. Like the delegation of responsibilities, these measures should be documented.

Evaluation of performance should be based on impartial assessment, which may well need to include outside advice. Recommendations for change, where indicated, should be directed to the group to which the decision-makers are accountable.

CHAPTER 4
APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION FUNDING ACTIVITIES

Description of Pension Funding Activities

"Funding activities" include:

- establishing funding policies for the pension plan (e.g., targeted funding position such as fully funded, over-funded or under-funded, surplus cushions, immunization, etc.);
- selecting the actuarial method (e.g., projected unit credit, aggregate method, entry age normal method, etc.) and assumptions (e.g., inflation, investment return, salary growth, etc.);
- determining the current funded status of the pension plan through actuarial valuations and deciding when to file with regulatory authorities;
- calculating the pension plan's desired and actual impact on the employer's financial statements;
- preparation of financial statements for the pension plan; and
- managing the pension plan's cashflow.

Application of Principles to Pension Funding Activities

Risk and Power Sharing

All responsibilities need to be clearly documented. Governing responsibilities include, for example, establishing funding policy, determining actuarial and accounting assumptions, approving the appointment of the pension plan's actuary and auditor, defining performance measures and evaluating performance through high-level monitoring.

Operational responsibilities include the preparation of valuations and financial statements for the pension plan, the choice of selection criteria for the actuary and the auditor and related recommendation, and day-to-day cashflow management.

Core Competences

Pension funding activities generally rely heavily on professional advisors such as an external actuary and auditor. Selection criteria and an impartial selection process should be established.

Information Flows

Pension plan funding is complex. The information required to inform decisions should be presented in a clear and understandable way. Examples of information appropriate to governing responsibilities include:

- actuarial reports and audited financial statements for approval (the reports should summarize the pension plan's progress towards the pension plan's funding and financing goals as well as its solvency position);
- certifications from senior management, the actuary, auditor and any other relevant professional advisor that the pension plan has been administered in compliance with the law and policies established by the governing body (or, in the alternative, disclosure of all incidents of non-compliance, why it happened and what has been done to remedy the breach);
- expenses compared to budget; and
- demographic and actuarial data supporting any recommended change in funding policies, assumptions etc.

At the operational level, more detailed membership and financial data will be required, as well as internal control information, so that managers, staff, and professional advisors can fulfil their responsibilities.

Performance Evaluation

Before performance can be measured, performance measures must be defined. Where funding activities are concerned. Typical performance measures include:

- achieving funding targets;
- compliance with legal and administrator-established policies and limitations;
- executing proper contracts with actuary and auditors on time; and
- achieving budget/expense targets.

CHAPTER 5
APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION INVESTMENT ACTIVITIES

Description of Investment Activities

"Investment activities" include:

- establishing investment policies and objectives (e.g. rate of return objectives, risk tolerance, fund asset mix guidelines, etc.);
- selecting an investment approach (e.g. active vs passive, pooled vs segregated, internal vs external, balanced vs specialist, range of choice for money purchase pension plans, etc.);
- choosing investment manager(s) and allocating investment funds to them;
- choosing a custodian; and
- establishing reporting procedures.

Application of Principles to Investment Activities

Risk and Power Sharing

All responsibilities need to be clearly documented. Governing responsibilities include, for example, establishing and stating policies and objectives, setting the asset mix, choosing investment managers and a custodian, establishing an investment style and evaluating performance.

Other activities are operational activities and it is the duty of the administrator to see that there are procedures in place to ensure these activities are competently fulfilled.

Core Competencies

Sometimes investment of the pension fund may be done "in house". Most often external managers are used. In any event, an impartial procedure for choosing competent managers should be established, with clearly stated choice criteria. External, professional advice can facilitate the selection of competent managers.

The choice of a custodian is also very important. The custodian should actively carry out its responsibilities and have sophisticated monitoring and reporting capabilities.

Staff and/or external advisors with the appropriate skills and knowledge should be available to the administrator for the effective management of the investment activities.

Information Flows

In the first instance, investment managers and the custodian must understand the administrator's investment policies and objectives, and reporting needs.

In general the information flows in support of the investment activities should provide an assessment of,

- investment performance (actual and in relation to agreed-upon objectives), and
- compliance (both to legal requirements and the plan's investment policies and objectives).

The administrator should establish the frequency and form of reporting, sufficient to its needs. These reports should be consistent, understandable and focussed on the objective of the report.

Examples of information appropriate to governing responsibilities include:

- performance reports (performance to objectives, relative performance, separate and consolidated performance),

- compliance reports (certification by the custodian, investment managers, and senior staff that investment policies, laws and regulations have been complied with),

- cash flow reports, and

- information on changes and developments in the areas of investment and custody.

Performance Evaluation

Before performance can be measured, performance measures should be defined and communicated to those responsible. A first step is the establishment of investment policies and objectives. Other evaluation criteria include:

- meeting overall rate of return objectives,

- meeting plan funding objectives,

- meeting expense objectives,

- performance of investment managers,

- establishing criteria for action in the case of under performance (e.g. a manager review if under-performance continues over a whole business cycle, etc.),

- establishing appropriate measurement periods (e.g. four years, not four quarters), and
- being fully compliant at all times.

External professional advisers can be helpful in establishing procedures for performance evaluation and meaningful information flows.

CHAPTER 6
APPLICATION OF PENSION GOVERNANCE PRINCIPLES TO PENSION ADMINISTRATION ACTIVITIES

Description of Pension Administration Activities

"Pension administration" activities include:

- enrolment of members,
- establishing and maintaining member records,
- calculating and processing pension plan benefits,
- collection and remittance of contributions,
- payment of pensions and other benefits,
- communication of the pension plan to plan members,
- communication of the status or position of members, and
- communication of information to facilitate the processing of plan benefits.

Application of Principles to Pension Administration Activities

Risk and Power Sharing

All responsibilities for pension administration should be clearly documented. Inadequate record keeping and inaccurate calculation practices can create financial risk. Imprecise practices can create legal risk. Lack of attention can create bad publicity.

Pension administration is rarely a core practice of any organization but a good structure can ensure it is well done. In an organization it should be clear who is responsible for it. Often responsibilities are divided between finance and human resources, with one or more third parties besides. Responsibility lines need to be clearly drawn. There should be procedures in place for both the decision to outsource responsibilities to third party suppliers and for the selection of such suppliers.

Governing responsibilities include, for example, the choice of where administration will be done, and by whom, the choice of outside advisors and the plan auditor, certification reports and service standards. Other activities are operational activities and it is the duty of the administrator to see that there are procedures in place to ensure theses activities are competently fulfilled.

Core Competencies

A process for the administration of the pension plan must be established. Some functions (e.g. member enrolment, collection and remittance of contributions) typically are 'in house" functions. Others are done "in house", by an external third party, or are shared. These include record keeping, pension payroll, benefit calculation, pension plan communication and advice.

Pension plans represent significant investments for sponsors and are extremely important features of the security of employees. It is important that the day to day administration of the pension plan be given adequate attention by players trained and competent to perform the duties assigned.

Information Flows

Pension plan administration is often complex and shared between multiple parties. A pension plan governance structure should provide that processes are in place which ensure that accurate and timely information is collected, transmitted and used by appropriate decision-makers. Further, such processes should ensure that accurate and appropriate information is transmitted to members in a timely fashion. This information, and the calculations based on it, should be subject to checks and periodic audits, on both input and output.

Examples of information appropriate to governing responsibilities include:

- compliance reports (certification by senior management and external advisors that legal standards are being met),
- service standards (accuracy of calculations and information, level of member service, adequacy of member information, etc.), and
- expense of operation (is the administration cost effective).

Performance Evaluation

Effective pension governance should include periodic pension administration performance evaluation. Performance reports could include:

- Are data checks and audits in place? Are the plan audits satisfactory?
- Are legal standards being met? Is performance to these standards tracked?
- Are there other standards and measures in place? What are these and how are they tracked?
- Is the cost of plan administration reasonable?