20 Questions

Directors Should Ask about their Role in Pension Governance

Gordon M. Hall, FSA, FCIA, MAAA

The Canadian Institute of Chartered Accountants

How to use this publication

Each "20 Questions" publication is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management – and themselves – tough questions.

The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics. In some cases, Boards will not want to ask the questions directly but they may wish to ask management to prepare briefings that address the points raised by the questions.

The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper if necessary. The comments summarize current thinking on the issues and the practices of leading organizations. They may not be the best answer for every organization.

Thus, although the questions apply to any organization, the answers will vary according to the size, complexity and sophistication of each individual organization.

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The Canadian Institute of Chartered Accountants

INSTITUTE OF CORPORATE DIRECTORS

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Directors Should Ask about their Role in Pension Governance

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of Chartered Accountants

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Preface

The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants commissioned this publication to assist Boards of Directors in discharging their governance responsibilities. Failure to discharge their responsibilities can expose directors to an increasingly significant liability risk. That risk is more apparent today than perhaps ever before in Canadian corporate history.

Pension governance, which has had a narrow focus in the past, is becoming increasingly important. This is not only because recent high-level corporate failures have emphasized the need for sound corporate governance in general and the management of pension plans in particular. It is also because pension funds are significant in Canadian capital markets, to the sponsoring entity, and in the lives of pension plan members. For many nearing retirement, their pension entitlement is a major (if not their largest) personal asset. Without sound pension governance, this asset is at risk.

Generally, pension plans and funds are off-balance sheet items and are not part of the reporting process for the core business of the sponsor. However, there is a growing awareness of their importance to all stakeholders and of their exposure to more and different kinds of risk. This publication addresses developments within the plan and fund and their consequences to the sponsor's directors, who bear ultimate responsibility for pension governance.

While some pension governance matters are regulated and most pension plans usually comply with the legislation, there are a considerable number of areas where decisions are at the discretion of the plan sponsor and/or legal administrator. These non-legislated areas are the primary focus of this publication. Because of their discretionary nature, they are more likely to represent a significant risk exposure for directors.

The 20 questions are appropriate for Boards in all sectors of the economy and for both registered and unregistered (supplemental executive) retirement arrangements. The questions address governance matters for both defined benefit and defined contribution pension plans. Most organizations sponsor one or the other and some arrangements contain a combination of both plan types. Regardless of the type of pension plan an organization sponsors, the Board of Directors bears ultimate responsibility for all aspects of its operation.

Pension governance in today's business environment calls for enhanced leadership by Boards of Directors. To exercise that leadership, Boards need to be knowledgeable about the issues and developments in this complex area. This publication is intended to assist them.

The Board thanks Gordon Hall, author, and acknowledges the contribution of the Directors Advisory Group, who advises the CICA. They identified the need for research and guidance in this specialty area and have provided high level coaching suggestions to the author throughout the course of his work.

Frank Barr, FCA
Chair, Risk Management and Governance Board

I. Why is pension governance attracting attention?

Because pensions are significant

While recent corporate failures have focused attention on pension governance, its importance extends well beyond such short-term and isolated, highly-publicized events. Pension governance is of long-term importance to the corporate community and its workforce for the simple but significant reason that pension plans and funds are themselves important to society at large and indeed, to our economy as a whole.

Simply put, a pension fund is significant:

- to the organization that sponsors it,
- to the capital markets in which it can be such a large and vital element, and
- to the employees who are protected by it.

This makes pension governance a material consideration for the corporate body ultimately responsible -- the Board of Directors. Helping the Board discharge its responsibilities in a way that will optimize benefits to pension stakeholders and minimize its risk exposures in doing so is the objective of this publication.

Significance to sponsors

The employer-sponsored pension plan is the single most important tool in effecting an orderly transition of a workforce from an active to a retired status.

For many sponsoring employers, the pension plan obligations and pension fund assets are material financial considerations.

A survey of private sector sponsors of Canada's 100 largest defined benefit pension plans, based on data at the end of fiscal 2001, found that:

- for 31 sponsors, the fair market value of pension assets was at least 20% of the sponsor's total corporate assets,
- for several of the 31, the percentage was in the 30-50% range, and
- for two sponsors, the pension assets were essentially equal to the total corporate assets.

The survey found as well, that 58 of these 100 plans had an aggregate pension asset shortfall (off balance sheet) of $11.2 billion at the end of fiscal 2001 and 27 of the 58 reported a pension-related asset on their balance sheets of $2.8 billion.

Source: Research into pension sponsors disclosures, by Wiedman et al, "Whither the pension plan? Accounting rules mask increasing debt," Ivey Business Journal January/February 2003.

The funded status (which is a proxy for the security of benefits) has been low historically for some defined benefit plans. In recent years, the funded status for all plans has weakened considerably and many sponsoring employers have been required to make significant cash contributions.

Directors should also be aware of the call on cash flow of other post-retirement benefits (such as health coverage and life insurance) that many pension plan sponsors provide. Most are funded on a "pay-as-you-go" basis. The Ivey researchers found that 84 of the 100 sponsors provided such other post-retirement benefits and that the total liability reported in the sponsors' disclosures for these benefits was $17 billion. Only $1 billion of assets was set aside to secure these obligations.

Significance to capital markets

In terms of total Canadian market capitalization as of December 1999, the total asset base of registered pension and registered retirement savings funds (together with funds accumulated under the Canada and Quebec Pension Plans) amounted to $C 995 billion. This was greater than the market capitalization of the TSE 300 (now TSX) of $C 742 billion and was 93% of Canada's gross domestic product at that time. There is no reason to believe this asset base is any less significant today.

Significance to employees

> In 2000, 5.4 million paid workers in all sectors of the Canadian economy belonged to registered pension plans. This represented 41% of paid workers overall and coverage of 87% for the public sector.
>
> Statistics Canada, 2002.

For employees nearing retirement, their pension entitlement is a major (and often their largest) personal asset. The prospect of losing one's retirement savings as a result of deficiencies in pension governance is not one anybody would wish to contemplate. Fortunately, few such cases exist. To sustain and improve this track record requires enhanced boardroom leadership.

Recent Pension Governance Developments

Several years before recent scandals focused attention on poor corporate governance, good pension governance was a priority matter in Canada resulting, since 1996, in some 20 authoritative papers on the subject by Canadian governments, pension regulators and private sector pension industry associations. Then some corporate failures shone the spotlight on directors' duties to both a sponsor's shareholders and its plan members.

Beginning in 2000, unprecedented capital market difficulties significantly reduced the market value of many pension funds and the expectation of future investment returns. Analysts and investors began to focus on the contribution of the pension fund's (assumed) returns to the income reported by the sponsoring enterprise under current accounting rules. Some sponsors required cash contributions to improve the security of the accrued benefit obligations.

The pensions area is also becoming more litigious. Sponsors have increasingly become the target of lawsuits in matters such as the use of fund surplus, benefit administration, and the payment of expenses from the fund. With the recent enactment of Class Proceedings Acts in Ontario, British Columbia, Quebec and Saskatchewan, large numbers of people have access to the courts in initiating cases that would be too expensive or complex for one person to sue individually. One large Canadian law firm reported recently on its website class actions of double-digit proportions, many of them pension-related. On another front, sponsors are increasingly called upon, by the nature of their fiduciary duties, to be the instigators of lawsuits where outside suppliers have not met their obligations to the fund or its members.

Also, except for the legislated requirement for annual member statements, communication programs to stakeholders are relatively undeveloped. In the current environment, communication programs to plan members, communications from management to boards, communications to investee firms and to a plan sponsor's investors are not only warranted but essential. Ensuring timely and transparent communications to all stakeholders is an important element of good pension governance.

A final development is concern about the security of Supplemental Executive Retirement Plans, which now include employees in middle management as well as executive positions. As cash funding of the obligations exists for only a modest percentage of SERPs, the security of the benefit promises for most is the sponsor's future cash flows and its ability to sustain the escalating claims on them.

The Board's Role and Responsibilities

Ultimate responsibility

While the performance of many functions may be delegated to management and Board committees, the Board itself bears ultimate responsibility for all aspects of an organization's pension plan and fund.

For virtually all private sector enterprises and for many not-for-profit entities, the Board of the sponsor has a dual duty: (1) it is responsible to the shareholders of the private sector sponsor or to the major stakeholders of the not-for-profit and public sector sponsors; and (2) it has fiduciary responsibilities as legal administrator of the plan and fund (as defined by various Pension Benefits Acts) to plan beneficiaries.*

In the public sector, and for multi-employer union-sponsored plans and funds, a Board of Trustees, separate from the sponsor, commonly has ultimate responsibility for many functions. These generally include all matters except for the decision to sponsor the plan and the decisions regarding the plan type and the generosity of the benefit. In other words, the responsibilities of the Board of Trustees are closely aligned with the requirements of the legal administrator as set out in the Pension Benefits Acts of the various jurisdictions.

No matter which sector and which governance structure, the relevant governing entity is responsible to shareholders and stakeholders to ensure that the organization's pension plan is meeting the sponsor's objectives and is discharging its responsibilities to plan members.

Pension benefits are an important aspect of an organization's ability to attract and retain employees. It is incumbent upon directors to ensure that members are informed about the rationale behind the plan design and the division of responsibilities in saving for retirement, and that promised pension benefits are appropriately secured.

*Quebec provincial legislation stipulates that a Pension Committee, which includes plan member representation, is the legal administrator with ultimate responsibility for selected elements of the governance of the employer-sponsored pension plan. In most cases, in the private sector, the handling of these responsibilities has been delegated back to the employer.

Conflicts of interest

The goals of the stakeholders (the sponsors and the plan members) are not always aligned. As well, certain investment information generally available to the relevant Board committee only if requested, may reveal conflicts of interest related to the work of external providers. Accordingly, good pension governance involves not only addressing conflicts of interest but also anticipating their existence.

The dual role that most employers in the private sector fill, as sponsor on the one hand and legal administrator on the other, is the source of potentially significant conflicts of interest that must be managed carefully. Other conflicts are manifest in such questions as:

- Is a specific decision in the best interests of the sponsor or the beneficiaries?
- If there is dual duty, which constituency should have precedence and why?
- Should plan members be permitted on the oversight Board and to make decisions in their own self interest?
- Are directors of outside providers also directors of organizations in which the pension fund might invest?
- Should the plan fund invest in the shares of the sponsor?
- Are there audit procedures to confirm that charges levied by investment managers and traders are appropriate for the institutional market in general, as well as for the specific fund?
- What use should be made of excess assets in the pension fund?
- What is the trade-off between cost reduction and quality of service?

Some conflicts of interest can be eliminated and others can be mitigated or managed. Boards should satisfy themselves that all conflicts are identified, disclosed and appropriately addressed, and that there is suitable documentation they have been handled objectively.

Two major valuations

The Board's oversight responsibilities are complicated by the fact that a registered defined benefit pension plan is subject to two major valuations:

- The funding valuation required by the Pension Benefits Acts. This valuation, primarily directed to the ability of the fund to secure the promised benefits, involves a solvency valuation (a proxy for a business termination valuation) and a going concern valuation. Together, they set the minimum contribution that must be made and the maximum contribution that can be made to the pension fund at a point in time.
- The accounting valuation prescribed by the Canadian Institute of Chartered Accountants (and the Financial Accounting Standards Board in the U.S.). This valuation requires "management's best estimates" for each of the demographic and financial assumptions including the discount rate for future benefit cash flows and the expected return on invested assets. These assumptions impact on the sponsor's financial statements.

A Board needs to monitor the funding valuation to balance its responsibility to plan members, with its responsibility to stakeholders/shareholders. It also needs to monitor the accounting valuation, to discharge its responsibility to stakeholders/shareholders regarding the integrity of the sponsor's financial statements.

Risk exposures

Most organizations sponsor either a defined benefit or a defined contribution plan. Some pension arrangements combine both plan types.

Sponsors bear the funding and investment risks for defined benefit pension plans. They must track the funded status and asset performance. Specifically, the need for additional contribution outlays may significantly affect the financial results of the sponsoring organization. Also, the tracking entails monitoring capital markets in Canada and in major markets abroad, as most plans invest close to the book value limit in foreign investments.

With defined contribution pension plans, the members bear the investment risk. For that reason, conventional wisdom holds that defined contribution plans carry little (if any) investment liability and risk exposure for directors. This conventional wisdom is wrong. Directors bear responsibility because the sponsor is involved in the selection of investment managers, in the asset classes that are offered, and in confirming that the book value limit in foreign investments is not exceeded. Member education and monitoring of investment performance and choices are matters that warrant the Board's ongoing attention. (Also, there are no statutory "safe harbours" in Canada as exist in US statutes.) Directors bear risks of litigation due to failure to educate members, or selection and retention of poor investments or managers.

Ultimately directors are at risk, regardless of which type of plan their organization sponsors.

Penalties

There are negative consequences for stakeholders associated with failing to deliver on plan promises, statutory requirements and fiduciary obligations. As an example, the penalty set out in the Income Tax Act for failure to comply with the foreign property limit is very punitive.

Oversight by committees

A Board's discharge of its oversight responsibility has frequently been by a combination of Board committees — a pension committee, the audit committee, an investment committee and/or a human resources /compensation committee — with no one Board committee being responsible for ensuring an integrated result and for comprehensive reporting to the full Board.

Finite Resources and Board Leadership

Some directors may conclude that this 20 Questions publication represents an exhaustive checklist that management and professional advisors should be asked to implement over a fairly short period of time. This conclusion is not warranted.

As sponsors do not have infinite resources to direct to pension governance enhancements, it is important that Boards identify the priority elements and work with management and external suppliers to address those that are of greatest importance.

Enhanced pension accountability will evolve over time:

- as sponsors refine their corporate governance practices; and
- in response to changing community standards for pension governance in Canada's private pension system.

To succeed in their leadership role, Board members will need to have or acquire specialist competencies, particularly those that enable them to:

- determine the level of quality with which functions are being handled on their behalf;
- understand the inter-relatedness of the pension governance elements;
- challenge conventional wisdom;
- ask discerning first (as well as second and third) round questions of management and professional advisors; and
- ensure that the finite resources available are being deployed effectively and in the right direction.

By implementing the pension governance enhancements that result from addressing the following questions, the Board will go a long way in exercising its leadership role to the benefit of the sponsoring organization, the pension plan members and beneficiaries and other stakeholders.

II. 20 Questions and commentary

The Board of an organization sponsoring a pension plan and fund is responsible for ensuring that both are running effectively and in the right direction and, as a part of that responsibility, confirming that all its obligations are properly discharged including:

- statutory obligations, to legislative and pension authorities in the relevant jurisdictions;
- contractual obligations, set out in the formal pension plan and fund documentation; and
- fiduciary obligations, which arise as a consequence of being entrusted with the property of others and which are largely determined on a case-by-case basis. These obligations may not be governed by a statute or by the official rules of a plan and fund.

As stated in the Preface, this publication's primary focus is on areas of pension governance that are not legislated because these areas, discretionary in nature, are more likely to represent a significant risk exposure to directors. Accordingly, except for the matters raised in Questions 19 and 20, it is assumed that sponsors meet their statutory and contractual responsibilities. Most of the 20 questions therefore, address the areas in which considerable discretion must be exercised, whether by management in running the plan and fund, or by the Board in confirming the discharge of its obligations.

The 20 questions are grouped into nine subject areas, followed by commentary on the relevance of the questions to good pension governance, trends and best practices.

With each question, a Board is encouraged to ask itself where its duty is owed (i.e., to sponsor, beneficiaries, or regulators) and whether the question should be directed at the Board itself, management, an external third party, or a combination of some or all of these.

(i) Roles and Responsibilities

Questions

1. Is there a written policy on who recommends, decides, manages and monitors all activities involved in governing and managing the pension plan and fund? Is there a process that allows the Board to confirm that all delegated functions are being appropriately handled?

2. Has there been a formal evaluation of the appropriateness of the governance structure, the delegation model, and the competencies of directors in the past two years? If yes, is there an action plan to correct any identified deficiencies? Are there conflicts of interest related to governance structure and if so, are they being appropriately addressed?

3. Does the Board have a process to keep itself informed about relevant developments that could have a significant impact on the plan's design, affordability, administration and financial management?

Commentary

Assuming or delegating responsibilities
One of the most difficult tasks in structuring the governance of a pension plan and fund is to determine and assign responsibilities for the performance of specific functions. The Appendix identifies the ten elements of good pension governance that senior executives and managers of sponsors focus on day-to-day in the running of their plans and funds.

The Board's first task is to ensure that responsibility for the performance of each of these elements has been assumed by the Board or by management, or has been delegated to an outside provider.

Another Board task is to ensure that responsibility for the oversight of functions external to the plan and fund, such as the financial reporting of their impact on the sponsor, is also assumed by the Board and/or management.

The specific governance structure is a Board decision.

No matter what the governance structure, the Board should review and confirm principal matters such as the following:

- The sponsor has reviewed and established sound delegation of functions for all elements. This process should be documented and there should be monitoring, report-back and evaluation procedures.
- There are policies to guide management and Board handling of functions including the retention and the expectations of professional advisors (e.g., the actuary, the investment managers, the investment consultant). These policies specify goal-setting, monitoring and evaluation.
- The directors have the knowledge and experience to appropriately discharge their financial, legal and social responsibilities to the parties to whom they are owed.

Sponsors of smaller funds may feel they cannot afford an internal dedicated management function. In these circumstances, some management responsibilities may be pushed up to the Board and others may be pushed out to external specialists. It is important to keep the management and director roles separate and distinct.

Many pension plans have gaps in the information loop, in reporting back to the Board by those to whom responsibilities have been delegated. In the interests of risk management and performance improvement, plan sponsors should implement a rigorous report-back system. In a time of increasing litigation, there is value in being able to demonstrate that duties have been considered, delegated, undertaken and monitored. This need not involve onerous reports. For many tasks, a checklist will convey the necessary information in a format where changes or gaps in performance can be highlighted and tracked over time.

Reviewing structure-related conflicts of interest

The inherent conflicts of interest are potentially very significant, especially where the employer is both the sponsor and the legal administrator. In some recent cases, officers of the plan sponsor revised the sponsor's financial statements but failed as a trustee of the employer-sponsored pension plan—and as one that invested in shares of the sponsoring employer—to take action to protect the interests of plan members and beneficiaries. In extreme cases, this has caused severe reductions in employees' retirement security. Boards are encouraged to review these conflicts of interest regularly, even if the governance structure conforms to regulation and is defensible on strictly legal grounds.

Staying current

In addition to acquiring the knowledge and experience to appropriately discharge its responsibilities, the Board needs to stay current on developments that have a significant impact on the elements of good governance. These developments could include:

- governance proposals;
- changes in the overall financial health of the pension plan and fund;
- legislative developments (e.g., new definitions of eligible partners, privacy legislation);
- financial reporting for the sponsor;
- new forms of investment;
- trends in litigation (e.g., on surplus); and
- proposals to outsource benefit administration.

(ii) Plan Design and the "Pension Deal"

Questions

4. Is the plan design appropriate for the sponsor, for its sector of the economy and for the current and contemplated workforce? Are decisions regarding plan design accompanied by decisions as to how the promises will be secured?

5. If the plan is a defined contribution plan, are the members receiving the appropriate investment education?

6. Is an enhanced communication program warranted to inform members of the rationale behind the plan design and to delineate the division between the sponsor's and the members' responsibilities in saving for retirement?

Commentary

Except where they have contractually agreed to do so, there is no legal or statutory duty for employers to establish and maintain pension plans. However, pensions are an important element of remuneration in most sectors of the economy. The Board has the final say on key design decisions such as whether the plan is to be a defined benefit or defined contribution plan and on the level of benefit it will provide to members. Directors should ask whether and how management uses the company pension plan to attract and retain the most appropriate workforce.

Directors should also ask management whether it has confirmed plan members' understanding of their employer's pension arrangements and of how these arrangements are assisting members in meeting their retirement security goals.

There are financial, legal, administration, and communication risk exposures for both defined benefit and defined contribution plan types, with consequences for the plan sponsor, the plan members, directors and officers, and professional advisors. The precise nature of the risk exposures varies by plan type. For example, defined contribution plans can be subject to pension benefits, securities, and insurance legislation, depending on the type of plan and the type of investment options offered. Sponsors of these plans should give careful consideration to:

- the provision of investment advice;
- any failure to inform or educate;
- the provision of erroneous information;
- the choice of investment options and levels of diversification;
- the choice of service providers; and
- conflicts of interest.

For the employer-sponsored pension arrangement, the Board's focus should not be narrowly on design but rather on the "pension deal" (i.e., what is the nature of the pension promise, what are the underlying risks and who is to bear them?).

The Board should ensure clarity regarding the target benefit level, who bears the risk for the delivery of the retirement income, and the form of the security. In articulating this broader accountability context for the company-sponsored arrangement, it should keep in mind major eventualities such as business terminations and low and high inflation environments and prolonged bull and bear markets.

Within current governance practices, an enhanced communication program would include a formal, written communication policy.

> "Communication was ranked as the number one priority for improvement, consistent with the finding that few plan sponsors have a formal written communication policy."
>
> – Mercer survey of current pension governance practices, January 2002.

(iii) Funding and Financial Reporting

Questions

7. Will the current funding policy:

- Put at risk the fund's ability to secure the obligations?
- Lead to over-funding of the benefits and result in stranded pension assets?
- Lead to a material call on the sponsor's future cash flow because the fund is not generating, or likely to generate, the rate of return assumed in the actuarial valuation? If so, what are the projected contribution needs?
- Lead investors to question the contribution of pension fund returns to the sponsor's reported financial results?

8. If the pension promise is the result of collective bargaining, is the Board satisfied that the fund, together with the future contribution cash flow, will be sufficient to meet the negotiated benefit obligations?

9. What is the process for developing "management's best estimate" assumptions for financial reporting purposes including the return expected on pension fund assets? Are investors fully informed about the impact of these assumptions on the sponsor's financial statement results?

Commentary

Funding

Only a few defined benefit plans have a formal written funding policy that:

- specifies the desired relationship between the fair market value of the assets and the liabilities at given points in time;
- contemplates going concern and business termination eventualities, high and low inflation environments and prolonged bull and bear markets;
- recognizes that the greater the asset shortfall and/or the greater the mismatch of assets and liabilities, the riskier the total environment becomes for all stakeholders; and
- provides guidance to management of the plan sponsor to determine whether the contribution to the fund should be the minimum required, the maximum permitted, or some other amount in between.

As well, given that (1) funding valuations of registered pension plans are required by statute only once every three years, and (2) valuation smoothing of the fair market values of assets is spread over periods up to three or five years, early detection of the impact of either a high inflation environment or depressed capital markets on benefit security and on the sponsor's future contribution requirements can easily be missed.

A sound funding policy is an essential foundation for benefit security and for investment discussions. It is also an important safeguard against over-funding and being left with stranded pension assets. Competent Board members will quickly grasp the essence of trade-offs between benefit security and necessary funding for defined benefit plans.

Normally one would anticipate considerable consistency between the key elements of an organization's funding policy and the key elements of its Mission and Values statements. For example, an organization that assigns a high priority to human capital matters would normally ensure that obligations under its pension arrangements are appropriately funded. Minimum required funding of registered retirement arrangements and not funding Supplementary Executive Retirement Plans (see category (iv), below) may be considered appropriate in organizations that focus on the sponsor's growth and fully communicate the risks to plan members.

A Board should encourage the early formulation and communication of a formal written funding policy. Each year, after the policy is adopted, the sponsor should voluntarily disclose to stakeholders whether the contributions to be made are the minimum required under the policy, or include additional discretionary funding.

> "While fluctuations in the present value of assets versus liabilities (funding ratios) represent high financial risk for all plan sponsors, most plan sponsors fail to recognize this risk because it is seriously attenuated by actuarial and accounting smoothing of financial statements."
>
> – Frank J. Fabozzi and Ronald J. Ryan, Journal of Portfolio Management, Summer 2002.

Financial reporting for the sponsor

Because of financial market reverses in recent years, many (investment analysts, Boards, etc.) have called into question (1) the impact of management's best estimate assumptions and (2) the expected return on pension fund assets on the sponsor's income statement and balance sheet.

This scrutiny has stimulated action and discussion on a number of fronts:

- Credit rating agencies have started to assess the health of pension plans and funds as part of their reviews of sponsors.
- Questions are being asked about refinements to the costing method, and the framework for assumptions-setting and amortization of gains and losses prescribed for accounting valuations.
- The appropriateness of the "mark-to-market" world of financial disclosure is being questioned.
- There are advocates for greater involvement by independent auditors in confirming that the determination of specific aspects of charges to income statements is in order and that obligations have not been significantly misstated. These aspects may include: data integrity, the enrolment of eligible full- and part-time employees, and confirmation that pensioners paid by direct bank deposit are still alive.

> "…rating agencies…have downgraded their ratings of several European companies…because of their pension shortfalls. The lower credit ratings mean that companies will have to pay more to borrow in bond markets."
>
> – Fairlamb et al, BusinessWeek, March 24, 2003.

"Management's best estimate assumptions" (as required by Section 3461 of the CICA Handbook, for use in determining the sponsor's income statement charges and for disclosures) warrant careful oversight by the Board. Key assumptions for directors to focus on include:

- the spread between the interest discount rate used to determine the present value of accrued benefits and the salary increase assumption used in estimating the amount of the accrued benefits; and
- the expected return on invested assets.

"Management's best estimate assumptions" is a somewhat misleading label, missing the point that these assumptions by management should also be reviewed by the Board. As these assumptions become more aggressive, the computed annual pension expense reduces. Incremental liberalizations in assumptions lead to significant reductions in pension expense. Losses arising from overly optimistic assumptions are pushed out to be borne by future generations of shareholders.

The relevant Board committee should confirm that management has appropriate processes for updating and refining these estimates and has guidelines for sign-off. This committee should also ensure that the key assumptions noted above, including any changes for the most recent financial reporting period, are disclosed to the sponsor's investors.

Pension financial reporting is being reconsidered by the Canadian Institute of Chartered Accountants and by the International Accounting Standards Board, with interest being expressed in the elimination of amortization of actuarial gains and losses, reporting pension fund investment gains and losses separately on the income statement, and in treating pension service costs as expenses. The Board should be cognizant of these developments and their potential impact on the pension plan sponsor.

> "…the full and immediate recognition of all gains and losses in the financing cost,… appears to be a popular view among financial economists…A (pension) plan deficit is unlike other debts because it does not entail contractual interest and capital payments; a plan surplus is not an asset immediately for use in the business. It is reasonable for financial statements to reflect those economic realities in spreading the recognition of gains and losses over future periods."
>
> – Zaki Khorasanee, letter to *Contingencies* (American Academy of Actuaries), January/February 2003.

Monitoring the financial health of a defined benefit pension plan

To track the combined effect on defined benefit pension plans of volatile asset values and growing liabilities, some sponsors examine the ratio of asset values to liabilities over time with the help of consulting actuaries and financial economists. This analysis is undertaken voluntarily for information purposes and is not a requirement of any statute or professional body.

Simulations of the financial health of a specific plan in this new era of "mark to market" financial management are used by sponsors of defined benefit plans to:

- obtain a fairly frequent reading on the combined effect of both asset and liability volatility;

- stay very close to deterioration in funding ratios and surpluses; and
- anticipate the need for higher sponsor contributions, drags on corporate earnings and potential deterioration in credit ratings for plan sponsors.

Mercer Human Resource Consulting introduced such a simulation to Canada, the *Mercer Pension Health Index*, which provides a monthly measure of the ratio of assets to liabilities for a model plan.

(iv) Supplementary Executive Retirement Plans (SERPs)

Question

10. If the organization provides a SERP, are the benefits funded or otherwise secured? If not, have the plan members (i.e., the managers and executives) been formally advised that their additional company-sponsored retirement income is at risk?

Commentary

Because of the limits set out in the Income Tax Act on the amount of annual pension that can be provided via a registered pension plan, many employees in Canada with pensionable earnings greater than about $C100,000 are covered by a SERP. These include middle managers as well as executives. Many of these people are unaware of the risks to benefit security that accompany pay-as-you-go funding. Forfeiture of the SERP entitlement can occur as a result of a sponsor's future financial difficulties or the loss of the entitlement in the event of a spin-off of a business division.

For defined benefit SERPs, the amount of the pension entitlement should be reasonable in a total compensation context as well as relative to attraction and retention objectives of the sponsor. The amount of the defined benefit payment should also be capable of ready determination based on earnings, years of service and vesting criteria.

Also, pension entitlements for all SERPS should be predictable in terms of the likelihood of payout. However, only slightly in excess of 20% of all SERPs are cash funded in whole or in part and a small additional percentage of all SERPs have security provided by Letters of Credit. The liabilities related to SERP entitlements are growing rapidly.

There are precedents (e.g., Confederation Life) where members of SERPs have been severely impacted. As a result of wide media coverage of such failures, there is now a general awareness of the risk exposure. Consequently, for future defaults of this nature, the risk of a class action against directors is fairly high.

(v) Business Transactions and Pension Obligations

Question

11. Are business transactions—such as acquisitions, mergers, divestitures and restructurings—being assessed with respect to the impact on pension obligations and their funding, keeping in mind duties to plan members, both continuing and divested, as well as to shareholders?

Commentary

Corporate strategies frequently lead to acquisitions, mergers, divestitures and restructurings. These corporate transactions can lead, in turn, to plan amendments, plan mergers, conversion of one plan type to another, transfer of pension liabilities and assets in the event of purchase and sale, plan splits as well as partial and full plan wind-ups.

Each of these events warrants close attention to (1) the requirements in pension statutes, (2) the consequences for each group of stakeholders; and (3) common law precedents.

In the case of transfer on purchase and sale for example, having a well-researched plan for determining and dealing with the pension obligations for employees affected by such a business transaction is critical to arriving at an informed strategy, avoiding nasty surprises, and achieving value-added results for all stakeholders. There are a number of steps for risk mitigation:

- due diligence to establish the magnitude of the unfunded pension liability relative to the asking price for the operating division;
- a current funding valuation for the pension plan, rather than one that might have been undertaken three years earlier; and
- due diligence on the purchaser who proposes assuming significant unfunded pension liabilities (with respect to divested employees) with an offset in the purchase price for the operation. If the purchaser subsequently declares bankruptcy, the vendor could end up with a "moral liability" and a public relations problem even though there may be no legal liability.

(vi) Cost Effectiveness in Spending

Question

12. Is there an accounting of the total annual administrative expenses, including administration and fees paid to third parties associated with sponsoring the pension plan? Does it include an assessment of the cost-effectiveness of current benefit administration procedures (e.g., in-house vs. outsourcing) and the fees to outside parties?

13. If the plan is a defined contribution plan, are the fees paid by plan members competitive?

Commentary

Relatively few sponsors in the private pension system prepare an annual report on all of the administrative expenses associated with running their plans and funds. These expenses include fees to third parties, such as for actuarial, investment management, investment consulting, custodial, trustee, legal, audit, consulting and outsourcing services. The stimulus for serious discussion on cost effectiveness is frequently a costly systems replacement. With incomplete expense information, a sponsor will not likely be inclined to evaluate returns on outlays (as defined by the sponsoring organization and in a value-for-money sense).

If outsourcing of pension administration is considered, due diligence should be undertaken regarding a potential supplier's ability to handle the outsourced functions over a prolonged period. This would include implementing a proven disaster recovery plan.

With regard to the competitiveness of fees, in the case of defined contribution pension plans the fee level charged to plan members will have a significant impact on the accumulation in an individual's account over time.

(vii) Investment of the Pension Fund

Question

14. Does the plan sponsor review the Statement of Investment Policies and Procedures (SIP&P) annually to ascertain that it is current? Are the investment policies that guide handling updated annually to align with the sponsor's beliefs regarding long term asset mix and the investment manager structure? Are the merits of new types of investments investigated?

15. With respect to monitoring the investment performance of the fund:

- How often is performance monitored?
- How does the sponsor measure and compare performance (e.g., use of quantitative and qualitative measures)?
- Is the performance adequate to meet obligations?
- What are the criteria for changing investment managers?

16. Does the organization have formal written policies with respect to:

- Proxy voting?
- Use of derivatives?
- Currency hedging?
- Soft dollars (i.e., rebates on brokerage commissions used to purchase research, software, etc.)
- Maximum single stock exposure?
- Ownership of equity of the sponsor?

17. If the pension plan is a defined contribution plan, is the overall performance of employees' investments monitored? Is there a measure of the effectiveness of employee investment choices and education?

Commentary

Sponsors generally have a disciplined approach for establishing and monitoring the investments in the fund. Most large pension funds review their Statements of Investment Policies and Procedures annually and ask their external managers to certify compliance with the investment style and goals specified. Sponsors generally use external managers, review all aspects of performance (quantitative and qualitative) quarterly, assess that performance against pre-set benchmarks and expectations, and evaluate the merits of new types of investment. They have developed policies on matters such as market concentration in the form of maximum exposure to a single stock and the use of derivatives.

As one would have expected, some large public sector funds have behaved increasingly as institutional investors. In doing so, they have challenged the management and Board performances of publicly listed enterprises in which they have invested. In the past, most private sector sponsors perceived that they had more to lose in stakeholder relations than to gain in investment returns by engaging in shareholder activism. Establishment of the Canadian Coalition for Good Governance is evidence that a significant number of pension funds and investment managers are working behind the scenes with the management and Boards of investee enterprises to promote corporate governance reform and, as needed, to push back on inappropriate proxy proposals.

Boards of pension funds who are not already actively involved in corporate governance reform should ask questions about the fund's role in future reform initiatives. For example, specific initiatives that management and Boards could investigate (none of them strictly required by statute) include:

- a definition of what constitutes conflicts of interest for all parties involved in the investment process (e.g., the investment analysts and investment managers) and a check that appropriate policies to guide their handling are in place;
- a policy as to whether the fund can invest in shares of the sponsoring entity or whether this represents an inappropriate conflict of interest;
- a periodic after-the-fact reporting by the investment managers of the major proxy voting matters for the period, how sensitive proxy proposals have been handled and what refinements (if any) to the SIP&P should be considered; and
- criteria in proxy proposals to be satisfied in the future before the pension fund's support will be forthcoming.

> "Investment banks have been unable to resolve conflicts of interest between their different businesses. Consumers are cross and regulators have their knives out."
>
> – The Economist, November 16, 2002.

(viii) Risk Assessment and Management

Question

18. Has there been an evaluation of exposures to risk in the operation of the pension plan and fund, including the balance sheet and income statement risks for the plan sponsor? If yes, what deficiencies were identified and what steps have been taken to mitigate and manage risk exposures?

Commentary

The risk assessment and management process could include:

- identifying the risk exposures for the plan and fund (e.g. financial, legal, administration, communication) as well as the pension-related risk exposures for the plan sponsor, for directors and officers and for professional advisors and service providers;
- creating a risk map for each risk exposure that sets out an assessment of the magnitude of impact, the likelihood of the occurrence of each risk, the risk owner, and how each risk exposure is managed/mitigated; and
- deciding which Board committee oversees each risk.

For example, the Board may want to initiate an early review of all pension-related legal causes of action in view of:

- the number of pension-related enquiries, notices from the pension standards regulators and tribunal hearings;
- the significant increase in the number and magnitude of pension-related litigation, including class action suits; and
- claims for breach of fiduciary duties not generally being subject to a statute of limitations.

The risk assessment and management process can be helpful to management in not only planning the most appropriate response to potentially negative outcomes, but also in identifying and evaluating opportunities to improve performance.

The process can also be helpful to a Board in evaluating a pension strategy brought forward by management, in bringing all key elements of pension governance together for evaluation and priority setting and in confirming that all risk exposures have been captured and appropriately addressed.

The process can also be helpful to both management and the Board in:

- confirming the risk exposures to be borne by the plan and fund, by the sponsor and by officers and directors;
- assessing the appropriate form and amount of insurance protection to be secured under director and officer liability and fiduciary (trustee) liability insurance policies;
- assessing the form of indemnities available from the company to directors and officers;
- reviewing the contractual arrangements with professional advisors and service advisors and determining whether appropriate indemnities are available and should be obtained; and
- assessing the errors and omission insurance coverage that professional advisors and service providers should be required to maintain throughout the terms of their appointments.

(ix) Management Representations Regarding Compliance with Statutory Requirements and Formal Policies

Question

19. Should the Board ask management for a representation, perhaps annually, that all of the functions management has been asked to perform have been handled pursuant to statutory requirements and formal policies?

20. As a basis for discussing and prioritizing accountability enhancements, should the Board go further and request a "gap analysis" that benchmarks the current governance practices for the plan and fund to:

- minimum statutory requirements; and
- the community standards for good pension accountability for plans and funds in the peer group?

Commentary

Consistent with a Board's responsibility to ensure that a plan and fund are being run effectively and in the right direction, it should seek assurance of ongoing statutory and contractual compliance and of compliance with formal policies that guide the handling of functions where the performance has been delegated to other parties.

Boards should seek periodic representations from management and external suppliers that all functions they have been asked to perform and that are required by statute, contract and formal policies, have been successfully handled. Boards should also ask management to identify areas where new policies and standards could eliminate exposures to penalties, ensure consistency of handling, streamline handling and achieve cost reductions.

While it is perhaps inevitable that some Boards will be satisfied with minimum compliance, all Boards are encouraged to reach for a considerably higher standard of governance if doing so will benefit the stakeholders and shareholders of the sponsor and the plan beneficiaries.

III. Directors looking ahead

While most pension plans and funds in Canada's private pension system have been capably managed and most have delivered on their promises, the time has come for directors to assume a more proactive leadership role in the boardroom than they have in the past.

Statutory Refinements - a place to start

Selected refinements to statutes can contribute to enhanced pensions and pension governance; government policy makers should give them serious consideration. These include: (1) a requirement that funding policies become formalized in a written document together with a requirement that the policy and contributions made pursuant to that policy are shared with relevant stakeholders, (2) clarifications (in statutes) regarding the disposition of excess pension assets for partial plan windups and (3) promulgation of the qualifications for directors who serve on pension committees and are considered to be pensions and pension-governance literate.

However, as good pension governance requires a leadership state of mind and not mere compliance with a set of rules, further strengthening of statutes beyond adding a few such refinements is not the preferred way to achieve improved performance within Canada's private pension system.

Boardroom Leadership - the means to the end

Unless Boards provide the leadership and introduce governance enhancements that are most relevant for their circumstances, more extensive statutes will be the likely outcome. That probability is high in an environment where resources are being shifted towards regulation and related oversight.

To date, Boards have most often concerned themselves with a limited number of high-level decisions: adoption of the plan, major benefit liberalizations, investment matters and in some instances, the sponsors' funding obligations.

For the future, a Board should consider whether its scrutiny of pension governance matters should be significantly broadened and deepened. This is not to suggest that the Board assume the role of management but that Board and management work collaboratively in undertaking this scrutiny. This undertaking involves knowing what the top-line questions are and knowing when, how and whom to ask for more details. Also, in the multi-faceted and rapidly evolving pension governance area, awareness of new developments will be critical to this enhanced form of Boardroom oversight.

Boardroom leadership on pension governance can take several forms including:

- Ensuring that Board members have the pensions and pension governance knowledge and experience base to appropriately discharge their financial, legal and broader governance responsibilities;

- Advocating policies and standards to guide the handling of functions by management, the Board and outside suppliers. Policy architectures are being introduced to corporate governance deliberations and can be adapted to pension governance;

- Keeping a watch on major pension reform proposals and on current and emerging governance practices. The following matters, for example, could be standing agenda items for periodic updates;

    - class action suits and case law;
    - retiree activism;
    - ownership of excess pension assets;
    - privacy legislation;
    - public comment and advocacy positions regarding refinements to pension statutes and regarding the role and the effectiveness of both pension standards and financial market regulators;

- Incorporating into the formal policies for a plan and fund, the codes of conduct of the professionals who render services;

- Advocating, and assigning a high priority to implementing, quality voluntary communication from sponsors to plan members, to investee firms and to the sponsor's investors; and

- Having the Board undertake a process of evaluation and self-assessment by annually asking itself: "How are we doing?"

In the future, more detailed governance rules and regulations for pension plans and funds may be expected. One question for stakeholders is two-tier regulation: Should large sponsors and funds be held to higher and more detailed governance standards than smaller enterprises? Those who favour principles-based regulation would have the same principles extend to all sized enterprises. In that event, the Board's essential decision is how to apply the principles to their particular organization.

Committee Oversight

As noted, some Boards have a pension committee that provides oversight of all pension governance matters, while others discharge their oversight responsibilities through a joint effort of several Board committees, including the audit committee.

Because of the audit committee's oversight of financial reporting and internal control matters for the sponsor, there is a case to be made for it to assume a significant part of a Board's oversight responsibility for pensions.

Recent corporate governance developments for publicly listed enterprises include specific changes for audit committees, such as:

- requiring audit committee members to be independent;
- having audit committees oversee the work of the external auditor and the internal audit function;
- empowering audit committees to retain their own advisors; and
- providing guidance regarding the qualifications of specialists who serve on audit committees.

Boards should ask themselves whether and which of these same changes should be adopted for their pension committees.

> "It is a new age – one where management is much more capital constrained, one where shareholders are going to have to be intensely aware of the prior claims on the cash flows and assets of their companies."
>
> – The View From Burgundy, Burgundy Asset Management Ltd, January 2003.

Appendix: Governance elements common to most plan types and governance structures

(a) Overview of the Ten Elements

There are ten elements of good pension governance internal to plans and funds that senior executives and managers of sponsors focus on day-to-day in running them:

1. *Functions and Ultimate Responsibilities.* Sponsors need a clear and documented delineation as to who does what —who analyzes, recommends, approves, implements, monitors, reports and evaluates.

2. *Plan Design.* Because the pure benefit cost is a chief factor of design review, and because cost effectiveness in spending is an element of good governance, plan design is therefore an element of good pension governance.

3. *Funding Policy.* For defined benefit plans, the funding policy sets out the desired ongoing relationship between the fair market value of fund assets and the liabilities accrued for service to-date. This policy is an important guide for other major areas of decision-making: benefit security for plan members, stranded assets and the investment policy for the pension fund.

4. *Investment Policy and Structure.* This element covers: the long-term asset mix set out in the Statement of Investment Policies and Procedures; return expectations; policy asset mix; investment manager structure; permitted and prohibited investments; quality standards; maximum quantity restrictions; delegation of functions; performance measurement and monitoring; policies to guide the voting of proxies; and the handling of conflicts of interest.

5. *Legal compliance.* This covers statutory requirements as well as trust and fiduciary law and common practices beyond minimum requirements.

6. *Administration.* This includes written policies and procedures; standards for core tasks such as calculations, year-end data collection and reconciliation and data certification; and annual administration reports.

7. *Fund Transactions.* This includes accounting for, and reconciliations of, all transactions including those reported by the custodian and the investment managers.

8. *Expenses Paid From The Fund.* This element deals with the external and internal fees that can properly be paid from the pension fund.

9. *Cost-Effectiveness in Spending.* The focus of this element is on whether/how sponsors track costs (all types, whether pure benefit or administrative costs) and on the evaluation of returns on expense outlays.

10. *Communication.* This covers communication strategies (for all stakeholders including plan members, investors, providers, regulators etc.), annual reports and the education and awareness of plan members.

These ten governance elements apply to most sectors of the economy and to each plan type, (i.e. defined benefit and defined contribution). Exceptions are funding policies, which apply only to defined benefit plans, and assurances that plan members are receiving sufficient investment education and choices, which apply only to defined contribution plans.

(b) The Roles of the Sponsor and the Legal Administrator Involving Fiduciary Duties to Plan Members

The Pension Benefits Acts focus on the role and responsibilities of the "legal administrator". Sample extracts from the Ontario Pension Benefits Act:

- Section 19(1) – "The administrator…shall ensure that …are administered in accordance with this Act and the regulations"
- Section 19(3) – "The administrator…shall ensure that…are administered in accordance with ….the filed documents…"
- Section 22(1) – "The administrator…shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person"
- Section 22(2) – "The administrator…shall use…all relevant knowledge and skill…the administrator possesses, or ought to possess by reason of profession"
- Section 22(4) – "The administrator…shall not knowingly permit the administrator's interest to conflict with…its duties/powers in respect of the fund"
- Section 22(9) – "Administrator not to benefit, except pension benefits, ancillary benefits and charging fees and expenses related to the administration of the plan…"
- Section 22 (5) – "Where it is reasonable and prudent…may employ one or more agents…in the administration of the pension plan and in the administration and investment of the pension fund"
- Section 22(7) – "…who employs an agent shall personally select the agent and be satisfied of the agent's suitability…and…shall carry out such supervision…as is prudent and reasonable."

The role of the "sponsor" is provided for in these Acts; however it is not spelled out as clearly as the role of the "legal administrator". The sponsor is the party with a vested interest in setting up a plan and fund. In the private sector (in those circumstances where the sponsor is a single employer), the employer has routinely acted as both the sponsor and the legal administrator.

(c) Charts Depicting Whether Ultimate Responsibility is to the Sponsor or to Plan Members

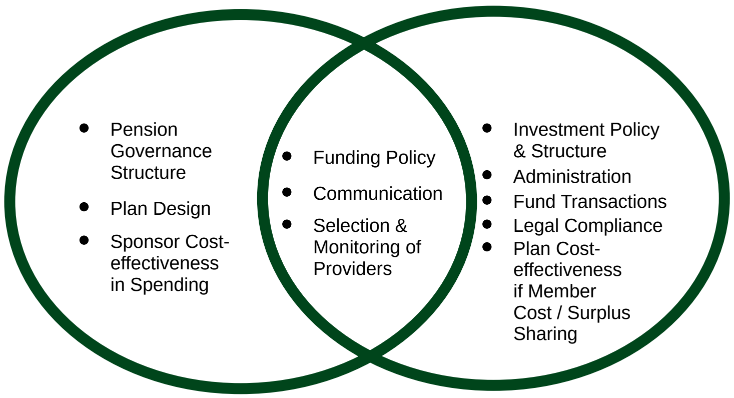
The following four charts provide a graphical depiction of:

- the elements of pension governance common to most plan types, funds and governance structures;
- the elements that involve:
  - responsibilities to the plan sponsor (and its shareholders if it is a private sector enterprise); and
  - fiduciary responsibilities to the plan members;
- the elements where a sponsor wears two hats (i.e., it is both the sponsor and the legal administrator); and
- the elements where some matters may involve fiduciary responsibilities to plan members.

Chart IV contains a reminder that a plan sponsor may want to exceed minimum standards, including all requirements set out in statutes, either because of the sponsor's corporate governance practices or the community standards for good pension governance.

Chart I

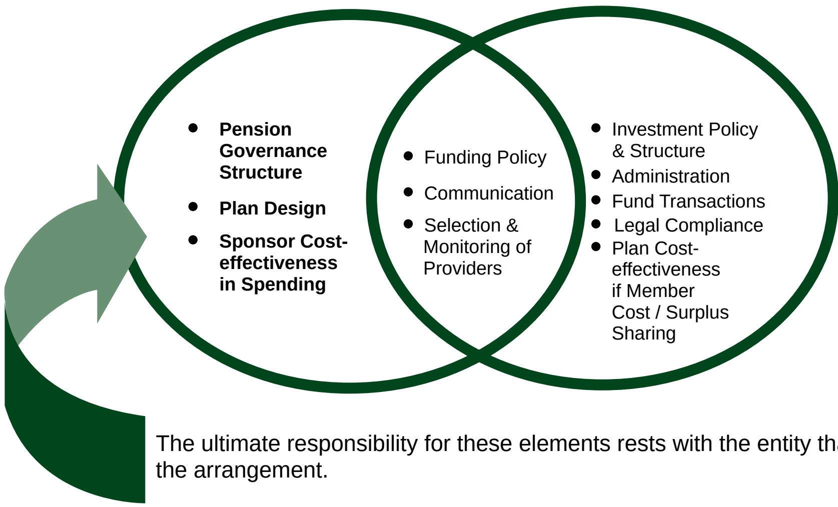
Governance Elements Common to most Plan Types & Governance Structures



The elements are clustered in the inter-locking circles according to whether responsibility is to shareholders/stakeholders of the sponsor (left side) or to the plan members (right side). Refinements have been made to the formal names assigned to the ten elements in those instances where one portion of the responsibility may be to specific shareholders / stakeholders and another portion is to plan members (e.g. cost-effectiveness in spending).

Chart II

Governance Elements Common to most Plan Types & Governance Structures



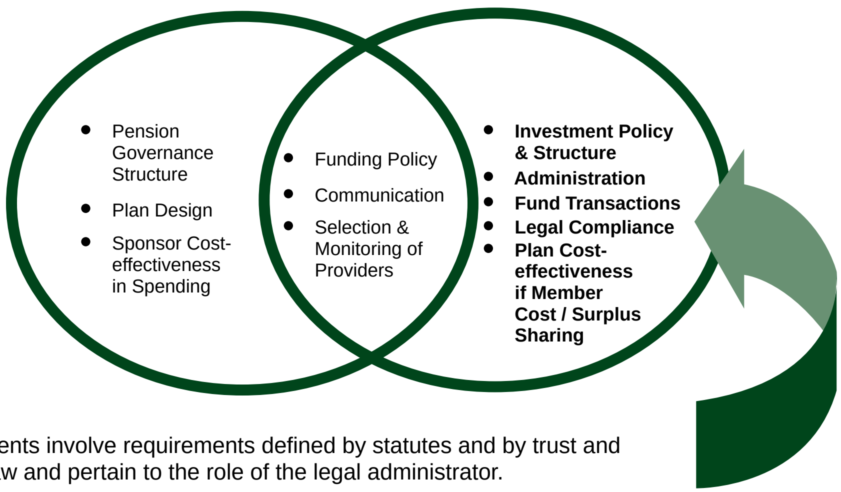
The ultimate responsibility for these elements rests with the entity that sponsors the arrangement.

None of these elements involve fiduciary responsibilities to plan members.

Considerable management and Board discretion is possible with these elements, as any statutory requirements are not extensive.

Chart III

Governance Elements Common to most Plan Types & Governance Structures



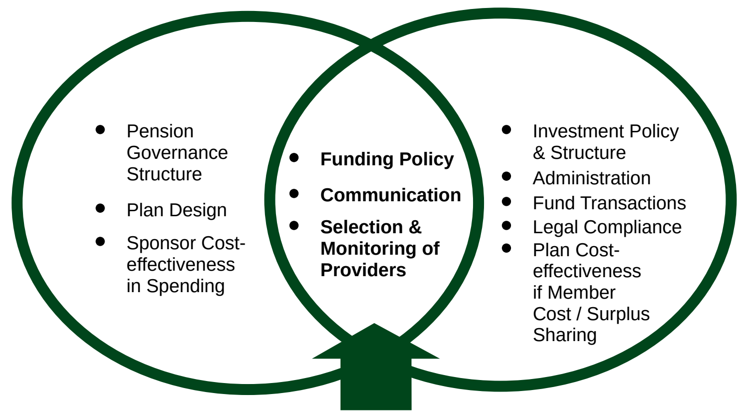
Most elements involve requirements defined by statutes and by trust and fiduciary law and pertain to the role of the legal administrator.

All of these elements of pension governance involve fiduciary responsibilities, and the primary accountability for these elements is to the plan beneficiaries.

Whenever an employer acts as both sponsor and legal administrator it is wearing two hats as it has ultimate responsibility as sponsor (for the elements highlighted in Chart II) as well as ultimate responsibility for these elements as legal administrator.

Chart IV

Governance Elements Common to most Plan Types & Governance Structures



Some parts of these elements may involve fiduciary responsibilities to plan members.

Considerable management and Board discretion is possible with these elements, as any statutory requirements are not extensive.

The sponsor may want to exceed minimum standards because of corporate governance considerations, and community standards for good pension governance.

Where to find more information

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20 Questions Directors Should Ask about Risk
20 Questions Directors Should Ask about Strategy

Notes

About the author

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Gordon Hall is a professional director and advisor to Boards on corporate and pension governance matters.

Gordon retired recently after forty years of practice as a consulting actuary, the last thirty with William M. Mercer Limited (now Mercer Human Resource Consulting). At Mercer, he consulted to sponsors of many of the largest pension funds in Canada's private pension system. He also held a number of senior executive positions at Mercer in Canada and was Chair of the global firm's International Business Development Group when the firm was focusing on global expansion. He was a Worldwide Partner of the global firm (William M. Mercer Companies Inc.) from 1984 until his retirement.

In 1994, he became editor of *The Mercer Bulletin, The Mercer Pension Manual* and the *Mercer Handbook of Canadian Pension & Benefit Plans.* In 2001, he led the Mercer team that designed and undertook the ground-breaking analysis of the governance practices of the largest pension plans and funds in Canada's private pension system. The report was published in February 2002.

His experience as a professional director includes:

- the Board of Directors of William M. Mercer Limited where he served seventeen years, ten of them as Vice Chairman;
- the Board of Trustees of Queen's University where he chairs the Audit Committee and serves on the Finance and the Pension Committees;
- the Board of Directors of the Institute of Corporate Directors where he chairs the Governance Committee and serves on the Communication and Fellowship Awards Committees; and
- the Board of Trustees of the billion dollar Pension Fund for Ordained Ministers and Staff of the United Church of Canada, where he is a trustee.

Gordon has undertaken considerable research and public comment on corporate and pension governance, public policy and human capital matters. In the last eight years, more than a dozen of his papers, texts and articles have been published.

Gordon is a Fellow of the Society of Actuaries and a Fellow of the Canadian Institute of Actuaries. He is also a member of the American Academy of Actuaries, and the International Association of Consulting Actuaries.

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New Developments In The Governance Of Employer-Sponsored Pension Plans: Are We Prepared?

October 20th, 2006 Presentation To
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Canadian Institute Of Actuaries/Society Of Actuaries Joint Meeting In Chicago, Illinois

Prepared By: Gordon M. Hall, FSA, FCIA, ICD.D

October 1st, 2006

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Preface

This paper looks at the governance or decision-making processes and protocols for plans and funds in Canada's private pension system through the eyes of Oversight Boards[1] in all sectors of Canada's economy and for all types and sizes of registered plans.

The paper is a commentary based on my experience and my impressions gained:

- over 30 years (1973-2002) as a consulting actuary in Canada's private pension system;
- since 1994 as a member of Oversight Boards including service as Chair of the Audit and Governance Committees of these Boards;
- as an author of published peer reviewed research on a variety of corporate and pension governance matters (1994 to the present); and
- from continuing discussions with sponsors of plans in Canada's private pension system and with professional advisors in all areas of pension specialization.

The views in this paper are those solely of the author.

The quality of the governance of employer-sponsored pension arrangements (as seen through the eyes of the Boards of those sponsors) is, in many instances, a distant second to the quality of corporate governance for the core businesses of the sponsors.

The governance of employer-sponsored pension arrangements is unlikely to change until the "tone at the top" set by the CEOs of the sponsors changes and the Oversight Boards make their "business conduct" expectations known. In the meantime, we can expect that isolated developments will continue to be addressed by many sponsors on an ad hoc basis and historic "rubber stamping" of pension matters by these Oversight Boards will persist.

There are good examples of quality pension governance reform and support from stakeholders is building. Further progress will depend on a plan-by-plan self-evaluation and some fundamental changes in understanding, protocols and processes.

Fundamental changes would include:

- CEO and Oversight Board leadership of pension governance reform;
- Oversight Boards significantly improving their understanding of the diverse and complex challenges, and committing to upgrade the collection of requisite

[1] Oversight Board = the entity(ies) at the top of the plan's decision-making hierarchy. If the sponsor acts as both the sponsor and the legal administrator of the plan, the Oversight Board is most likely the board of directors of the sponsor. If the sponsor and legal administrator roles are separate there will be two Oversight Boards for the plan

skills and experience of the Board and to strengthen the governance structures, protocols and processes for the plans that their corporate entities' sponsor;
- Oversight Boards attending to all forms of conflicts of interest including the conflicts between sponsors' and members' interests, and to how to manage these conflicts; and
- consulting professionals and the corporate executives of the sponsors who retain their services, finding ways for the specialist advisors to a plan to work more closely together with the objective of significantly improving the quality and timeliness of support to CEOs and Oversight Boards.

The basics of being a director for the core business of a sponsor and of being a member of an Oversight Board where pension deliberations and decision-making take place are set out in recently published documents.[2]

This paper points to the parallels between the good corporate governance practices and protocols for the core business of the sponsor and the strengthened decision-making needed for employer-sponsored pension plans and funds.

As well, the paper references the considerable thought leadership in recent publications of the Canadian Institute of Actuaries (CIA) and does so with the hope of stimulating further dialogue within the profession regarding:
- the role of the actuary;
- the contemplated enhancements in various areas including standards of practice; and
- the initiatives that are likely to cause the profession's service to the public to be as wholesome as the members of the profession would like it to be.

By sharing the paper in due course with members of other professions and with the CEO and corporate director communities, the author hopes to stimulate dialogue and action on pension governance reform and in the process to contribute to improved performance (broadly defined) for Canada's private pension system.

[2] See Appendix A

Acknowledgements

I am grateful to Elizabeth Brown LLB, Partner, Hicks Morley Hamilton Stewart Storie LLP, for her summary of selected pension law cases and of Pension Standards Regulatory activities, a copy of which is attached as Appendix C of this paper.

This research has influenced the recommendations in the paper.

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I. Introduction

A. Perspective For The Paper

The paper looks at pension governance from the top (i.e. Oversight Board)-down.

This perspective is fairly unique. Most other papers and articles about governance in Canada's private pension system are "bottom-up" efforts:

- led by the agents of the Oversight Board (i.e. management of the sponsor and professional advisors retained by management); and
- in some instances are closely aligned with governance initiatives of the pension standards regulators.

Unfortunately, little of the output of these bottom-up efforts has to date found its way into the protocols and practices of the Oversight Boards. Hopefully these top-down and bottom-up initiatives will come together and stimulate and support CEO and Oversight Boards towards pension governance reform.

Much of what constitutes good pension governance is not legislated but is instead derived from fiduciary principles, best practices, and the jurisprudence. The lack of specific legislative guidance creates uncertainty and potentially greater risk exposures than those, which come from failure to simply comply with statutory requirements.

No two employer-sponsored arrangements are alike. There is no "one-size-fits-all" governance solution. Members of Oversight Boards and professional advisors need to be acutely aware of the distinguishing features including:

- the culture of the sponsor;
- the make-up of the plan membership;
- commitments in collective agreements and other employment contracts;
- a plan's funding deficit as a percentage of the sponsor's total debt and total shareholder value;
- the plan and fund's exposure to the increasingly litigious environment in Canada's private pension system; and
- for a defined benefit plan, who has ownership of surplus.

An in-depth understanding of these matters is critical in considering whether the *pension deal*[3] must or can be changed; evaluating the elements of governance reform that can be considered; and deciding on the urgency that should be attached to pension governance reform.

[3] *pension deal* = what is the nature of the pension promise, what are the underlying risks such as having to increase funding outlays to secure pension benefits or having to live with uncertainty regarding the amount of pension that will be available at retirement and who is to bear these risks.

Lastly, the "We" in the title of the Paper is interpreted broadly to include sponsors/legal administrators, pension standards regulators, government policy makers, professionals and professional service firms, pension industry associations and suppliers of director/trustee education.

B. No Easy Answers To Questions About Plan Type

Pension plans have and continue to be an important element of attraction and retention for many employers.

Most defined benefit ("DB") pension plans are fairly mature in a demographic profile sense:

- funding deficits represent a significant problem for a number of plans;
- there is serious concern at the Oversight Boards of many of these plans that funding deficits may become even larger and that timely action to curtail/freeze them is critical;
- Oversight Boards are questioning whether the sponsor can continue to fulfill the promises made or whether the *pension deal* must be changed; and
- Oversight Boards are asking "What should we do?" and "What can we do?"

For a DB plan sponsor "switching over" and sponsoring a defined contribution ("DC") arrangement is easier said than done. It may not in fact be the prudent thing to do for a number of reasons:

- a different workplace culture is needed to support a DC arrangement;
- there may be a strong sponsor preference for a significant portion of the funds to be invested in the stock of the sponsoring employer;
- the sponsoring employer may incur new costs, some due to the administrative infrastructure (internet-based interactive systems), and others due to additional sponsor contributions intended as a "trade-off" for the stability in contribution levels for the sponsor going forward;
- significant and different employee disclosure requirements and the need to demonstrate compliance with the *Capital Accumulation Plan Guidelines*[4] create challenges for the sponsor not present in a DB plan; and
- from a risk management perspective, the switch over could be just exchanging a DB funding risk for a DC litigation risk.

While considering the merits of a DC pension arrangement, it could be a mistake not to comment on Group Registered Retirement Savings Plans ("GRRSP") as alternative delivery model.

The deficiencies in a GRRSP can be significant:

- employee participation on a voluntary rather than a mandatory basis;
- inadequate contribution cash flow to the GRRSP relative to:

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[4] These Guidelines were promulgated by the Joint Forum of Financial Market Regulators in May 2004 to become effective December 31st, 2005. While they do not have the force of law, the CAP Guidelines set out minimum governance standards for all tax sheltered defined contribution plans that offer investment choice to plan members.

    - the amounts needed to provide adequate pensions for employees; and
    - the amounts that would normally be contributed to a registered DB or DC pension arrangement;
- modest or sometimes no matching contribution by the sponsoring employer;
- a retail, rather than an institutional, approach to both pricing and to investing. With retail investing participating employees are provided with a long list of investment alternatives, few of these employees have the relevant investment and capital markets knowledge and the sustained interest needed to deal with these matters;
- the likelihood of employees being influenced by "developments of the day" and "buying high and selling low" is quite high. The potential risk exposure for the sponsor appears to be considerable;
- expenses being borne, all or in large part, by the participating employees; and
- no or weak monitoring and evaluation by the Oversight Board of the quality of handling of functions by the provider of the GRRSP and by the management and staff of the sponsoring employer who are assigned to work with the record keeper and provider.

GRRSPs with these deficiencies likely represent questionable value for both the sponsoring employer and the participating employees.

Some of the latter deficiencies represent deficiencies in governance practices and protocols.

Others are design in nature and may result from Oversight Boards either not being involved with the decision to sponsor the arrangement in the first place or being unaware of the deficiencies and risk exposures when the proposal to sponsor the arrangement was brought forward for approval.

While most pension plans are either DB or DC, the variations in plan type and form of the benefit promise are important in pension governance. Consider a hybrid pension plan (i.e. both DB and DC benefit provisions) under which:

- plan members receive the greater of a DC and a DB promise upon retirement;
- members are paid a variable annuity throughout retirement with a minimum DB guaranteed entitlement;
- there is one fund that supports both the variable and minimum guarantee promises; and
- the sponsor desires stability and predictability in its funding obligations.

In this case, the interests of the plan sponsor and of the plan members will be misaligned. The misalignment exists because the plan members are interested in enhancing total fund returns (albeit volatile) and the sponsor is interested in mitigating annual fund return volatility and ensuring a stable and predictable funding pattern for the DB pension promises.

Such a plan creates a significant governance challenge, particularly where plan members participate in decision-making relating to the plan and there is no clear and unified statement of guiding principles.

In any event, and irrespective of the plan-type, it is generally not easy to change the *pension deal*. In fact, in the private sector if pensions are bargained with a union, the sponsor may gain union co-operation if it is obvious that the sponsor is financially distressed and bankruptcy is a very real possibility, however co-operation, in these circumstances, is not a certainty.

Also, since the early 70s, when the paper's author joined the actuarial consulting fraternity, we have experienced:

- equity market pullbacks (1974, 1982, 1990, 1998 and 2001);
- periods of hyper-inflation (1974, 1981);
- increased long term interest rates (early 1980s) and dramatically declining rates (2005-06);
- periods of excess investment fund returns, which were followed by arguments over who owns pension surpluses under DB plans; and
- grave concerns as to whether sponsors can fulfill DB plan promises and over the volatility in funding requirements for these plans.

The more optimistic amongst us might volunteer that all forces affecting the pension system are cyclical in nature and that sponsors (and members of Oversight Boards of the sponsors) should simply be patient and wait for a return to "normal times".

It is important not to lose sight of the core roles and responsibilities of Oversight Boards of employer-sponsored arrangements and not to get lulled into the conclusion that refinements to the *pension deal* and/or governance reform can wait until the next serious challenge or the next serious risk exposure surfaces.

For me, when it comes to pensions, the core roles and responsibilities of the Oversight Board are to:

- ensure that the benefit promises made continue to be fulfilled[5];
- confirm that functions that have been delegated to others are appropriately performed;
- ensure risk exposures[6] are managed and mitigated and that residual or excess risk exposures are transferred to an insurer;
- improve performance of the plan (broadly defined);
- promote awareness of the core developments for the plan including the quality of services to plan members; and

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[5] The word "fulfilled" is used here in a general sense. For a retired plan member, the word "fulfilled" has a precise meaning in that the form and level of payout are fixed and generally cannot be modified. For an active plan member, the word "fulfilled" has a less precise meaning in that the sponsor with suitable notice and union co-operation where pensions are bargained generally has the right to modify the basis of future pension accruals.

[6] See Appendix B

- foster transparent reporting of the financial position and of the performance of the plan (broadly defined) to stakeholders.

In summary:

- whether the current plan benefit type continues to be appropriate for a specific work force; and
- whether 2006 is the most opportune time in the sponsor's evolution and in the economic cycle to change the *pension deal*;

are important matters for discussion. However these matters are far from the end of the list of good pension governance matters that an Oversight Board should have under consideration.

C. Optimal Pension System and Governance Structure

One minority view (not mine), in Canada's private pension system, is that:

- members of today's Oversight Boards will fail in terms of understanding their roles and responsibilities as members of an Oversight Board, and in initiating necessary follow-on actions, with respect to employer-sponsored pension arrangements ;and
- a brand new governance structure, namely single-purpose pension co-operatives with contributions adjusted over time in response to good and bad investment returns and with decisions made by "arms length experts", is needed.

This view may enjoy some support in the future. If it does, I suppose that a few sizable plans could be born.

However, I believe that there are a number of obstacles standing in the way of such single-purpose pension co-operatives, including:

- to become a reality, they need political will. I do not see this emerging in the near term given the lack of progress in rationalizing a fragmented pension standards regulatory system;
- they likely cannot be mandated; and
- support for the proposal would have to come from segments of the economy where employers do not compete for human capital on the basis of pensions. There do not appear to be many of these.

There are two challenges that must be addressed on a case-by-case basis for my advocacy for CEO and Oversight Board leadership of pension governance reform to become a reality.

They are:

- the corporate executives that have considerable control over the evolution of pension governance reforms for specific plans and funds and who in many instances spend modest amounts of their time tending to these employer-sponsored plans, will likely have to re-set their priorities and will likely have to significantly improve their understanding of pension finance and pension governance matters; and

- at the moment, the pool of specialists with both formal corporate governance and pension governance training and experience and an inclination to "serve in the boardroom" when pension matters are deliberated and decided, will have to grow.

Oversight Boards of sponsors can help to ensure that the first of these two challenges is addressed.

The solution to the second challenge lies within the recently retired and near- term retirements of professionals and senior business executives who have the relevant competencies and experience. These individuals can strengthen their capabilities through formal broadly-based director education now available in Canada from two suppliers.[7]

In summary, I believe that CEO and Oversight Board leadership of pension governance reform (working within the current system) represents both a viable and a critical avenue for real progress for the next few years and deserves to be supported and fostered by the broader community.

[7] The ICD Corporate Governance College (e-mail: college@icd.ca) and The Directors College (e-mail: thedirectorscollege.com)

II. New Developments

There have been a number of developments within sponsoring employers and the financial analyst community, and within employer-sponsored pension arrangements, that cause me to conclude that a properly functioning pension governance system is a "must do" and not a "nice to have".

A. Corporate Governance Reform For The Sponsoring Employer

Corporate governance reform for the sponsors related to their core businesses has been significant. It includes audit committee reform, internal control over financial reporting, a strong focus on enterprise-wide risk management, and Board-approved management discussion and analysis[8] (MD&A)-type annual reports.

I believe that these governance reform developments for the core business should and will filter through to employer-sponsored pension plans.

The following quotations from corporate governance gurus are representative of the collective thinking of senior directors in the private sector and the author believes these views warrant careful consideration by Oversight Boards contemplating the need for and the form of pension governance reform:

- Stephen Jarislowsky (June 2006): "There are three requirements of directors…curiosity, competence and the courage to speak your mind and stand for what you believe in"; and
- Richard Leblanc (York University professor, corporate governance consultant) (May 2006): "…at the end of the day, your decisions are only as good as the people around the table."

Also, a colleague noted recently that:

- "If the core business is steel making, one Board member at a minimum should know how to make steel. If none of the Board members know how to make steel, then the CEO had better know how to make steel and the Board should be very confident in the CEO's steel-making capabilities."; and
- "For the many human capital intensive employers in Canada, if none of the Oversight Board members know how to make pensions then the CEO had better know how to make pensions and the Board should be very confident in the CEO's pension-making capabilities."

[8] MD&A is a view of the core business… or for this paper, a pension plan and its companion fund… through the eyes of management that interprets the material trends and uncertainties that are affecting results and the financial condition and that contains forward-looking statements regarding management's objectives, outlook and expectations. These statements alert the reader to risks and uncertainties and to the fact that actual results may differ from those anticipated.

B. Enhanced Capabilities Of Credit And Equity Analysts

Credit and equity analysts now have sufficient information to incorporate pension-related risks into their models and in many instances have different perspectives from those of company management and its employees.

The external market's view of the financial health of a pension plan and of its significance to the sponsor, is generally of considerable interest to the Oversight Boards of sponsors. If Oversight Boards (and their Committees) have the collection of requisite pension skills and experience, they will be in a position to assist management prepare for the interviews with the analysts and to deal with the analysts' findings.

C. Developments Within Employer-Sponsored Pension Arrangements

(i) The demographics of covered plan memberships have matured considerably and in several instances:

- the liabilities for retirees now exceed those for active members;
- low interest rates are creating significant funding strains for the sponsors of several DB plans;
- annual contribution cash flow to a fund represents only about 2% of the fair market value of assets. This is the hard evidence that additional sponsor contributions are not a likely solution for sizable funding deficits including those that have a liability genesis;
- for plans that have self-annuitized pensions-in-pay, the net annual cash flow in the fund is negative and annual investment returns (interest and dividend income and realized gains/losses on sale) represent at least 80 - 90% of the annual cash income in the fund. This is the hard evidence of the importance of steady cash investment returns to the financial health of the plan; and
- the burden of "lighter than provided for" mortality has surfaced recently in funding valuations.

The ability of the sponsor to respond given these constraints and to gain near-term relief is limited, especially as the promises for retirees and for actives (accrued-to-date) are, with the exception of union-sponsored multi-employer plans and funds, protected by law.

(ii) There is increased litigation in Canada's private pension system, as evidenced by the pension governance-related allegations including:

- plan members' allegations against plan sponsors, pension committees, consultants, and legal administrators relating to pension plan expenses, pension plan contributions, and investments;
- pension standards regulators' (and regulator appointed administrators') actions against:
    - plan sponsors and, legal administrators, boards of trustees of multi-employer pension plans, directors of (insolvent or bankrupt) plan sponsors and actuarial advisors in relation to non-compliance with

  - pension standards legislation including funding deficiencies and unpaid pension plan contributions;
  - legal administrators for failing to comply with various provisions of the applicable pension standards legislation; and
- an increased number of regulatory investigations into the actions of legal administrators.

As well, there is increased litigation in related but less pension governance-specific areas:

- disputes over benefit entitlements;
- allegations by retirees against legal administrators for unfair treatment as compared with active members;
- human rights complaints relating to pension plans alleging age and sex discrimination stemming from historical plan provisions;
- attempts by plan members to gain control over and ultimately wind up closed pension plans and unwind plan mergers;
- ongoing disputes over the ownership of surplus assets on wind up;
- challenges to pension plans conversions and asset transfers even where these have been approved by a pension standards regulator; and
- securities law issues.

Appendix C contains a summary of five recent significant ongoing governance-related regulatory and civil actions in Canada's private pension system.

Please note that the content of Appendix C:

- is based solely on information in the public domain; and
- may be of greater relevance for CEOs of sponsors and for Oversight Boards than it is for pension actuaries.

Nevertheless, beneficiary initiated claims and the allegations and investigations of pension standards regulators:

- have increased recently in both number and type;
- have a significant impact on the evolution of governance for a plan; and
- are likely to be of considerable interest to Oversight Boards and their advisors;

and the author believes that attention to these developments at this time is the prudent thing to do.

(iii) Legislative and regulatory developments:

(a) the Canadian Association of Pension Supervisory Authorities (CAPSA) released the final version of its *Pension Plan Governance Guidelines* in October 2004. The Guidelines define governance as "the structure and process for overseeing managing and administering a pension plan to ensure the fiduciary and other obligations of the plan are met." Adherence to the guidelines by plan sponsors is voluntary but will likely be viewed as being required as the guidelines will become the industry standard.

(b) *Guidelines for the Operation of Capital Accumulation Plans* were promulgated by the Joint Forum of Financial Market Regulators in May 2004, to become effective December 31st, 2005.
While these Guidelines do not have the force of law, they set out the minimum governance standards for all tax-sheltered defined contribution plans that offer investment choice to plan members.

Although these two regulatory developments represent a step in the right direction, each is just a "checklist" form of governance that may (or may not) involve oversight by a group that collectively has the relevant competencies and experience, and can provide the leadership needed to ensure a quality pension governance result.

(c) Bill 30 in Quebec requiring Pension Committees to adopt rules of internal governance and denying external advisors the opportunity to limit their liability exposures.

Surely the latter liability exposure matter belongs to the sponsor and that it is the sponsor's duty to manage and mitigate this risk exposure. The Quebec policy maker's willingness to let sponsors neglect good pension governance practices and in the process increase the likelihood of litigation and of professional advisors being named in allegations where the liability is unlimited, is inappropriate and must be strongly resisted.

(iv) Competency and experience deficiencies of Oversight Boards

My experience is that:

- few Oversight Boards (and Committees of these Boards) have the collection of requisite skills and experience to:
    - understand and interpret the key developments and considerations that are presented to them;
    - ask tough questions of the specialist advisors and suppliers; and
    - evaluate whether this information is sufficient for them to discharge their responsibilities effectively;
- most "education"[6] initiatives for members of Oversight Boards are naive; and
- few Oversight Boards have formulated formal customized protocols such as Guiding Principles for benefit design, funding, investment and administration and few have customized Codes of Conduct to guide the agents and the Board in the performance of their functions.

Also, just as the independence of the audit committee is essential to the core business, so are:

[6] See Appendix B

- the independence of Oversight Board members (and Committees that undertake research for a Board); and
- the members' ability to exercise independent judgement;

very important in pension governance.

If there are concerns that a sponsor might not be able to fulfill its pension promises, there is little likelihood that an Oversight Board or a Committee of the Board comprised largely of plan members will have the objectivity needed to research the fundamental considerations and to find the optimal solution for the future.

For plans in the not-for-profit sector that involve plan members in decision making, a Committee (of an Oversight Board) with plan member representation, may be able to participate in useful functions provided purely technical pension matters are involved and the members have the relevant competency sets and work experience.

(v) Trustees/directors/officers seeking legal advice regarding:
- their personal liability exposures based on pension and related litigation, concluded and in progress, and associated trends;
- how much expertise and what kind of expertise is required to serve as a trustee;
- whether they must be pension-literate or perhaps even a pension specialist to discharge their fiduciary duty;
- the standard against which they will be judged. Specifically, is it "what the trustees actually knew" or is it "what the trustees should know and should do"; and
- the circumstances in which they are permitted to resign their office and circumstances in which a court or regulator may preclude resignation.

As well, in the past, there has sometimes been a hesitation to ask questions for fear of receiving an unfavourable opinion. It is important to note that legal advice is privileged and confidential. Where there is a concern about the outcome of the opinion, legal counsel will often provide an oral opinion first or a draft written opinion for initial review. In any case, it is, in my experience, far better to ask the question than not.

(vi) Quality of "pension governance safety nets" such as indemnification clauses in sponsors' By-Laws and Directors and Officers ("D&O") and Fiduciary Liability insurance coverages, including:
- Oversight Boards' lack of awareness as to:
    - whether and how indemnifications in sponsors' By-Laws co-ordinate with D&O and Fiduciary Liability insurance coverages;
    - whether the indemnifications should be relied upon;
    - exclusions; and
    - the nuances within the insurance contracts such as the "Pacman effect" where legal fees are subtracted from the coverage available,

thereby diluting/eliminating the protection for the corporate entity and for the directors and officers.

- underwriters at the head offices of property and casualty insurance companies that provide D&O and Fiduciary Liability coverages are awakening to the significant risk exposures under these contracts.

(vii) U.S. FASB's decision to recognize the net unfunded status of pension and other post-retirement benefit plans on sponsors' balance sheets (deadline originally applicable to fiscal year ends after December 15th, 2006 for public companies). This decision will, in most cases, have a significant impact on "retained earnings" for the sponsoring employers, and as charges will henceforth flow directly to the sponsors' balance sheets, it will most likely trigger reviews of the sponsor's credit ratings and of pension protocols and processes;

(viii) Considerably increased pressure to improve the investment risk/return relationship[9];

(ix) Relatively new investment vehicles for pension funds, such as:

- private equity, venture capital and income trusts[10]; and
- absolute return strategies and hedge funds;

are (and should be) receiving considerable director/trustee-initiated scrutiny, from those funds that have attained a certain size. And, real estate is experiencing a rebirth.

Most of these alternative investments involve complex considerations and additional costs. As well, some require considerable customization to the unique circumstances of the plan in order to be relevant.

For all of these, the work of staff at the sponsor and legal administrator and the work of Oversight Boards is even more challenging and time consuming.

From a good governance perspective, several of the above nine developments are applicable to both DB and DC pension arrangements albeit in varying degrees.

Also, for the author, these nine developments make the case for "getting one's pension governance house in order".

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[9] The investment risk/return relationship can be either a desire to increase the expected return with no increase in the volatility of return or a desire to reduce the volatility of the investment return with no companion reduction in the expected return.

[10] **T**he term "income trusts" describes a variety of Canadian equity investment vehicles that allow investors (unit holders) to invest in businesses with higher payout ratios than those for dividends in comparable companies.

III. Pension Governance Reform: Leadership

There are a number of stakeholders in Canada's private pension system who have an interest in and an ability to enhance the quality of pension governance processes and protocols for plans.
They include:

- Oversight Boards of Sponsors and Legal Administrators;
- Managements Of Sponsors;
- Pension Standards Regulators;
- Government Policy Makers;
- Plans/Funds As Institutional Investors;
- Fund Custodians and Corporate Trustees;
- Professions, Professionals And Professional Service Firms;
- Pension Industry Associations; and
- Suppliers of Director/Trustee education.

As successful large-scale initiatives require a few leaders and many enthusiastic followers, a decision regarding the most meaningful sources of leadership must be taken.

It is the author's sense that this leadership should come from:

- the CEOs of sponsors who need to set the "tone-at-the-top" and the Oversight Boards of the sponsors and legal administrators who need to make their "business conduct" expectations related to pension governance reform known; and
- the professions, the consulting professionals and the firms that employ them.

The Oversight Boards have the ultimate responsibility for the plans and funds.

The professions and the consulting professionals have the intellectual capital and the specialist training and expertise that is needed to anticipate and to advise regarding the diverse and increasingly complex challenges facing plan sponsors and legal administrators.

Also, the consulting professionals and the professions to which they belong have considerable clout with the public, the government policy makers, and the pension standards regulators. They can play an important role in ensuring that published quality peer-reviewed research that is critical to the orderly evolution and long term financial health of plans and funds in Canada's private pension system, is shared broadly.

Strong support from the balance of the stakeholders including broadened curriculum and more rigorous certification protocols by suppliers of director/trustee education, will be critical to realizing improvements to the system.

IV. Governance Best Practices

A. Two Best-In-Class Cases

The Ontario Teachers Pension Plan (OTPP)[11] has become a standard against which other plans in all sectors of the economy are evaluated in various respects. The management and Board of OTPP are making a special effort to share their insights with the broader community, including their perception of what constitutes good pension governance.

An example of a sponsor in the not-for-profit sector, which has enhanced the quality of its pension governance in the last 2-3 years and for whom there are several other plans and funds in its peer group, is The United Church of Canada.

The church sponsors a plan for its Ordained Ministers and Staff in Canada. The DB plan is fully funded and the market value of the plan assets is approximately Cdn$1.1 billion.

The General Council/Executive (GCE) of the United Church of Canada is the legal administrator of this plan and is the Oversight Board. The Pension Board, which is directly accountable to GCE, oversees the operation of the plan pursuant to the guidance provided by the GCE in the Statement of Beliefs & Guiding Principles. The Pension Board is comprised of representatives of the GCE, members-at-large and expert members. The latter have expertise in pension-related disciplines such as economics, investments, actuarial science, law, human resources and governance. The Pension Board in turn is supported by two expert Committees, the Investment Committee and the Pension Plan Advisory Committee, and by expert staff at the National Office.

The Pension Board had a very active 2005 as communicated in the recently published Annual Report of the Pension Plan[12].

B. Specific Recommendations

The "best-in-class" examples that the author is aware of together with the Supreme Court of Canada's findings in the Peoples Department Stores Inc v. Wise (2004)[13],

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[11] Visit the OTPP website, click on Publications-Financial Reports and peruse the "Report To Members 2005 Results" (8 pages) & "Transparency:2005 Annual Report"(94 pages).

[12] A copy of the Report together with the document " Beliefs and Guiding Principles for the Pension Plan of The United Church of Canada" can be viewed by visiting the Church's website at www.united-church.ca.

[13] In the 2004 case of Peoples Department Stores Inc v Wise, the Supreme Court of Canada said that: "The establishment of good corporate rules should be a shield that protects directors from allegations that they have breached their duty of care."

prompt coaching suggestions[14] which are worthy of consideration by Oversight Boards.

They are of two forms: (1) Framework; and (2) Orientation & Processes:

(1) Framework:

(i) Update the Terms of Reference for the Oversight Board and for each of the agents that perform functions on the Board's behalf;

(ii) Correct the deficiencies in terms of requisite skills, experience and qualifications in the Oversight Board and in Committees that support the Oversight Board;
For sponsors in certain sectors of Canada's economy, there is a self-imposed limit on the size of the Oversight Board and in turn on the number of experts (of all kinds) that can belong to it (and its Committees). Accordingly, for these Oversight Boards to gain access to the necessary collection of diverse specialty skills for the oversight activities without increasing the Board's size, they may find it necessary to ask another forum, accountable to it, to perform a number of pension governance functions on its behalf and to provide that forum with formal guidance in the form of high level beliefs and principles.

(iii) Formulate beliefs and guiding principles for design, funding, investment and administration, update related policies (e.g. SIP&P) and undertake whatever fundamental research is needed to underpin these guiding principles;
In formulating policies to guide the handling of various functions such as proxy voting, strive for a reasonable balance between idealism and pragmatism and be careful not to over-reach in the sense of going beyond the sponsor's ability to administer it;

(iv) Formulate a Code of Conduct (dealing with Confidentiality, Conflicts of Interest, Collegiality, Safe Disclosure, etc) to guide the Oversight Board's deliberations and the handling of functions delegated to others.

(v) Develop a quality orientation and awareness package/program for new members of the Oversight Board and of its Committees;

(vi) Decide on (self) education initiatives for Oversight Board members dealing with regulatory, capital markets, etc matters; and

(vii) Introduce a form of self-evaluation that fits with the culture.

(2) Orientation & Processes:

(i) Ask tough questions. Coach and mentor. Work as a team.
As part of coaching and mentoring, be prepared to volunteer tactical ideas, even though you, as a Board member, might expect them to come from management of the sponsor.
They could include:

[14] These coaching suggestions assume 100% compliance already with all statutory requirements including policies such as the Statement of Investment Policies & Procedures that is a requirement of the Pension Benefits Acts.

- explanations of the funding challenges for DB plans to the 30 year old plan members, especially as the latter generally have limited ability to contribute more in payroll deductions and they may represent the base of support that is needed to refine the "pension deal" and to proceed with long overdue pension governance reforms;
- if pensions are part of a Collective Bargaining Agreement, obtaining the union's agreement to proceed with fact-based updates to individual plan members setting out the financial health of the plan, the elements of concern for the future and possible solutions;

(ii) Stick to high level guiding principles, to promulgating guiding principles and policies and to follow-on monitoring and evaluation and leave the tactical implementation to the Oversight Board's agents;

(iii) Be diligent in confirming the qualifications, service capabilities, products and performance of consultants/advisors/vendors to serve the needs of the plan in Canada's increasingly diverse and complex pension system;
For the relatively new investment vehicles such as absolute return strategies and hedge funds referred to in Section II C. of this paper, decide whether these strategies make sense keeping in mind the challenges facing the plan and the sponsor and the size of the plan and fund.
If a decision is made to proceed to the next step in the evaluation:
- decide on the 1 or 2 vehicles that are most likely to provide the desired improvement in the risk/return relationship;
- be thorough with the due diligence of the vehicles and the vendor firms;
- insist on steady and timely progress with the due diligence and the formulation of recommendations to make use of these investment vehicles; and
- recognize that a very sizable portion of a fund will likely have to be committed to the recommended strategy for the investment risk/return relationship for the fund to be materially altered.

(iv) Create a sense of partnership and community amongst all suppliers for the good of the plan;

(v) Revisit the "pension deal" to confirm that the interests of the sponsor and plan members are sufficiently aligned. If they are misaligned, consider whether the effort to improve the alignment is worth it;

(vi) Stay on top of litigation and legislative developments[15] for the plan including the litigation exposures for directors, trustees and officers;

(vii) Stay current with the pension standards regulators, especially as they will likely continue to be pro-active for the indefinite future (e.g. who is a fiduciary and when; Bill 30 in Quebec);

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[15] Three of several legal sources that are available in addition to the review of five significant governance-related cases in Appendix C of this paper:
- Hicks Morley Hamilton Stewart Storie LLP's *Client Updates*;
- Koskie Minsky LLP's 63 page publication *Top 20 Pension And Benefits Legal Cases Of 2005*;
- The Bulletin *What's New In Pension And Benefits* prepared by and for members of the Pension and Benefits Section of the Ontario Bar Association as an alert to developments in the law relating to pension and benefits.

(viii) Support management in pressing government policy makers for pension standards regulatory reform, especially with respect to the current asymmetrical treatment of surpluses under DB plans;
(ix) Determine whether the minimum standards are being met in your case and even if they are, consider whether the particular circumstances warrant exceeding these minimums;
(x) Insist on appropriate documentation of the Oversight Board's activities, including agendas, work plans and minutes;
(xi) Insist that agents peer review all materials they provide to the Oversight Board and its Committees and that there is an indication on each document as to who undertook the peer review, the recommendations and date completed;
(xii) Insist on consistent quality between the governance of the sponsor's core business and the governance of the plan with respect to:
  - the control environments; and
  - the annual Board-approved MD&A-type reporting;

(xiii) Network with members of other Oversight Boards to foster the flow of good pension governance ideas; and
(xiv) Focus on effectiveness and strive for continuous improvement in the quality of pension governance.

The Oversight Boards of smaller plans will likely have to exert considerable care in the selection of those elements of pension governance reform that are expected to add the most value in the near term. The medium and larger funds should have the resources to comfortably adopt all of the governance reform suggestions in this paper, over a period of 2-3 years.

When this reform is accomplished, it will lay the foundation that should ensure that the functions are competently handled and that there will be quality oversight by a group that collectively has the relevant competencies and experience and has an inclination to work effectively as a team.

C. Pension Funds As Institutional Investors

There are two other areas where a sponsor's and legal administrator's awareness of the issues and pursuit of a plan of action is advisable:

- continue to pressure the firms whose shares are owned by the fund for higher quality corporate governance, through support of the work of the leaders in this area, such as the Canadian Coalition for Good Governance; and
- upgrade the Board's awareness of "good corporate citizenship" related to environmental and social considerations and formulate a policy based on published peer reviewed research, not advocacy and promotion, that will resonate with the plan sponsor and with most plan members.

The activities involved in upgrading the Board's awareness of good corporate citizenship may or may not lead to a formal "good corporate citizenship" policy and may or may not lead to positive and/or negative screens of investment holdings. However, the research activities and the related deliberations should serve a useful purpose in determining whether a formal policy and guiding principles and whether the related on-going monitoring, are likely to add value.

V. Significance Of Pension Governance Reform For Professions and Consulting Professionals

A. The Integration of Professional Advice

We have entered an era of problem solving where the breadth and the integration of specialty advice from the relevant professions have become critical to an Oversight Board's deliberations. Professional advice is necessary regarding:

- governance for the plan;
- funding deficits;
- whether DB plans sponsors can improve the investment risk/return relationship;
- whether sponsors can continue to fulfill benefit promises;
- whether the pension deal needs to be refined or significantly changed; and
- the management of risk exposures for the plan, for directors, trustees and officers of the sponsor, and for the sponsor.

Further, the interface of thought leadership between professionals, the actuaries, lawyers, accountants/auditors, economists, capital markets specialists, and financial engineers, is likely to escalate as sponsors realize that solutions to the increasingly diverse and complex challenges are of higher quality and emerge considerably sooner when the relevant specialists have the opportunity to interact in real time.

The recent debate focused on financial economics versus traditional actuarial science has been at the profession level and is an example of how professional interaction can considerably improve the collective understanding and better serve the public's interests.

There is plenty of evidence that actuarial-led asset/liability modelling (deterministic and stochastic) and investment specialist-led risk/return relationship modelling will be critical support to Oversight Board decision-making for the indefinite future.

Lastly, the US FASB's decision to recognize the net unfunded status of pension and other post-retirement benefit plans on sponsors' balance sheets together with the high level of interest in strong control environments for the core businesses of sponsors are likely to increase the dialogue that the sponsors and their Oversight Boards will have with their accountants/auditors and in turn with the actuaries and financial analysts.

B. The Actuarial Profession

The governance of the actuarial profession is being strengthened in a number of ways:

- an independent standard-setting process;
- non-members are being added to the Committee on Professional Conduct;
- continuing professional development requirements are being strengthened;
- independent reviews of the work of practitioners;
- a task force on whistle-blowing has been created;
- work on skills and knowledge and inventories is underway; and
- the CIA is striving to have more public policy influence and to be recognized as a key player in matters of public policy.

The actuarial profession has been responsive to the professional leadership needs of its membership in terms Educational Notes, the Reports of Task Forces and Committees and revisions to the By-Laws. The related publications include:

- Pension Plan Funding (January 2003);
- Public Policy Principles in Pension Plan Funding (November 2004);
- Statement of Principles On Revised Actuarial Standards Of Practice For Reporting On Pension Plan Funding (March 2005) and the Report of PPFRC on the Statement of Principles (October 2005);
- Discussion Report On The Role Of The Pension Actuary And Challenges In Professional Integrity (April 2005);
- Report On Financial Economics And Canadian Pension Valuation (2006);
- Actuarial Report Review Projects (2005 and 2006); and
- Splitting the Practice Standards Council into an Actuarial Standards Board and a Practice Council (2006).

With the exception of documents that have been shared from time to time with entities such as CAPSA, ACPM, and the CLC, the above-noted publications are generally available only within the actuarial profession.

The author notes as well the observation in the May 2005 Report *How Should Standards Of Practice Be Set?* "our actuarial standards may lag current developments (both technical and environmental) or legislative changes."

Accordingly, some of us may be asking ourselves:

- is the profession making sufficient investments ?
- is it structured to ensure adequate support to practitioners?
- are we building consensus on important matters on a timely basis?
- is the study curriculum current?
- is the profession's service to the public as wholesome as the members of the profession would like it to be?

The foundation for the profession appears to be strong and that it is a case of leveraging this strength.

For example, The CIA's publication that sets out the roles and responsibilities of actuaries, sponsors, pension standards regulators and tax authorities related to the funding of pension liabilities in Canada's private pension system is a very informative piece and if shared broadly might be a basis that all stakeholders could agree to and could serve as a framework for future thought leadership initiatives across Canada's private pension system.

Also, the author hopes that the actuarial profession will be sufficiently proactive and sufficiently externally focused with its professional affairs, that uninformed journalism such as the January 28^{th} ,2006 Economist Article - "Actuaries And The Pensions Crunch" will never qualify for publication and should such a piece ever be published, the profession will be equipped to respond publicly on a timely basis and with authority.

Because of the CIA's expressed desire to be more actively involved in public policy matters, the author has some sympathy for Daniel Pellerin, the recently retired Chairperson of the Member Services Council, who suggested that "The CIA must expand its inventory of public positions so as to be able to influence societal debates and raise the profile of our profession"(May 2006 CIA Bulletin).

However, if the CIA finds that all of its priorities cannot be addressed, the author senses that the most important ones for the near term are:

- quality and timely governance reform for the profession;
- building consensus on a timely basis on important matters such as standards of practice; and
- getting the considerable thought leadership already in Educational Notes, Reports of Task Forces and Committees, draft Statements of Principles and draft Standards of Practice converted into practical advice on a timely basis for the benefit of plans and funds in Canada's private pension system and conveyed in layman's terms to the broader community.

C. The Actuarial Consulting Professionals

For considering the significance of governance developments to actuarial professionals, it seems natural to divide these professionals into two groups:

- those not close to retirement "as an actuarial practitioner"; and
- those close to this form of retirement.

For the first group, the focus would seem to be on:

- ensuring that one's consulting advice is custom-fit to the unique circumstances of the plan and to the challenges facing the sponsor;
- seeking to integrate this advice with that of other advisors to the plan and the sponsor; and
- stating the position that the Oversight Board needs to hear even if it deviates from what management of the sponsor might perfer.

For the members of the second group who also have an inclination to self-teaching and to serving on Oversight Boards where pension deliberations and decision making take place, the author encourages:

- formal corporate governance education to complement self-teaching initiatives; and
- hands-on experience as a member of the Audit and Governance Committees of the Board of at least one enterprise in the not-for-profit sector.

For many, the latter hands-on experience will broaden and deepen the member's understanding of the core businesses of sponsors, of the best practices for financial reporting (and for controls) and of the good governance protocols of these entities. In turn, this should prompt reform ideas for the pension plans sponsored by these entities.

Members of both groups should continue to assist the CIA in its service to the public including its work with stakeholders to address the current asymmetrical treatment of DB plan surpluses.

VI. Are We Prepared?

The short answer to the question is "not quite".

And, over the longer term, as pension governance reform takes hold, we will likely never be 100% prepared especially since governance reform is about improving effectiveness and involves continuous improvement.

The author hopes that the major themes in this paper:

- CEO and Oversight Board leadership of pension governance reform;
- Oversight Boards being qualified and experienced and each Board working successfully in a collegial environment;
- governance structures, protocols and processes that will assist quality Oversight Boards and agents in performing their functions and in successfully managing all forms of conflicts of interest; and
- a greater sense of community and partnership amongst all suppliers and the corporate executives who retain their services, working for the common good of the plans they support;

will serve as a common focus and rallying point for all stakeholders in Canada's private pension system.

Appendix A: Where To Find More Information On Corporate And Pension Governance

Corporate Governance

1. Hansell, Carol, *Corporate Governance: What Directors Need To Know*, Carswell, 2003
2. Dimma, William A., *Excellence In The Boardroom,* John Wiley & Sons, 2003
3. Dimma, William A., *Tougher Boards for Tougher Times*, John Wiley & Sons, 2006

Pension Governance

1. Hall, Gordon M., *20 Questions Directors Should Ask About their Role In Pension Governance*, The Canadian Institute of Chartered Accountants & The Institute of Corporate Directors, May 2003
2. Hall, Gordon M., *A Call To Action For Boards: Governance Of Employer-Sponsored Pension Plans,* The Canadian Institute of Chartered Accountants & The Institute of Corporate Directors, May 2005
3. Hall, Gordon M., *Pensions: Getting An Off-Balance Sheet Responsibility On-Board,* The Canadian Institute of Chartered Accountants & The Institute of Corporate Directors, February 2006

Appendix B: Clarifications Of Terminology And Concepts

Presently there are elements of terminology and there are some concepts that do not necessarily mean the same to all practitioners and to all readers.

To acquaint the reader with the author's use of these terms and his coaching suggestions, attention is drawn to the following:

(i) "Delegation of the Performance of the Functions" versus "Delegation of Responsibilities".
Many readers have a preconceived notion that "delegation of responsibility" means "delegation of ultimate responsibility" and are surprised to learn that the Oversight Board of the sponsor cannot delegate that "ultimate responsibility". The Oversight Board acting as the principal can delegate the performance of functions to its agents and if it does so, it has the responsibility to monitor and evaluate the performance of these functions by its agents.

(ii) "Policies versus Tactics"
The Oversight Board of the sponsor/legal administrator approves "policies" (e.g. quality of bonds cannot be less than BBB). The agents of the Oversight Board are tactical experts that frequently recommend policy content and are expected to work within the approved policy frameworks.

(iii) "Advice", "Counselling"," Education" for plan members on the one hand and "Awareness", "Orientation", and "Self-teaching" initiatives on the other hand. The first three words "Advice", "Counselling" and "Education" can easily create substantive expectations amongst plan members and new Oversight Board members that were not intended by the sponsors. Accordingly, these words should be used by the sponsors only where they appropriately convey the sponsors' intents.

(iv) "Risks" and "Risk Exposures".
In discussions of the *pension deal*, the word risk is used in a fairly high level and uncomplicated sense to refer to:
- a plan sponsor's exposure under a DB plan to increased funding outlays or to increased volatility in those outlays; or
- a plan member's exposure under a DC plan to uncertainty in the amount of pension that will be available at retirement.

In discussions of a *pension risk decision framework* for a plan and its sponsor, the term risk could refer to:
- risk exposures for the plan, economic and non-economic ones, and whether the capital markets ones are to be hedged; and
- risk exposures for the plan sponsor that flow from sponsoring a plan such as the impact of doing so on the sponsor's credit rating and reputation.

Appendix C: Recent Significant Governance-Related Regulatory and Civil Actions In Canada's Private Pension System

1. **<u>AON Consulting Inc. and J. Melvin Norton</u>** (relating to filed valuations in respect of two Slater Stainless Steel pension plans)

The Pension Bulletin, January 2006 (Volume 15, Issue 1), reported that on **April 11, 2005**, charges were laid alleging a failure to comply with section 16 of the Regulation 909 under the *Pension Benefits Act* and 22 of the *Pension Benefits Act* against AON Consulting Inc. and J. Melvin Norton . All of the charges against AON Consulting Inc. were subsequently quashed on a motion to quash brought by the Defendants. The charges related to actuarial valuations filed in connection with two Slater Steel Stainless Corp. ("Slater Steel") bargaining unit pension plans. The valuations were filed prior to Slater Steel seeking insolvency protection under the CCAA.

Status: Ongoing.

Related Actions: There is a related civil action which was commenced by the administrator of the relevant pension plans appointed under the *Pension Benefits Act* to wind up the plans. The action is against Aon Consulting Inc. and J. Melvin Norton and claims damages for breach of fiduciary duty, among there things, in the amount of $18 million. In addition, FSCO previously made claims against the directors and officers of Slater Steel in the CCAA proceedings in relation to the filing of the valuation reports. These claims were ultimately settled pursuant to minutes of settlement with the Monitor and Receiver of Slater Steel and the directors and officers. The settlement was approved by an order of the Commercial Court.
.
Status of Civil Action: Ongoing.

2. **<u>Canadian Commercial Workers Industry Pension Plan.</u>**

Fifteen charges were laid against the trustees of the CCWIPP in **June of 2006**. The charges relate to the period February 15, 2002 to December 31, 2003. The Plan is a private sector multi employer pension plan (with members in several Canadian jurisdictions) and the charges allege that the trustees committed the offence of failing to exercise the care, diligence and skill in the administration and investment of the pension fund for the Plan that a person of ordinary prudence would exercise in dealing with the property of another person in the course of lending or otherwise investing the assets of the pension fund. Charges were laid after a long investigation by FSCO which culminated in a lengthy Report (and a follow up addendum to that report) . The purpose of the investigation was to assess compliance of the CCWIPP with the Act and Regulation and it consisted of a limited review of certain real estate investments and investment corporations held by the pension fund.

Status: Ongoing

3. **Participating Co-operatives of Ontario Trustee Revised Pension Plan.**

The Participating Co-operatives of Ontario Trustee Pension Plan (the "Plan") is a multi-employer pension plan under the *Pension Benefits Act.* There are a number of interrelated proceedings in connection with this Plan. The Plan is in a significant deficit position. The Trustees made a decision to wind up the Plan effective march 31, 2005 and to reduce benefits accumulated under the Plan prior to that date. In 2005, the Trustees sought to be removed as trustees of the Plan and to have a court appointed receiver appointed to take over the Plan's administration. At about the same time the members of the plan initiated a class action (which was certified by the Court in February 2005) against the trustee and others alleging serious investment losses in the Plan.

More recently, the Superintendent of Financial Services has issued a Notice of Proposal dated April 12, 2006, (a) refusing to approve an amendment to the Plan reducing accrued benefits prior to March 31, 2003, and (b) refusing to approve the wind up of the Plan effective March 31, 2003. The NOP states that the trustees had filed a wind up actuarial valuation as at March 31, 2003 which reflected, in part, the decrease to benefits accumulated prior to the effective date of the Amendment and the fact that the trustees anticipated that no payments would be made under section 75 of the Act. The Superintendent's view as set out in the NOP was that the Plan did not permit amendments reducing accrued benefits. He was also of the view that the participating employers were required under section 75 of the Act to jointly make contributions to eliminate the funding shortfall in the Plan.

Status: The matter before the Superintendent (of the approval of the wind up reports) has been adjourned pending a settlement conference. The class proceeding is ongoing.

4. Wyman MacKinnon v. Ontario Municipal Employees Retirement Board ("OMERS"), Borealis Capital Corporation, Borealis Real Estate Management Inc., Ian Collier, R. Michael Latimer and Michael Nobrega

This is a civil action that was originally commenced in May 2005. The Plaintiff is a union officer (CUPE) and a member of the OMERS Plan. The Court recently ruled (August 2006) that he can bring a representative action against OMERS in connection with its establishment of Borealis Real Estate Management Inc. and the sale to that corporation for $11 million in June of 2002 of OMERS realty business. The claim asserts breaches of fiduciary duty and conflict of interest among other things in connection with this transaction and the fees paid to Borealis in respect of its management of these assets. It has been widely reported that the Financial Services Commission is also investigating the transactions and a report is due in December 2006.

Status: Ongoing

5. Langlois v. Roy [2006] J.Q. no. 448 (*Superior Court of Quebec)

This is a court decision certifying a class proceeding in Quebec against Jeffrey Mines. Jeffrey Mines financial difficulties occurred over a period of several years leading up

2002 and by August 2002 the Company was running an operational deficit of $1.8 million. On October 7, 2002 Jeffrey Mines sought protection from creditors under the CCAA. The company ceased all special payments to the pension plan but continued current service contributions until February 9, 2003 when those also ceased and the Regie des Rentes du Quebec declared a wind up of the Plan. By that time, the Plan had an actuarial deficit of $21,644,000 yielding a solvency ratio of 63.43%, triggering a loss of pension benefits of 36.57% for plan members.

The plan members alleged in their statement of claim (against the committee and the plan's investment consultant) that the asset allocation policy adopted by the Pension Committee over a period of 10 years leading up to the insolvency, and on the advice of its consultants, was reckless in light of the following factors: (a) the plan was a mature plan (b) it had a growing solvency deficit (c) the precarious financial situation of the Plan sponsor Jeffrey Mines. In particular, the Plaintiffs alleged that given the tense ecopolitical climate of September 2001, the Pension Committee ought to have reduced the Plan's exposure to equities and increased its fixed income investments. Instead, the shift towards a more conservative portfolio only took place in October 2002 as the company sought the Court's CCAA protection.

The Court had no difficulty in finding that the plaintiff had met the relatively low threshold of certification under Quebec's article 1003 of the *Civil Procedure Code*. Quebec's Civil Code (article 1343) authorizes a beneficiary to sue an administrator directly.

Status: No decision yet on the merits of the case.

A Call to Action for Boards: Governance of Employer-sponsored Pension Plans

By **Gordon M. Hall** FSA, FCIA, ICD.D

Addendum to *20 Questions Directors Should Ask about their Role in Pension Governance*
Reprinted from *Director*, Issue 118, February 2005

Over the past few years, boards of directors have made strong progress in enhancing the governance structures for their core businesses. A next step to ensure the long-term health of these organizations is stronger board oversight of the pension arrangements they sponsor.

We have recently seen a number of financially challenged employers and restructurings where under-funded pension liabilities have put the interests of shareholders, as well as the pension beneficiaries, very much at risk. Although the sponsors and their plans/funds are separate legal entities, they can easily become one in an economic sense, … in which event the options for the core businesses can be severely constrained.

At the end of 2002, the estimate of the unfunded liability for Canada's private pension system was $225 billion, approximately 27% of the market cap of the S&P/TSX composite and approximately 25% of Canada's gross domestic product at that time. With falling interest rates throughout most of 2003-2004 and the resultant strengthening of pension liabilities, this deficit may well have grown.

Further, my analysis of the merits of government agency guarantees of private pensions suggests that these guarantees are fraught with problems and are not a viable long-term solution to benefit security for plan members.

In addition to underfunding and lack of benefit security, recent developments in Canada's private pension system have led me to conclude that greater board involvement and indeed inspired leadership are now not only warranted but necessary if the pension system is to survive and to thrive. Three such developments, discussed further below, are:

- the *20 Questions* publication and the feedbackon it;
- the current legal environment; and
- the publication of a Canadian Institute of Actuaries Report.

This article also briefly reviews other developments that support a "Call To Action." It concludes with core considerations and next steps for boards that are interested in assuming a greater leadership role related to pension governance.

20 Questions

In the spring of 2003, the Canadian Institute of Chartered Accountants published *20 Questions Directors Should Ask about their Role in Pension Governance*[1]. This document:

- emphasized the need to look at the whole plan and fund, not just the investment performance;
- pointed to a range of risk profiles and the governance elements involved; and
- reminded directors of the dual responsibility of many pension committees — to the beneficiaries and to the sponsor — and the need to identify and rigorously manage conflicts of interest.

The positive response from senior corporate directors suggests that this publication has been a valuable resource to these directors in preparing for meetings and in

[1] For more information on this publication, go to **www.cica.ca**.

understanding the challenges facing the senior managers and the professional advisors who are performing certain functions on the board's behalf.

Current Legal Environment

With the enactment just over a decade ago in Ontario (and more recently in other Canadian jurisdictions) of class proceedings legislation, large numbers of people have access to the courts in initiating cases that would be too expensive or complex for one person to pursue individually.

The recently launched $100 million class action suit against the trustees of the Participating Co-Operatives of Ontario Trusteed Pension Plan, the fund custodian and advisors is a case in point. It is a sobering reminder of the responsibilities of the boards that oversee pension funds and of the expectations that plan members have of them. One of the allegations in the Co-operatives case is that those responsible for investment policy did not have sufficient regard for the liability structure and the type of investment risks that were appropriate for the pension promises made to the current and future beneficiaries. Another allegation is that plan members were not informed about the risk of pension reductions.

Some observers express surprise that directors of a sponsoring entity might be a target for pension litigation, especially since statutes setting out director liabilities in the event of bankruptcy do not include responsibilities for pensions. After all, they are "off-balance sheet" obligations. Nevertheless, when it comes to company-sponsored pension arrangements, board members have the ultimate responsibility for all functions involved in the operation of a plan and fund.

David Gavsie's explanation of the legal considerations in the Supreme Court decision in the **People's Department Stores Inc. (Trustee of) v. Wise** case (see the November 2004 issue of the *Director* newsletter) may be of assistance in understanding why directors are a real target for pension litigation. As there is no rule specifying that a director has no liability, then the normal exculpatory corporate law rules apply to directors. Consequently, in the event of a claim against one or more directors of a sponsor, the two duties — fiduciary duty and the duty of care — and whether the directors exercise them properly will come under scrutiny. Fiduciary duty deals primarily with conflict of interest issues. The duty of care is best expressed by the phrase "business judgement," which focuses on whether or not the directors carried out due diligence in making the decision and in whether he or she made a reasonable decision … not a perfect one. As long as the process is followed, a court will not likely interfere with the decision made by the board. In pension matters, putting one's head in the sand, being oblivious to the issues, and assuming that management and actuarial advisors to management have things in hand can be a recipe for disaster because the board would not be carrying out due diligence and hence would blow its "business judgement" cover. The need to be diligent is reinforced in the Pensions Benefits Act, where the fiduciary standard and the duty to monitor are also set out.

In summary, the board of a pension plan sponsor has an ongoing responsibility to monitor, evaluate and confirm the quality of performance of functions that have been delegated to others and it can be the target for pension litigation if it fails to discharge this responsibility.

Recent Report from the Canadian Institute of Actuaries

A November 2004 Report of the *Task Force on Public Policy Principles of Pension Plan Funding* from the Canadian Institute of Actuaries (CIA) proposes some changes in actuarial practice and reporting that are expected to improve the transparency of the pension "black box." Selected proposals, if adopted, should lead to more attention to the financial management of the liabilities of pension plans and contribute to a stronger governance environment.

The CIA *Report* addresses a number of matters including:

- the actuary's role in providing guidance on the funding policy to support the funding objectives adopted by the sponsor;
- appropriate provision for adverse deviations;
- equity among cohorts of contributors;
- the expected stability of contributions as part of the actuary's report;
- more guidance on the process of selecting assumptions for funding valuations;
- greater transparency in the funding policy, with the numbers and assumptions involved in amortizing gains and losses; and
- a best-estimate assumption for the rate of investment return, with a provision for adverse deviations.[2]

This last point is an important development as it involves the sponsor in an important risk management decision. Specifically, for a sponsor with low or no tolerance for volatility, the provision for adverse deviation would reduce the interest assumption to that of the risk-minimizing portfolio.

The CIA *Report* is well researched and written, but it is not light reading. Although the Report is mainly directed to the actuarial profession, it raises issues and questions that those with an interest in pension plan and fund governance will likely want to explore. The report is available at www.actuaries.ca.

Other Developments

There are a handful of other developments since the publication of the *20 Questions* document in 2003 that also support this Call To Action.

Firstly, there is an increased awareness that Canada's private pension system is based on the presumption that all sponsors will continue to enjoy good health.

[2] The investment return includes the risk premium based on the plan's investment mix. The provision for adverse deviations needs to be appropriate for the sponsor's tolerance for risk and volatility in future contribution requirements.

Accordingly, it is no surprise that flaws in the system surface as soon as sponsors experience financial distress and the continuation of contributions to fund the promised pension benefits becomes a burden.

Secondly, there have been a number of criticisms recently about the burden that pension arrangements represent for certain employers, leading to suggestions that plans be wound-up and the full responsibility for dealing with retirement security be left with employees. In practice, this often takes the form of cancelling the defined benefit promise for future service or converting to a defined contribution arrangement for all years of service. Under these circumstances, certain investment risks are transferred from the sponsors to the employees, but the sponsor maintains the monitoring responsibilities while taking on obligations regarding the education of plan members and the offering of a menu of investment options.

Thirdly, there is considerable focus currently on the formalization of processes to manage and mitigate a wide range of risk exposures for the core businesses. The assessment and management of the risks arising from sponsoring pension arrangements should be part of the sponsor's framework for enterprise-wide risk management, unless there is clear evidence that the plan and fund are not expected to be material in financial terms relative to these core businesses.

Fourthly, governance enhancements that address weak or ineffective management and/or oversight are expected to generate direct financial benefits. For example, fiduciary liability insurers now underwrite and price fiduciary liability risk exposures based on the quality of the entity's pension governance policies and procedures. As well, D&O insurers have signalled that they plan to take the quality of pension governance into account when deciding on the amount, quality of contractual provisions and the rates for this coverage for the sponsor.

Board Leadership: Core Considerations

Because of the need to exercise their duty of care, directors serving on the pension committee (and they are acting on behalf of the full board) must be equipped with the experience and knowledge to ask relevant and tough questions of management and of third party suppliers across the full spectrum of functions involved in sponsoring a plan for employees, including:

- benefit appropriateness: When pension enhancements are granted, can the company bear the freight, now and 30 years from now?
- security of benefits: Is the “pension deal” being presented honestly to the beneficiaries including those who will retire in five years and in 30 years?
- appropriateness of investment strategies in light of the liability profile and the larger framework of enterprise-wide risk management for the sponsor;
- proposed changes to accounting standards and investigations into compliance with these standards (e.g., the current SEC investigations into compliance with FAS 87/106);
- protection of the privacy of member data;
- disaster recovery for systems storing data and processing entitlements; and
- disclosures of the material elements to the relevant stakeholders.

It is not enough to just track investment returns or to question the assumption regarding the investment return on assets for the next year for the accounting valuation.

The pension committee, together with management, should also take the longer view and gain a full understanding of “liability-oriented investing.” The latter includes matters such as:

- deciding whether to invest to achieve “stable nominal” or “stable real” returns;

- new forms of investment that will ensure that total fund returns will measure up to those assumed in the most recent valuation of the liabilities;
- explicit recognition of the relationship between investment risk and the stability of future contribution requirements;
- for mature funds where cash flows are negative, initiating refinements to the long-term asset mix to avoid having to sell equities in a bear market to meet benefit disbursements; and
- attention to the currency mismatch risk (e.g., the pension liabilities are 100% in $Cdn and up to 30% of the assets are routinely invested in non-Canadian $ securities).

Statutes and income tax law set out minimum and maximum funding constraints. The pension committee should have a clear understanding as to where the sponsoring employer, given its industry and longer- term financial health and risk profile, should be on the spectrum.

Also, part of the leadership related to pension governance is to ensure meaningful disclosure to stakeholders of all significant risk exposures that are part of the operation of the plan and fund.

To effectively discharge one's responsibilities as a pension committee member, most, if not all, members of the committee must be "pension literate" and some need to be pension specialists — analogous to the current requirements and best practices for financial expertise for the audit committees of boards. And, there needs to be a diversity of specialists on the pension committee — capital markets advisors, economists, actuaries, lawyers — to ensure that the oversight is suitably comprehensive.

While there are a number of pension specialists in the business and professional communities, there may not be an abundance of these specialists who are able and willing to undertake oversight in the broader context of a corporate director. This deficiency can be addressed in a couple of ways: formal broadly based director education at the ICD Corporate Governance College and/or the use of Pension Advisory Boards.

Lastly, legislation, regulation and certain litigation have discouraged several sponsors in recent years from funding beyond the bare minimum. There need to be changes in pension benefits and income tax legislation to address the current anomalies especially those involving surplus ownership and arbitrary limitations on funding under the Income Tax Act. Legislators and regulators, with sponsor input, need to rethink a number of positions. Given past experience, this will likely take some time.

Next Steps

Boards of sponsors who decide to take the lead on pension governance should:

1) signal to the managements and advisors they oversee that governance enhancements for company sponsored pension arrangements are a top priority;
2) embrace an evolutionary approach to good pension governance. It is unreasonable to attempt to formulate high quality policies and procedures and to introduce strong management and oversight overnight. However, in the near term, a board can be very demanding regarding:
   - the introduction of a quality governance structure … one which will readily accommodate new/upgraded governance elements as they are formulated; and
   - significant and steady progress in terms of identifying and dealing with priority governance matters for a specific plan/fund;
3) focus on:
   - the total plan and fund; and
   - guiding principles for each of plan design, funding, and investment and on making sure that these guiding principles are consistent with and mutually supportive of each other;

4) confirm that there is a sound delegation of the performance of functions in the operation of the plan and fund, and that the monitoring, reporting and evaluation procedures are also sound;
5) confirm that directors serving on the pension committee have the knowledge and experience appropriate to discharge their responsibilities; and
6) ensure that risk strategies look at both the financial health of the sponsoring company and the security of the pension promises made to pension plan members and beneficiaries.

In Summary

We have entered a new era in corporate governance and enterprise-wide risk management. Corporations have made considerable progress in enhancing their governance and in mitigating critical risk exposures for their core businesses. A next step in ensuring the long-term health of the organization is stronger board oversight of the pension arrangements they sponsor for their employees.

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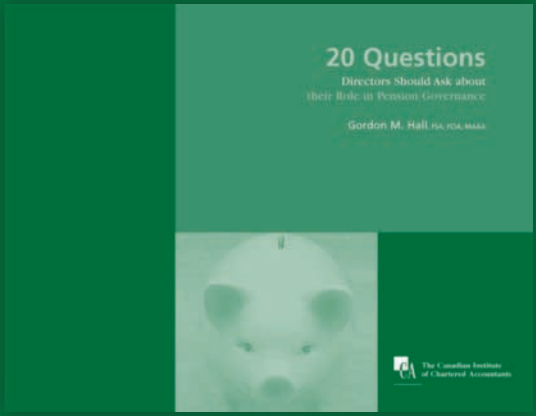
Pensions: Getting an Off-balance Sheet Responsibility On-board

What Works in Practice

By **Gordon M. Hall** FSA, FCIA, ICD.D



Addendum to *20 Questions Directors Should Ask about their Role in Pension Governance*

Reprinted from *Director*, Issue 124, February 2006

Most employer-sponsored pension plans, both defined benefit (DB) and defined contribution (DC), are essentially off-balance sheet items for the plan sponsor. For any company that has been established for some time, the obligations are usually significant — in terms of both financial and human impacts and possible legal challenges. The quality of pension governance should measure up favourably to that of the main lines of business. In particular, boards need rigour and clarity around oversight of the many agents acting on their behalf in running the pension arrangement. But, formulating a framework for guiding agents in their handling of delegated functions and for allowing the board and its agents to assimilate and integrate new developments requires more rigour than most boards have at present.

This article covers:

- examples of recent developments that make the case for board leadership with the governance of employer-sponsored pension arrangements; and
- protocols that boards are starting to use to ensure a focused and efficient result.

Recent Developments

The financial impact of the pension plan on the main business lines can be material. Pension arrangements were a critical part of the financial failures or near failures of some Canadian companies (Air Canada, Algoma Steel, Stelco). The board has a responsibility not only to shareholders but to plan members.

These off-balance sheet arrangements are a particular challenge, especially in companies where their workforce has matured to the point where the liabilities for pensions-in-pay have outgrown the liabilities for their active workforce. There is a justifiably high level of current interest in liability-driven investing. It is no longer good enough to monitor the return on investment. For DB arrangements, if the level and volatility of the sponsoring employer's contributions are to be contained within reasonable bounds, the investment strategy must take into account the liability profile.

Addressing this off-balance sheet challenge becomes more complex as the long-term Government of Canada bond yield has continued to fall. At the time this article was written, the yield was just above 4%. There are two important funding valuations:

going-concern valuations that anticipate continuation of the plan into perpetuity and solvency valuations that are a proxy for a business termination result. Actuaries are rightfully advocating lower discount rates for determining the present values of liabilities for going-concern funding valuations, which may well call for increased contributions from sponsors of DB plans. The discount rate for solvency funding valuations of DB plans also continued to fall as required by statute. This downward trend is leading to sharply higher liabilities for these solvency valuations.

A diversity of investment strategies has emerged, such as interest rate hedging for defined benefit plans and increased exposures to oil and commodity prices. There is now a similar diversity of new investment vehicles, such as income trusts and infrastructure investing.

The limit (previously 30%) on the portion of the pension fund that can be invested in capital markets outside of Canada has been eliminated. This was welcome news. It means, however, that the pension investment strategy may well require more consideration of the currency exchange risk that goes with increased international diversification. Currency exchange risk warrants careful attention, as all plan liabilities are denominated in Canadian dollars and the short-term swings in exchange rates over a two to three year period can be considerable.

New investment strategies are also governance challenges for DC plan sponsors. Do the investment choices now offered to participants reflect the new investment strategies and vehicles? Are the rather long lists of investment choices presented to participants confusing or helpful? Where investment choice is offered to the plan participants, have they been made aware of the opportunities and risks, and have they been equipped with sufficient knowledge of capital markets and with the tools to make informed decisions? If not, a company … and its board … may be confronted by soon-to-be pensioners who come to realize that their "pension deal" is really not a deal at all.

Guidelines for the operation of Capital Accumulation Plans were promulgated by the Joint Forum of Financial Market Regulators in May 2004, to become effective December 31, 2005. They codify the minimum governance standards for all tax-sheltered defined contribution plans that offer investment choice to plan members.

Currently, compliance with these guidelines is on a voluntary basis. In a recently published commentary, Mercer Human Resource Consulting suggested that DC plan sponsors fall into two broad groupings: those with a formal governance structure that complies fully with the Guidelines and those without a formal governance structure who would be wise to revisit their responsibilities.

Lastly, a recent communication from the Canadian Institute of Actuaries suggested that members of the actuarial profession have the duty to put the financial security of plan participants front and centre and over and above the sponsor's own commercial interests. If this duty presents a conflict of interest, the board of the sponsor must manage it.

Getting Pension Governance On-board

Board leadership on pension governance matters is taking hold and there are some excellent examples of "what is working in practice".

Boards need to provide guidance at a high level for:

- the functions whose performance has been delegated by them to management and to external service providers and advisors; and
- the strategy and tactics of these diverse specialists with respect to their impact on the current and future performance of the pension arrangement as a whole.

The benefits of board-adopted protocols to guide and evaluate these activities are now apparent.

My board experience suggests that a framework made up of the following board-adopted protocols is key to the board's success in discharging its responsibilities in a focused and efficient manner. The protocols include:

- rigour and clarity for all principal and agent dealings;
- terms of reference for parties performing functions on the board's behalf;
- beliefs and guiding principles for each of plan design, funding, investment and communications/disclosure; and

- a code of conduct with guidance for management and external service providers and advisors regarding their handling of functions delegated to them by the board.

With this framework in place:
- the diversity of specialist input on critical matters can be readily addressed;
- the merits of new opportunities and best practices can be evaluated; and
- risk exposures can be evaluated and mitigated.

The balance of the article discusses each of the above noted protocols.

Principal and Agent Dealings

The board of the sponsor is the genesis of the pension deal. At the introduction of the pension arrangement, the board sets down the rights and responsibilities of all parties and is responsible for ensuring that the terms of the deal are unambiguous and are respected.

With employer-sponsored pension arrangements, conflicts between competing interests are common. Boards must, for example, balance the interests of pension plan members and shareholders. Boards should also be aware that the actions of agents (the management and staff of the sponsor, the external advisors and the service providers) are not always aligned with the interests of the principals… that is, the boards.

As well, in the absence of board guidance, agents are inclined to draw inferences and jump to conclusions regarding the strategic directions that the principals would otherwise choose had there been wholesome deliberations on the matters of greatest strategic importance. Further, agents do not always seek advance guidance regarding the handling of conflicts of interest even though the matters may be problematical.

Addressing these matters in advance minimizes the negative impacts that inevitably emerge.

Terms of Reference for Agents

Formal terms of reference — sometimes called mandates or charters — make sense for the work of the principal and the work of all agents to whom the performance of specific functions has been delegated. The required work occurs in various forums (e.g., the full board, a board committee and/or a management committee).

These terms of reference typically specify:

- the scope of responsibilities of each forum with guidance on whether they analyze, recommend, or approve;
- operating guidelines that focus attention on the methods and processes and signal in advance what is appropriate when dealing with the property and the confidential information of plan members;
- the composition of each forum, including guidance for member selection and on the resignation, termination and removal of members;
- the remuneration of the members of each forum;
- reporting policies and guidelines; and
- periodic review of the quality of performance of each forum.

The terms of reference documents for external advisors and service providers are generally in the form of formal service contracts.

Management and staff of the sponsor, through their deliberations with the board committee providing oversight on pension matters and with the external advisors and suppliers, make a pivotal contribution in helping to ensure that the diversity of specialist input is appropriately assimilated and integrated for presentation to, and discussion with, this committee.

Statements of Beliefs and Guiding Principles

A formal strategic framework for the management of the pension arrangement that captures the agreed-upon understanding for plan design, funding, investment and communications/disclosure represents a major step forward in ensuring that:

- the day-to-day handling of the delegated functions is pursuant to this agreed-upon knowledge; and

- there is an integrated platform upon which the body of knowledge and the governance practices and protocols can evolve.

This formal strategic framework typically contains:
- specific sections that set out the beliefs and guiding principles for each of the four elements noted above; and
- general direction that reminds the agents that all plan and fund-related activities are to comply with legislation and that guiding principles are intended to be consistent with and mutually supportive of each other.

For example, the statement of beliefs and guiding principles for plan design might set out expectations and understandings related to the shared responsibility between the sponsor and plan members for saving for retirement and the degree of flexibility available for providing program enhancements, such as unreduced early retirement pensions.

The statement of beliefs and guiding principles for funding a DB arrangement might set out expectations regarding the stability and predictability of contributions by the sponsor and the level of certainty regarding the security of benefits under the pension arrangement.

The statement of beliefs and guiding principles for investment might set out expectations regarding the ability of selected asset classes to offer inflation protection as well as the expectation that investments in established foreign capital markets will lead to higher total investment returns over the long term than if the fund is invested solely in Canadian capital markets.

The statement of beliefs and guiding principles for investment is the accepted body of knowledge/beliefs that serves as valuable input to the quantitative targets and limits/constraints found in the compliance-oriented Statement of Investment Policies & Procedures (SIP&P), as required by the Pensions Benefit Act.

The statement of beliefs and guiding principles for communications/disclosure might reference the most substantive risk exposures borne by the sponsor and the plan members respectively and the expectation that diligent and informed handling of specific functions is expected to mitigate these risks. Litigation involving pension plans frequently pertains to gaps or errors in disclosures to members. Guidance to the board's agents can be very effective in mitigating this risk exposure.

Code of Conduct

A code of conduct applies to all involved in the performance of functions and in oversight and typically:

- sets out general standards of conduct (e.g., high standards of ethics, competence and integrity) and a stated expectation that applicable professional standards will be respected;
- outlines the strategy for the stewardship of the funds that provide the security for the pension promises;
- specifies a range of objectives, such as the desire to reduce the risk and associated costs of fraud and misappropriation of fund assets;
- provides guidance regarding member relations, the handling of conflicts of interest, confidentiality, privacy standards, safe-disclosure (i.e., whistle-blowing), and relations with external agents and advisors; and
- sets out protocols for the monitoring and investigation of infractions of the code and any resulting sanctions.

In Summary

Board leadership on pension governance matters is taking hold, and support from interested parties is building. However, many of the challenges are multi-faceted and must be carefully considered by the board before quality and enduring governance protocols will be commonplace.

These are substantive but worthwhile challenges. After all, sponsors of pension arrangements are dealing with other people's monies. They are the parties who formulate the pension deals and who have the obligation to ensure that the deals are respected.

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