

Ensuring Pension Fund Governance is Fit for Purpose

Report by Brian Holden, MBE

November 2008

About the Author

Brian Holden has had 40 years' involvement in the trusteeship and governance of occupational pension funds. He took early retirement in 2004 and continues to coach trustees and pension boards in successful pension fund governance.

He is also Chairman, trm Advisory Service, Trustee Risk Management Limited, UK (a subsidiary of The Occupational Pensions Defence Union – opdu) which facilitates good governance and sound risk management of occupational pension funds.

He was the founder chairman of the UK Trustee Code of Practice Group, which successfully developed and published a code of practice for pension fund trustees in 2002. In 2005, he produced a user-friendly internal control model for trustees and pension boards, which is freely available on CD to pension funds.

His name is synonymous with the best in lay governance and he has successfully advised on the lay trustee/pension board structure and involvement for over 400 pension funds. He has written a book on good pensions governance. He is a familiar figure to many in the world of pensions, but is perhaps best known for tireless efforts on behalf of lay trustees and pension boards, for which he has been called “the trustees' champion”.

He was previously commissioned to undertake a review of pension fund trusteeship in the UK and his independent report “Putting structure into the system – a review of pension scheme trusteeship” was published in November 2006.

His work was recognised in 1998 when he was awarded the MBE for services to occupational pension funds.

About this Review

The invitation to undertake an independent review of the governance principles and structures of occupational pension funds is extremely timely and comes at a time when pension fund governance is, once again, at an all-time high. During the last decade or so, whenever there has been a review of pension funds – by governments, industry bodies or academics – it is always governance that remains firmly in the spotlight.

Questions are continually being asked whether pension fund governance remains fit for purpose in the current legal, financial, regulatory and demographic environment for work-based pension funds. What are the risks associated with running pension funds? What are the current approaches to governance that companies use to manage these risks?

My initial research drew on three main initiatives:

- Via a dedicated, and confidential, IPE email address I asked those involved in, or interested in, pension fund governance to consider a range of questions [see Chapter 1]. Respondents represented a wide range of pension fund interests.
- These principal issues were also the subject of a ‘user-friendly’ web-based questionnaire which respondents completed on-line [see Appendix 2].
- To supplement the above results, and to draw more detail out of these responses, I conducted a short programme of qualitative research, comprising in-depth interviews with trustees and pension board members, advisers and other participants in the wider pensions environment.

I would like to thank those who contributed to the research and who, for reasons of confidentiality, did not wish to be named.

In addition I drew on information publicly available on a number of “pension web sites” across Europe, including governments, regulators, pension associations, and EU committees and associated bodies etc.

I would like to thank IPE magazine and its editorial staff for their assistance during the review stages. Also, I must thank colleagues and friends in the pensions industry who have been willing to provide comment (whether critical or supporting) on some of my intentions etc. In particular, I would like to thank Pioneer Global Investments Limited who gave enthusiastic support to my review and to The Occupational Pensions Defence Union [OPDU] who put the outline of my review on their website, thus enabling me to have access to over 350 of its pension fund members.

However, at the end of the day the words in this report are mine and I take full responsibility for them. I hope that this report will be read and considered against a backdrop of a fast-moving and still, very confusing, environment for those involved in pension fund governance.

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PS: It is important that discussion and debate about effective pension fund governance should continue with a regular exchange of views on the continuing governance scene. Chapter 15 [Conclusions] recommends a European way forward. In addition, I would welcome your views and opinions after reading this report. Please respond to: **governance.review@ipe.com**

Sponsors' Letter

Some European countries are fortunate enough to have a robust and functional occupational pension system that provides a secure retirement income for participants, while providing employers with relatively stable contributions and a valuable human resources tool. A robust second pillar pension system is highly beneficial in lessening the burden carried by increasingly unsustainable state pension systems.

The outlook for pension systems in many countries, however, is not so rosy. Private pension provision faces a crisis of confidence either due to funding and participation levels or a sub-optimal legislative and regulatory framework that prevents the system from working well.

All countries are faced with heightened legislative and regulatory complexity coupled with an ever increasing requirement for investment sophistication on the part of pension fund fiduciaries. The proliferation of investment concepts and new asset classes increases this burden, especially on non-professional pension fund board members and trustees.

This report recognises that all pension fund investment boards should aspire to best practice in governance, regardless of size or location. This is especially relevant given the increasing influence of the institutional investment community on wider corporate governance issues. There is also a need for the pension fund community to adopt best practice, especially if intrusive and excessive further regulation is to be avoided.

The recommendations of this report are highly valuable in that they do not seek to promote any one country's pension system. Neither do they put forward a complex or unworkable blueprint. Instead they offer up a robust and flexible best practice framework for the structure of an occupational pension organisation that can be adapted to the needs of regulatory and supervisory frameworks in different countries, as well as to the unique requirements of funds themselves.

The recommendations are also intended to promote a debate. And this is a debate that we intend to support in the coming months and years. A European Governance Forum – a coming-together of practitioners from all countries and backgrounds – would be a positive next step that could provide a valuable marketplace of ideas in promoting best practice between countries and all those interested in the maintenance and furtherance of occupational pension provision.

We join Brian Holden in seeking your views on how this debate should continue and we hope this report will serve to stimulate this discussion.

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Executive Summary

Overview: a question of trust

- Pensions are in a state of flux throughout Europe. Governments, media, company boardrooms, trade unions, and workers (who, after all, are tomorrow's pensioners) all agree.
- Healthy dialogue is essential, not just between national regulators and supervisors but with all key stakeholders in today's new, more transparent, pensions environment.
- New challenges are facing employers and governing boards. Many organisations are reassessing the nature of their pensions promise to the wider workforce, sometimes at home and overseas
- Many of the changes over the years have been to increase legislation. Each change has been apparently well-intentioned, and often necessary, but the cumulative effect has been counter-productive.
- We need to build on a consensus for the future and to develop a framework for effective pension fund governance.

Governance short and simple

- 'Governance' is the pensions 'buzzword' of the moment. Governance has become a significant part of business life.
- The governance of pension funds depends on the specific framework of each country and, despite some 'European changes', pensions are still very much a national affair, including the roles of the national regulators and supervisors.
- But what is pension fund governance? Short and simple: "Is the business done properly and seen to be done properly?"
- The first principle of good governance is to provide transparency towards the pension fund's stakeholders – i.e. the fund's sponsoring employer and the beneficiaries.
- It is the system of governance and regulation and the public perception of occupational pensions that is at stake and the system must have the confidence of the stakeholders.

The European dimension

- Recent European debate on pension fund governance has focused on the contribution that regulatory and governance structures make to the effective performance of national pension systems.
- Can "non-professional" governing boards continue to contribute positively to pension fund governance in an era of increasing investment complexity and uncertainty, the challenge of funding requirements and continuous regulatory change?
- The European Directive 2003/41 is the basic regulatory framework for funded pension providers with a workplace connection.

- Europe is changing and there is a shift from defined benefit towards defined contribution funds. This presents a major challenge to governments, companies and employees. Pension provision must be modernised.
- Is the regulatory burden aimed more at achieving unrealistic levels of security rather than delivering affordability? Have national regulators over-reacted to events and, as a result, magnified their effects?

The Employer perspective

- An employer's reputation, financial results, workforce productivity and industrial relations are all affected by risks associated with providing and operating pension funds.
- Companies have a responsibility to their shareholders to see that the costs of providing pensions yield business benefits.
- Pension funds are subject to considerable external and regulatory scrutiny which can have a profound long term impact on a company's pension obligations.
- As a result, there are calls for stronger and more effective pension fund governance practices.
- It is imperative that company directors understand their company's pension issues and are competent to deal with them.

Regulation and supervision

- European legislators and regulators may be tackling the issue of pension governance, but there is still a long way to go.
- The main objective of pension fund regulation is to promote the stability, security and good governance of pension funds, and to protect the interests of members and other beneficiaries.
- The OECD's latest draft revised guidelines are part of a broader effort to strengthen public confidence in private pension systems. The focus of these revised guidelines is mainly based on prudential supervision, but raises new issues including the need for balanced representation of stakeholders on pension fund boards, greater expertise and knowledge and risk-based governance systems.
- Regulators have over-reacted to market and industry events and, in some circumstances, have magnified their effects.
- Pension funds need to adopt a smaller number of simplified, higher-level principles and, preferably, on a pan-European basis.

Experience and qualifications

- The EU Pensions Directive states that a pension fund must be "run by persons of good repute who must themselves have appropriate professional qualifications and experience or employ advisers with appropriate professional qualifications and experience".

- Are we now expecting too much from many governing boards and should the burden be taken out of the hands of lay boards?
- Whilst member involvement is a worthy concept, any insistence that a proportion of a fund's governing board must be "member-nominated" will not on its own improve governance.
- The argument is now being advanced that members of governing boards must possess appropriate professional qualifications to deal with the complexities of modern day pension funds.
- Has the time arrived when qualifications are no longer just "nice to have" but essential to the success of the pension fund?

Governance and internal controls

- The time has come when we must look at pension fund governance as a whole, and not in the piecemeal approach adopted by governments and regulators.
- Public policy demands high standards of pension fund governance.
- It is essential to ensure that no further disincentives are introduced into what has become an increasingly difficult environment for pension funds to flourish.
- The ongoing universal debate has drawn attention to the "what", "why", "when" and "who" of pension fund governance. Participants are agreeing on what good governance should involve, why it is necessary and when it should be undertaken. However, who should be responsible for this increasingly complex activity is not an issue that has been the subject of sustained debate and discussion.
- If society wants broadly-based boards to supervise the successful operation of the pension fund, we should be moving towards a two-tier system of pension fund governance.

The Governing Board's chairman and secretary

- Leadership and direction is a necessary function of specific positions, enabling the board members to fulfil their responsibilities for overall governance and strategic direction.
- The purpose of a Chairman is to provide leadership and direction to the members of the board and to ensure the fund is run in accordance with its legal documentation and national legislation/regulation.
- The purpose of a Secretary is to liaise closely with the Chairman so that all board members discharge their duties efficiently and effectively, and to support the board's administrative business.
- These positions are of crucial importance to the success of the governing board.
- Where there is a substantial "lay" involvement, there is a weak link in the chain that now needs to be scrutinised.

Understanding the risks

- Everywhere, the pensions sector has undergone an unprecedented transformation over recent years.
- There is now an increasing tendency to seek recompense for failures and inadequacies.
- Potential conflicts of interest are now commonplace.
- The plethora of legislation and regulation has now ensured that governing boards have a mass of potential exposures.
- Should protection for governing boards now be mandatory?

Risk versus reward

- Employers have seen the gradual transformation of pensions from a “best endeavours” gratuity into a binding contractual promise with increasing regulation.
- The move towards greater transparency has put governing boards firmly into the limelight.
- There is now an increasing cultural shift from DB to DC.
- The role of the governing board has expanded significantly and choosing the right people is crucial.
- Companies are thinking twice about whether the risk/reward ratio is appropriate.

The art of the possible - “bolting on” to what we have

- Alternative structural changes to existing governance systems are being explored.
- The practice of Fiduciary Management is increasing in popularity. What does it offer? Is it understood? What it is – and is not.
- Independent (i.e. professional) members are joining some governing boards.
- Can the board function be completely outsourced?
- Can “bolting on” bring the right mix of experience?

The principal question to be asked

- As representatives of pension fund beneficiaries and fund sponsors, how can “lay” individuals (whether they are fund members or company executives) continue to have a role to play in the governance and supervision of their pension funds?

An ideal structure

- New business models are needed, but important issues must first be addressed.
- Governance in the 21st century inherits a major challenge.
- There is an overwhelming consensus that the role of “lay” fiduciaries should come under greater scrutiny.
- Governance has become increasingly clouded and confused because those responsible are also inextricably linked to the day-to-day management.
- Can “lay” representatives continue to supervise the governance function?

Is there a will?

- When we seek to incorporate a structure of “lay” involvement then the debate becomes less clear.
- We must review the “bigger picture” and develop a more business-like position on lay involvement.
- Government attempts to “simplify” pension systems have resulted in more complications and complexities.
- Politicians’ short-term considerations and lack of realisation is not good for pension fund governance.
- Will more complexity follow across Europe?

Principal conclusion

- Pension Fund Governance Principles And Practices Need Re-Balancing:-
 1. A new two-tier governance model to involve both “lay” and professional with a Fiduciary Body and a Board of Governors.
 2. A Code of Pension Fund Governance to provide guidance and assessment for high governance standards.
 3. A European Pension Fund Governance Forum to involve pension fund stakeholders in exchanging views and solutions.

What it's all About

As an important contribution to the review, I sought views and experiences on the governance of pension funds in different national systems.

This initial contact with interested parties included a number of fundamental points:-

- What are the main objectives in any model of pension fund governance?
- What is the governance method for your fund? Is it trust-based, pension board, supervisory board etc?
- What is the board constitution? How many representatives from employer(s), employees, others?
- What are the main strengths of this method of governance?
- What are its weaknesses?
- How do you think that it might be improved?
- What are the main strengths of contract-based models?
- What are their weaknesses?
- How do you think these might be improved?
- Do you think that current governance models need replacing?
- If so, with what?
- Should any particular distinction be made between defined benefit and defined contribution funds when determining an appropriate governance model?
- Should smaller companies/pension funds be subject to any particular considerations?

Responses to these important questions disclosed some major concerns about many principal pension fund governance issues. These can be summarised as follows:-

- What is pension fund governance?
- The fiduciary responsibilities of the trustees, the pension board and the company.
- Pensions from the company perspective.
- Pension fund regulation and supervision.
- The experience and qualifications of trustees and pension boards.
- Ensuring workable governance processes and internal controls.
- The role of the trustee board/pension board chairman.
- What are the alternative governance structures and systems?
- Is there an ideal structure?
- Protecting the fund and the trustees/pension board members.
- Is there the necessary will for change?
- Can pension funds, their trustees and pension boards help each other?

I have studied, reflected on, and discussed the views and opinions given by all of the respondents and the results of this dialogue are expressed in the chapters of my report.

Appendix 1 briefly summarises the structures in different European countries, e.g. trust-based, contract-based, pension foundation, joint-stock company, non-profit organisation, mutual, association, co-operative etc.

Appendix 2 sets out the web-based questionnaire that was available for respondents to complete on-line.

Overview: A Question of Trust

Pensions are in a state of flux throughout Europe. Governments, media, company boardrooms, trade unions, and workers (who, after all, are tomorrow's pensioners) all agree. Pensions influence almost every facet of daily corporate life, but they are not an insoluble problem. Regaining control over company pension funds, and managing the costs associated with them, requires holistic commercial thinking and not just actuarial and legal know-how. Some companies are looking at more innovative strategies to manage pension fund risks, but many are still struggling to come to terms with their new and unwanted problems.

Healthy dialogue is essential not just with national regulators and supervisors but with all key stakeholders – trustees, pension boards, pension fund members, trade unions, shareholders and lenders in today's new, more transparent, pensions environment. Trustees and pension boards, as well as the company board, have increased responsibilities and risks, and are under increased scrutiny from stakeholders. There is renewed focus on pension fund risks and how a high quality system of controls should be an integral part of effective pension fund governance. New challenges are facing company directors, trustees and pension boards. Many companies are having to reassess the nature of their pensions promise to the wider workforce, sometimes at home and overseas. Companies have to balance inequities arising from the closure of defined benefit funds and reassess the role that pensions play as part of the overall reward in the employment package.

Many of the changes over the years have been to increase legislation. On the face of it, some of these changes provide a strong foundation where pensions are secure and valuable to members, but the reality is that many pension funds have been forced to close in the face of rising costs. It is hard to argue that the deluge of pensions legislation over the last 15 years or so has been largely beneficial. In some cases, each change has been apparently well-intentioned, and often necessary, but the cumulative effect has been counter-productive.

When we read media headlines about savers losing confidence in financial institutions, we are reminded of those members of defined benefit pension funds who have suffered reductions in their pensions due to the wind up of funds in deficit. A lack of confidence in pension funds is often cited as a reason for individuals not to join their employer's fund or to make any proper provision for their retirement.

In a well managed pension fund the membership will not, however, be aware of the time spent by the governing board in fulfilling its responsibilities and its approach to risk and governance if they are not told. It is, therefore, essential for boards to develop and implement communication plans that set out the actions that the board has taken to ensure compliance with the law and high standards of governance. Transparency and openness are key to gaining the confidence of members and potential members.

Confidence in the pension fund should also extend to the employer. A well run pension fund in which the members have confidence will enhance morale and give a greater appreciation of the investment being made by the employer. The employer should be seen to work with the governing board and to support the board's funding objectives. The governing board should also be seen to be sympathetic to the other demands on the employer's cash flows, whilst achieving the best funding rate for the benefit of the fund's beneficiaries.

In essence, a question of good communication between the governing board, the company and the fund members. Members of pension funds must be satisfied that the governing board, responsible for the operation of the fund, is acting in their best interests and that proper procedures and controls have been established to mitigate the risks that exist. Appropriate action by the governing board is a part of the process, but it is essential that this is also communicated to the members.

Whilst it is too late to undo any mistakes of the past, we need to consider how to build on a consensus for the future: for example by moving to principles-based legislation and regulation, and developing a framework for effective pension fund governance.

“Firstly, getting the balance right...”

Part One

Introduction: Governance Short and Simple

‘Governance’ seems to be the pensions ‘buzzword’ of the moment. Pension funds are rapidly changing the way they operate, looking to the future and planning for what might happen. There are many debates and different opinions on how to best prepare for the future. But there seems to be agreement on one point – the increasing complexities of the present systems of regulation, supervision and governance must give way to a more dynamic approach. Can governments, regulators, employers and governing boards take proactive steps in this direction in order to ensure the continuation of good quality pension funds and without prejudicing the interests of the beneficiaries?

Governance has become a significant part of business life.

For example, corporate governance is about responsible investment, exercising your voting rights and engaging with the companies you invest in to ensure that they are transparent about what they are doing. It is about quality of performance, accountability and value for the shareholders.

How has this transformed itself into the quality of performance, accountability and value for the shareholders when it comes to managing pension funds?

The governance of pension funds attracted little attention in the past. Now this is all changing. This should not be surprising to anyone. In recent years ‘corporate governance’ has become a very familiar term in all European languages. At the same time, pension issues appear regularly in the media headlines. Increasingly, pension funds need to be prepared as their own governance comes under greater scrutiny.

The involvement of pension funds in corporate governance issues has not only become more widespread and institutionalised in recent years, but has also raised questions about the transparency and substance of the decision-making of pension funds themselves. The governance of pension funds does, of course, depend on the specific framework of each country and despite some ‘European changes’ – for example, the EU Pensions Directive – pensions are still very much a national affair. This also applies to the roles of the regulators and supervisors in the different countries.

Despite the existence of these different national systems, there are some common objectives – for example, to safeguard and invest pension fund assets in the interests of the beneficiaries.

But what is pension fund governance?

Short and simple: “Is the business done properly and seen to be done properly?”

The first principle of good governance is to provide transparency towards the pension fund's stakeholders – i.e. the fund's sponsoring employer and the beneficiaries. They have a right to know how the governing board acts and how the governing board motivates its decisions. It is the fund sponsor's reputation and the beneficiaries' financial future that is at stake and a pension fund's governance arrangements must attract confidence.

Similarly, the first principle of good regulation is to provide transparency towards the regulator's stakeholders – i.e. the regulated community [governing boards] and those whose interests are being protected [the beneficiaries].

It is the system of governance and regulation and the public perception of occupational pensions that is at stake and the system must have the confidence of the stakeholders.

Whilst it is possible to identify best practice principles in general terms, there are some important issues that have to date not given rise to any universally accepted solutions, e.g. rather diffused accountability, potential for conflicts, limited board resources with members having other priorities, limited board expertise alongside increasingly complex issues, obtaining truly independent advice, insufficient financial controls and piece-meal risk management, often insufficient disclosure, board structures and allocation of responsibilities.

Pension funds operate in an environment of continuous change. Yet, many funds still lack a clear and transparent business plan. Sometimes, it is still difficult for people to quantify the advantages of good pension fund governance.

Within the various national systems, discussions still continue about a number of “common ground” issues. For example:

- Pension funds are being required to be more active shareholders;
- Transparency of investments and socially responsible investments;
- Pension regulators are acquiring an increased role which raises the question of excessive regulation and pension scheme costs;
- But reverting to simpler regulation or voluntary governance rules may seem simple, but ineffective, “box-ticking” exercises; and
- Harmonising the broad representation of interested parties on governing boards with “appropriate qualifications and experience”.

Experience indicates that not all questions about pension fund governance have easy answers!

The European Dimension

Recent European debate on pension fund governance has focused on the contribution that regulatory and governance structures make to the effective performance of national pension systems. In many quarters, attention has focused on governing boards and their ability to manage pension funds, particularly those which are becoming large financial entities. Some commentators have questioned whether “non-professional” governing boards can continue to contribute positively to pension fund governance in an era of increasing investment complexity and uncertainty, the challenge of funding requirements, and continuous regulatory change.

The governance of pension funds attracted little attention in the past, but the governance scene is changing rapidly and governance issues are now creating media headlines across Europe. This is not really surprising because many pension funds, irrespective of their nationality, are facing problems about disappointing investment returns, increasing liabilities and greater intervention by national regulators. Many European countries are attempting to reform their pension systems and key governance issues have to be addressed.

Governance in general – running the business properly and being seen to be doing so – has been around for some time. Indeed, in Europe it has taken more than one attempt to get the process started.

The European Commission [EC] first proposed a Pensions Directive over 15 years ago to set out the basis of minimum regulatory standards for pension funds. It was met with a mixed response. Whilst the proposals were greeted with a reasonable degree of enthusiasm by a few countries, there were forceful objections from others. After three turbulent years of discussion in EU circles, the draft Directive was finally dropped in 1994.

However, undeterred, in October 2000 the EC proposed another Directive that was largely modelled on the first. In so doing, it also took the first tentative step towards creating a benevolent regime for pan-European occupational pension funds. After another round of discussion in EU circles, a Pensions Directive was eventually adopted in 2003. Member states had two years [to September 2005] to implement the Directive.

The Directive – Dir.2003/41 EC on the activities and supervision of institutions for occupational retirement provision [IORPs] – is the basic regulatory framework for funded pension providers with a workplace connection:

- it introduces the prudent person rule as the standard for investment practice;
- it delivers an effective prudential framework;
- it acknowledges IORPs as specialised financial services providers with their own set of rules; and
- it is the first EU law relating to pension matters to recognise that financial services issues must dovetail with labour and social policy.

Implementation of the Directive is proving to be a lengthy and protracted process. Three years on from the official deadline for implementation, we are beginning to see initial results from this significant piece of EC legislation. However, indications are that the Directive is proving itself although it will take more time to deliver the full potential of the Directive. After all, it is a new generation of regulation: slim-line and principle-based. This is an approach that should be heeded by member states when reforming their own national systems.

The EU Pensions Directive should be given time to deliver its full potential and any wide-ranging review is a matter for a later date.

The European pension scene is complex and despite recent reforms following the EU Pensions Directive, pensions are still very much a national affair, with the supervisory bodies or social partners having different roles in different countries. In this respect, it is important to note the different pension fund governance constitutions across Europe. For example, the use of:

- pension foundations in some countries, e.g. the Benelux and Nordic countries and Switzerland and Italy;
- trust law and trustees, e.g. UK and Ireland;
- corporate entities – mutual assurance companies, co-operative associations etc – e.g. Germany and Austria;
- other contractual arrangements, e.g. under contract or labour law.

Although there is a difference in the governing structures, there are some common objectives, e.g. safeguarding and investing pension fund assets in the interests of the beneficiaries and, in the terms of governance, there is perhaps more in common than many commentators think.

Europe is changing and occupational pension provision is undergoing a profound change. The main trend is the shift from defined benefit towards defined contribution funds. This involves a major challenge to governments, companies and employees.

Because Europe is changing, pension provision must be modernised. A balance must be struck between security and affordability. Efficiency should make pensions more affordable, but there needs to be greater certainty that the “pension promise” will be delivered. But is the regulatory burden aimed more at achieving unrealistic levels of security rather than delivering affordability? Have national regulators over-reacted to events and, as a result, magnified their effects?

Deregulation in workplace pension funds is a high-ranking necessity in order to increase the overall efficiency of national pension systems. This involves the deregulation of the pensions’ regulatory framework.

This also requires many governance issues to be identified and addressed. In particular, can a governance model for occupational pension funds – irrespective of their nature [DB or DC etc] – be developed? How should the model be constructed? What should it comprise? Obvious inclusions should be:

- the fund’s governing body and its obligations;
- board structures, appointments and removals;
- skill sets and competencies, both collectively and individually;
- what are “appropriate professional qualifications and experience”?
- risk management;
- internal controls;
- managing conflicts of interest; and
- the governing body’s dialogue with the sponsoring company.

Practical experience of those directly involved indicates that governance is not just a formality but frees up time and resources for better decision making. But excess regulation is increasing the cost of workplace pension provision. In some quarters it seems to be difficult to quantify the advantages of good pension fund governance.

There needs to be a more open discussion on pension fund governance.

The Employer Perspective

Irrespective of the type of organisation, many things depend on the successful management of pension funds. An employer's reputation, financial results, workforce productivity and industrial relations are all affected by risks associated with providing and operating occupational pension funds. If providing these workplace funds is a material expense or represents a significant risk, or if there is some uncertainty that a risk exists, then improving pension fund governance and risk management should be a corporate imperative. Yet despite the incorporation of risk management principles into the decision making processes of many company functions, it has taken a long time for the same governance principles to be applied to the pension environment. Companies providing pension funds for their workforce have a responsibility to their shareholders to see that the costs of providing these pension funds yield business benefits.

Pension funds have been, and still are, subject to considerable external and regulatory scrutiny. This can lead to a modification in pension fund management and can have a profound long term impact on the way companies view their pension obligations. As a result of these developments, there has been a steady call for stronger and more effective pension fund governance practices. Addressing these issues can be resource-intensive and is made more challenging by the different requirements in different countries.

Decisions on pensions can have a significant impact on a company. The long term and volatile nature of defined benefit liabilities and the cost of defined contribution arrangements are strategic issues that require strategic management. Making effective decisions is crucial, requiring more executive time [that is becoming scarce] to understand the exposure that a company faces from its pension liabilities.

While there are differences in company law and corporate governance requirements in different jurisdictions, there has been a gradual convergence of relevant themes, and in particular the company board's accountability to the shareholders and other stakeholders and its fiduciary responsibilities. It is the directors' duties to exercise their powers in the best interests of the company. This fiduciary duty should inform every decision made and any process employed in making those decisions. Implicit in this is an obligation of care, which requires directors to have the requisite competence to discharge their responsibilities by acting on a fully informed basis, with due diligence and in good faith. Companies are recognising the expectation for directors to have the requisite knowledge and skills relevant to the business.

The company board must oversee the company's business strategy, with the necessary time and effort to make sure its assumptions are realistic and that the company is on track to meet its strategic goals. In addition, the board monitors the performance of the company, focusing on both risk and return. The directors must understand the drivers of performance and set the tolerance for risk, including the oversight of operations, financial performance and reporting as well as regulatory compliance and risk

management. The overall objective of the governance structure and process is to maximise shareholder values through effective use of the company's capital.

It is imperative that company directors understand the company's pension issues and are competent to deal with them, thus acting in the company's interests. The company board must determine what its pension objectives are – e.g. understanding, clarity, transparency, accountability, good communication and reporting. Implementing the right processes in each of these areas produces reliable information and enables the company board to respond to pension issues in the long term business context and to identify what the company is trying to achieve.

On behalf of the company board, some of the principles involved will also “ring familiar bells” with members of pension fund governing boards. For example:

- the right people must be involved and make a value-added contribution in the boardroom;
- the decision-making process must be robust and have integrity that is clear and explicit;
- there is commitment to the decisions reached because decision makers must be satisfied that their decisions are based on appropriate information and an understanding of the business implications;
- there is little or no conflict at decision-making level – real or potential conflict must be identified;
- actions must be implemented in a timely manner and correctly;
- the effect of pension decisions and the implications on business strategy must be identified and quantified.

Pensions are challenging from the company's viewpoint. The company's fund sponsorship responsibilities can be managed well if the company board does its job properly. Identifying risks at an early stage can avoid major problems at a future date. Understanding pension liabilities and the effect on the company's debt and credit ratings can enable the company to develop strategies to manage the debt, thus ensuring that capital is available for the growth of the business.

Ongoing monitoring on behalf of the company by all those with oversight responsibility will ensure that the governance framework is fit to address the risks posed by sponsorship of the pension fund in the light of the ever-changing circumstances that have become a constant feature of our times. It is clear that fund governance does not begin and end with the pension fund governing board. The sponsoring company has a major commitment in the success of the pension fund and, therefore, must have appropriate expertise and systems to oversee its involvement in, and responsibilities to, the pension fund.

Regulation and Supervision

European legislators and regulators may be tackling the issue of pension governance, but there is still a long way to go.

The world's leading institutional investors display a strong correlation between superior performance and their strong governance. [“The State of Global Pension Fund Governance Today: Board Competency Still A Problem” ICPM 2007]. But pension funds that have neglected governance issues are losing dramatically in performance. In many cases there seems to be a confused logic that having an in-house governance strategy is not a priority, but a cost and an overhead. But if pensions funds spent more time in getting their governance strategy and procedures right, they may have to spend less elsewhere.

However, it has to be acknowledged that a pension fund's governance strategy and systems are, to some degree, directly affected by the actions of their national legislators and regulators. It is not a surprise then that legislation has come in across Europe to tackle governance issues, and even less of a surprise that some pension funds are dragging their heels implementing it.

The main objective of pension fund regulation is to promote the stability, security and good governance of pension funds, and to protect the interests of pension fund members and beneficiaries. This involves the oversight of pension funds and the enforcement and promotion of adherence to compliance with regulation in order to promote a well functioning pensions sector. Given the speed in which the pensions landscape is changing and the increasing complexity of the financial markets etc, regulators should be alert to developments which might pose a challenge to regulatory objectives. This should involve and acknowledge appropriate action when some regulation is seen as an over reaction to market trends.

The operation of private pension funds is not the only topic that has received the attention of the international community. The activities of national regulators have also been the subject of some oversight. For example, the International Organisation of Pension Supervisors [IOPS] has issued guidance by way of its “IOPS Principles for Private Pension Supervision”[2006].

The listed Principles are:

1. objectives
2. independence
3. adequate resources
4. adequate powers
5. risk orientation
6. proportionality and consistency

7. consultation and co-operation
8. confidentiality
9. transparency
10. governance

These principle headings are not uncommon to the management and governance of pension funds themselves.

It is worth repeating the five sub-principles that comprise Principle 10 [Governance]:

The pension supervisory authority should establish and adhere to a governance code, outlining suitable internal controls, checks and balances, and effective processes for risk and performance management. A code of conduct should be established and enforced in relation to all staff members.

There should be clearly documented procedures for decision-making, with processes for referring decisions up to the appropriate level of seniority, reviewing and documenting decisions.

For interventions with serious impact there should be some separation between those within the authority proposing interventions and those taking the final decision, so the scope for emergency action is balanced by a review process.

Pension supervisory authorities should be clearly accountable for their general conduct and activity. Pension supervisory authorities should have accountability arrangements, which may vary according to specific country circumstances and which may include accountability to a range of bodies, from parliament to the members and beneficiaries of pension funds or plans.

Procedures should be in place for the governing body of a pension plan or fund to appeal to the pension supervisory authority or relevant tribunal for decisions taken by the pension supervisory authority that affect them and which they consider inconsistent with legal provisions.

Principle 10's main theme is that the Supervisory Authority should adhere to its own governance code and should be accountable – a principle that should be developed and taken up by all pension funds.

Earlier this year, the Organisation for Economic Co-operation and Development [OECD] published draft revised guidelines on pension fund governance. [Pension Fund Governance Challenges & Potential Solutions: OECD Working Paper on Insurance and Private Pensions No.18]. These revised guidelines are drawn from the IOPS Principles [referred to above], the

OECD's "Core Principles of Occupational Pension Regulation" and other OECD/IOPS guidelines and projects, and are part of a broader OECD effort to strengthen public confidence in private pension systems.

The focus of these revised guidelines is mainly based on prudential supervision, but raises new issues including the need for balanced representation of stakeholders in pension fund boards, greater expertise and knowledge among board members, and risk-based governance structures and mechanisms.

Prudential supervision is a key theme in the successful governance of pension funds themselves and the new issues raised by the OECD guidelines further add to the emphasis in this report that successful governance should involve a two-tier structure that places the responsibility for the overall management and governance on a professionally qualified fiduciary body, with regular prudential supervision of the fund's governance and management under the control of an elected/appointed board of governors representative of the stakeholder interests in the fund.

A pension fund itself has the responsibility to conduct adequate governance and risk management and to comply with any statutory provisions. In the same way that pension regulators expect to adhere to guiding principles and good practice, so should pension funds themselves expect to be conducted by governance principles and good practice guidelines. But the character of any principles and good practice should emphasise the overriding principle that it is the responsibility of pension funds to develop and implement their own governance policies in a responsible manner.

Despite these regulatory principles and practices, the ultimate responsibility for the development of best practices and the proper operation of the pension fund rests with the pension fund management.

When considering pension systems a balance must be struck between security and affordability. Efficiency should make pensions more affordable, yet there needs to be sufficient certainty that the 'pension promise' will be honoured. What we are seeing is that the regulatory burden on pension funds is more skewed towards achieving unrealistic levels of security than delivering affordability.

Much is made of the "ability" of companies to fund pension arrangements. But, surely our biggest concern should be the continuation of their "willingness" to do so. Unless regulators recognise that too much "red tape" is exactly what makes even the most generous of employers think twice before signing more cheques, they will not have much left to regulate.

Regulators have over-reacted to market and industry events and, in some circumstances, have magnified their effects. Regulators should promote, and play their part in, a deregulation of the pensions regulatory framework. Deregulation – in both state and private pension provision – is badly needed and, if implemented, will increase the overall efficiency of pension provision.

However, in developing a stronger but more principle-based regulatory approach to governance, one size does not fit all and there is a danger of making legislation/regulation so broad that it is open to too much interpretation. At the same time, looking to the future, pension funds need to adopt some universally simpler governance principles if there is ever going to be a pan-European approach to these issues. We are not anywhere near there yet.

Experience and Qualifications

The EU Pensions Directive states that a pension fund must be “run by persons of good repute who must themselves have appropriate professional qualifications and experience or employ advisers with appropriate professional qualifications and experience”.

In the ongoing debate about pensions, some observers make the point that those responsible for the governance of occupational pension funds must possess appropriate professional qualifications in order to deal with the complexities of the running of modern day pension funds. Others argue that, at governance level, appropriate knowledge is sufficient to monitor the activities of appointed professionals. To many people, there is a very thin and confusing line between qualifications and experience and this has given rise to a plethora of providers offering training programmes. Some providers offer training because it is part of their mandate and others because they can profit from it.

Members of pension fund governing boards may often wonder why they do the job! When they do it well, nobody notices. When things go wrong, they find themselves in the firing line. The nature of the role has changed substantially in recent years. It is no longer a welfare/human resource activity. It is now largely financial in nature and increasing year on year.

Governing boards have access to better education and training than ever before but, in an increasingly complex world, will they ever have enough knowledge? In assessing the education and qualifications of those who are responsible for the governance and operation of our pension funds, is there a credibility gap that needs to be bridged?

The pension fund governing board’s responsibility has taken on a major investment role. In today’s complex world of investment and funding, many investment strategies are out of kilter with their funds’ governance arrangements. This gap cannot in most cases be bridged through training alone because of increasing investment complexity.

It is because of such demanding responsibilities that the question now being asked is: “Are we expecting too much from our governing boards and should the burden be taken out of the hands of lay boards? Indeed, some lay board members are already complaining that they are sinking under the weight of guidelines, which need to be more specific, rather than more plentiful. For an increasing number of governing boards, they are now running very hard just to stand still!

Governing the operation of the pension fund involves a detailed involvement in the management of the fund’s assets and risks. The primary types of risk include:

Market Risk – share prices may fall, bond prices may fall, interest rates will change;
Risks associated with the companies in which the pension fund invests – the companies may suffer major, sudden or catastrophic changes;

Economic Risk – the risk that inflation will be higher than anticipated;

Credit Risk – the risk that a counterparty or fund manager will fail to meet their obligations;

Performance Risk – the risk that the fund manager’s financial performance will not meet or exceed the benchmark;

Operational Risk – the risk of loss caused by error or fraud, which could be the result of system failure, breakdown of processes or human error;

Mortality Risk – the risk that pensioners will live longer than anticipated;

Health Risk – the risk that a higher number of members will take early retirement due to ill health or other reasons.

Regulatory Risk – the risk that the fund is subject to investigation for breach of regulatory requirements.

For many pension funds, the risks which are inherent in their investment strategies are not well understood. Universally, the investment industry is moving so fast that, even with training, governing boards are having a difficult time catching up on their knowledge of better investment management and new specialist products. The sophistication and experience that governing boards need has outpaced their education. So many of these people have got behind the curve simply because the level of sophistication has never moved as fast as it has in, say, the last five years. Over complication is also part of the problem.

Generally, where governing boards are required to have a minimum number of lay members nominated by the fund membership, there is at least a corresponding number appointed by the sponsoring employer. In many cases, the two groups comprise the total number of board members and provides for a group of people to be responsible for the governance and operation of the pension fund and who are all ‘lay’ members. Regulators have stated that in such circumstances governing board members are not expected to be experts on everything or to have the detailed technical knowledge of a professional. In other words, it is not the intention to “professionalise” the role of governing board member. It is expected that they will have a rounded knowledge of their pension fund together with a good understanding of the theory and practice of occupational pensions, insofar as they are relevant to the functions being carried out. But is this enough?

The obligations on governing boards are potentially very onerous in an environment where national systems are changing to require significant changes in the way these individuals are expected to operate. But in many ways this is a fast process. Can these individuals be expected to change so quickly? Collectively, governing boards need to process ever increasing amounts of information and draw conclusions regarding decision making, risk, the employer covenant, funding and so on. Regulators want to revolutionise the way pension funds are run and a consequence of this is seemingly ever increasing expectations of those responsible.

In many jurisdictions, a member of the governing board is a volunteer, part-time, non-specialist in pensions and usually with other responsibilities outside their pension fund and pensions industry. It is argued that the pressures that make businesses well run need to be developed into pension funds. The equivalent of shareholders for a pension fund is its membership. To achieve this, greater transparency is a key issue. This can be a significant drain on resources for employers and their pension fund governing boards who have other core responsibilities in other parts of the company.

Running pension funds is complex and a high level of knowledge is crucial. It has also become time-consuming and expensive. The responsibility can worry many individuals and there are clearly risks for them.

The key purpose of a predominantly 'lay' board should be to ensure the fund's prosperity by collectively directing the fund's affairs, whilst meeting the appropriate interests of its members and other stakeholders, taking into account the law, relevant regulations and fund considerations.

The board can achieve this key purpose by implementing the following principles:

- *By establishing and maintaining vision, mission and values*
This enables the board to determine and maintain the pension fund's vision and mission to guide and set the pace for its operations and future development; to determine and maintain the values to be promoted throughout the operation of the pension fund; to determine, maintain and review the fund's objectives and ongoing policies.

- *By deciding strategy and structure*
This enables the board to review and evaluate present and future opportunities, threats and risks in the external environment, and current and future strengths, weaknesses and risks relating to the internal operations of the fund; to determine strategic options, selecting those to be pursued and deciding the means to implement and support them; to determine the business strategies and plans that underpin the fund's strategy; to ensure that the fund's organisational structure and capability are appropriate for implementing the board's strategies.

- *By delegating to management and professionals*
This enables the board to delegate authority and monitor and evaluate the implementation of policies, strategies and business plans; to determine monitoring criteria to be used by the board; to ensure that internal controls are effective and to communicate to with senior management and professionals.

- *By exercising accountability and responsibility to all members and beneficiaries*
This enables the board to ensure that communications both to and from members and other relevant stakeholders are effective; to understand and take into account the interests of fund beneficiaries and other relevant stakeholders; to monitor relations with members and other relevant stakeholders by the gathering and evaluation of appropriate information; to promote the goodwill and support of fund members and other relevant stakeholders.

Whilst member involvement in this area is a worthy concept, any insistence that a proportion of a pension fund governing board must be member-nominated will not on its own improve governance.

In their respective national environments, the pension system [whether it is trust-based, contract-based, foundation, joint-stock company, non-profit organisation, mutual, association, co-operative etc] can work well and many of their principles are still relevant to the good governance of occupational pension funds.

However, it is when we seek to incorporate a structure of lay involvement into the system that the debate becomes less clear because of the ever-increasing and onerous responsibilities.

For the future, there is no reason why well-selected, well-motivated, well-advised and regularly trained generalists cannot supervise those professionals who have executive responsibility for the operation, in whole or in part, of the pension fund. However, it must be decided how pension fund governance is to operate in the future. Membership of the governing board is a team game and not an individual pursuit. Has the time arrived when qualifications are no longer just “nice to have” but essential to the success of the pension fund?

If society wants broadly-based governing boards to supervise the successful operation of the pension fund, should we not be looking at a twin-track system of pension governance? Under this method, “governors” appointed by the employer and the members can govern the operation of the fund without having to raise the bar of technical knowledge to the level where broad participation would be frustrated. A “fiduciary body” [in reality, the managing board] can then be appointed by the “governors” and comprise of those with appropriate qualifications who can use their professional skills to manage the fund in accordance with the policies set by the “governors”. Appropriate qualifications should be required through both good education [e.g. university degree and/or professional qualification] and relevant prior professional experience. In this way it might be useful to apply appropriate tests of competence to those who fulfil these professional functions and to those who sit in governance.

The demands placed on pension funds are continually changing in scope and complexity and this is causing companies and governments to regularly review the appropriateness and effectiveness of existing arrangements. In so doing, we must not be obstructed in modifying future pension fund governance arrangements to be able to continue to acknowledge the principle of lay involvement in the oversight and supervision of our pension funds.

Governance and Internal Controls

The time has come when we must look at pension fund governance as a whole, and not in the piecemeal approach adopted by Governments and Regulators. In an increasingly risk focused environment, radical changes are needed to reform the overcomplicated regimes that currently provide a straightjacket for many employers and pension fund governing boards. If employers are given more flexibility in how they run their funds, members should be able to rely on a pension fund management and governance system to protect their interests and strike a fair balance between the interests of different groups of beneficiaries.

Previous national reports have highlighted many of the issues that need to be addressed to bridge the pensions gap and remove the barriers to adequate saving for retirement. In recent years there have been a number of proposals, spanning many areas of private pension provision, to introduce measures to make it easier for employers to set up and run good pension funds by reducing the complexities in pension legislation and regulation. Unless effectively managed, however, greater simplicity for employers can result in more complexity for governing boards.

Public policy demands high standards of pension fund governance. In many jurisdictions, national policy supports a system of governance that requires some ‘lay’ representation [the general description given to those individuals who are not paid professionals] from fund members as well as the sponsoring company. This is seen in some quarters as a growing obstacle to pension fund governance as a result of the increasing complexities in the business and pensions world.

It is essential to ensure that no further disincentives are introduced into what has become an increasingly difficult environment for pension funds to flourish.

There have been public references to the possible downsizing of the fund management industry at a time when pension funds need most help, and this will impact on the role of those responsible for pension fund governance. However, within the pension fund infrastructure, these individuals have the primary responsibility for safeguarding the interests of the fund’s beneficiaries. The role of these individuals should be largely a supervisory one, and it is essential that they should adopt a risk-focused approach to the good governance of their pension funds.

When a governing board comprises of a proportion of lay members [elected by the fund membership and appointed by the company] they are not paid executives and it should not be their function to carry out, or be responsible for, the specialised management functions. Their primary function must be to exercise a supervisory role and ensure [on behalf of the members and the company] that the risks faced by the fund are effectively managed and controlled. Proper identification, control, management and supervision of risk will protect members, employers and governing board members, and in consequence is highly beneficial.

What about the process of risk management?

“Risk” can mean different things to different people in different situations. What is a “risk”? Put simply, it is “something that prevents or hinders the attainment of objectives”. Successful risk management for pension funds involves a supervising governance body taking a positive role in the identification of the fund’s risks and the development of relevant risk management objectives. This body should be effectively measuring, monitoring and assessing the risks they have identified. They should determine how the monitoring and reporting will take place and ensure that timely and reliable information is available. This information, which really underpins the supervisory risk management process, is vital and those responsible for governance must ensure that there is an adequate information system because they need to know that all activities are being properly undertaken as they intended.

The increasing level of interest in internal controls and risk management has been prompted by national legislation arising from Article 14(1) of the EU Pensions Directive which required trustees or managers of occupational pension funds to have “sound administrative and accounting procedures and adequate internal control mechanisms”. Whilst this may have always been the case for some [of the larger] funds, it must now be the case for all. This requirement cannot be avoided and could become a burden unless approached in a structured and documented manner. This must be undertaken by the fund and must be integrated into its business plan, for which a supervising governing body must be responsible.

Governing boards should demonstrate their own good practice by making a positive statement in their annual report, confirming that they have considered risk as it affects their fund and that they believe that there are adequate internal controls in place to mitigate it.

Risk modelling in itself need not be onerous or particularly complex for lay individuals. It is a method of focussing time and effort in proportion to need. In the context of pension funds, it requires governing boards to actively take time in considering the risk framework and review ongoing work and responsibilities. To some it can be viewed as a distracting and time-consuming academic exercise, but in reality it is a positive way to organise, and re-organise, the governance of the pension fund.

Risk assessment needs to be considered, and progress reviewed, at regular intervals throughout the fund year. Moving forward, pension funds should also ensure that risk management is embedded in their culture.

In broad terms, the fund’s governing body should consider the approach, assessment and delivery process.

Applying classic risk management modelling will lead to a structured approach under the following headings:

- identifying risks
- assessing likelihood and impact
- risk reduction
- actions plans
- establishing a Risk Register
- monitoring and reporting

An integral part of the risk management process is to include the fund's governance arrangements in the risk management modelling approach. For example:

Constitution of the managing & governing bodies:

- what is the process for reviewing their composition?
- Is the current composition suitable for the fund?
- Are the competencies of the board members adequate, and is there a sufficient breadth of skills/specialisms within these bodies as a whole?

Discharging the managing & governing bodies' responsibilities:

- Is there a system for assessing/monitoring their performance?
- How frequent are meetings? Is attendance recorded and reviewed?
- How are decisions taken between meetings?
- Are there any sub-committees?
- How are sub-committees' terms of reference and constitution determined?
- How are the competencies and skills of sub-committees kept up-to-date?

Conflicts of interest:

- Is there a record of activities undertaken in relation to the employer's business?
- What is the policy for identifying and dealing with conflicts of interest?

Inadequate fund governance:

- Is there a governance policy?
- Does the pension fund have a business plan?

Inadequate risk management structure:

- What is the risk management structure in place?
- How is the risk management structure reviewed and kept up-to date?
- Are there sufficient levels of indemnity?

If [as they do] governing boards have a responsibility to monitor and review the ongoing governance of their fund, they also have a responsibility to monitor and measure their own effectiveness on a regular basis. This is now being referred to as “self-assessment” or “self-evaluation”. This involves not only the evaluation of the board’s governance of the fund, but also the evaluation of the performance of individual board members. Although many board members acknowledge the merits of this exercise, as individuals they often find the process to be quite difficult. However, undertaking a self-assessment can prove to be an extremely useful and enlightening exercise.

A combination of fund governance through risk management and individual self-assessment is invaluable in reminding governing boards of their ultimate duties to the members, and will enable them to focus on the areas to improve as they go forward.

The size of pension funds in terms of assets under management, contributions and impact on the sponsoring employer and members, makes it sensible to review the overall risks involved on a regular basis. The basic internal control objectives do not differ as between different types of pension fund. However, the methods by which the objectives are achieved can differ significantly between the larger pension funds which are able to support an “in-house” team and smaller/medium sized funds which, for a variety of reasons, employ a mixture of advisory and employer resources. The involvement of various advisers and the not infrequent lack of consistent attention by some governing boards can lead to significant gaps appearing in the internal control process. For many smaller funds it is not practicable to install extensive [and sometimes expensive] risk management procedures. Despite this, however, fundamental risk management objectives should remain consistent with that of the larger funds.

In recent years, the ongoing debate has drawn attention to the “what”, “why”, “when” and “who” of pension fund governance. More participants are agreeing on what good governance should involve, why it is necessary and when it should be undertaken. However, who should be responsible for this increasingly complex activity is not an issue that has been the subject of sustained debate and discussion.

As mentioned in Chapter 7, if society wants broadly-based boards to supervise the successful operation of the pension fund, perhaps we should be moving towards a two-tier system of pension fund governance. Under this method, “governors” appointed by the employer and the members can supervise the operation of the fund, including the setting of objectives/business plan and the monitoring [through fund specific risk management/modelling] of an appointed fiduciary body which would comprise of individuals with appropriate qualifications who can use their professional skills to manage the fund in accordance with the policies agreed with the governors.

The Board's Chairman & Secretary

In addition to the collective responsibilities of the governing board, leadership and direction is a necessary function of specific positions, enabling the board members to fulfil their responsibilities for the pension fund's overall governance and strategic direction.

These responsibilities fall to the Chairman and Secretary.

The **purpose** of a Chairman of a Governing Board is to provide leadership and direction to the members of the board, to enable the board to fulfil their responsibilities for the fund's overall governance and strategic direction and to ensure that the fund is run in accordance with its legal documentation and national legislation.

The duties of the Chairman can be summarised as follows:

- lead the governing board;
- approve the agenda and meeting papers drafted/collated by the Secretary;
- approve the draft minutes of meetings and sign the final document;
- ensure that discretions and decisions, whether taken between meetings or at meetings, are properly executed and, where appropriate, attributed to any professional advice taken;
- prepare for, attend and chair meetings at the time and frequency agreed by the board, ensuring that internal and external conduct of meeting requirements are observed, timetables are adhered to, all board members are encouraged to participate and confidentiality is observed and respected;
- see that the board's sub-committees [of which the Chairman may be a member] carry out their work in accordance with agreed terms of reference including reporting back with recommendations;
- take responsibility for the preparation and development of the fund's business plan;
- ensure that the board has a proper appreciation of the views of the fund's members, other beneficiaries and the sponsoring company;
- ensure that a training plan is in place, and appropriate, for each member of the board;
- ensure that suitable communication procedures with all parties are in place and working;
- ensure that the fund is compliant with all relevant legislation and regulatory requirements;
- ensure that relationships with advisers and other delegates are maintained and, where appropriate, enhanced;
- review draft contracts and performance standards with service providers [including the managing board] to be put forward for the board's approval;
- liaise with the Secretary to ensure that the fund's annual accounts and financial audits are completed in a timely manner and in accordance with any regulatory requirements, that any complaints are properly handled and in a timely manner, that any potentially significant events are reported to the relevant authority; that all of the fund's budgets are appropriately estimated and monitored, and that

- copies of board papers and records of meetings are stored in secure facilities for an appropriate period;
- be satisfied that the fund's administration is carried out soundly, and that members' benefits are correctly calculated and promptly paid when due to the correct beneficiary;
 - be aware of the regulator's requirements and ensure that the fund is compliant with them;
 - ensure that the board's performance is regularly evaluated;
 - provide guidance and advice to the Secretary and board members, as appropriate;
 - ensure that good relations are developed and maintained with the managing board and sponsoring employer;
 - represent the views of the board in meetings and fund correspondence.

The above points are not an exhaustive list of the duties required to be demonstrated by the Chairman, but it can be seen that the position is of crucial importance to the success of a governing board and its relationships with other parties.

The above Chairman's duties include a positive relationship with the Secretary to the Board whose responsibilities and duties can also be summarised.

The **purpose** of a Secretary to the Governing Board is to liaise closely with the Chairman so that all board members discharge their duties efficiently and effectively, and to support the board's administrative business.

The duties of the Secretary can be summarised as follows:

- arrange board meetings for the fund's calendar year, with agreement of the Chairman and the other board members;
- arrange any additional board meetings, if and when required;
- prepare draft agenda and cross reference with the fund's business plan as appropriate;
- distribute the agenda and papers to the board members in good time for proper consideration prior to a meeting;
- draft the minutes of the meeting, agree with the Chairman and distribute to board members in a timely manner;
- keep safely the original signed minutes with other relevant papers in secure facilities as determined by the board;
- ensure that:
 - decisions, particularly those taken between meetings, are properly recorded and referred to in the subsequent meeting.
 - the board reviews [via the managing board] the performance of all service

- providers [including the managing board] periodically and in accordance with the fund's business plan.
- there is a structured process [via the managing board] to review the strength of the sponsoring employer's covenant to the fund.
 - actions arising from board meetings are logged, attributed and monitored.
 - the board receives regular reports [via the managing board] that enable them to assess all aspects of the fund's operations.
 - the board is properly constituted at all times.
 - the fund's annual accounts and other financial statements/audits are completed in a timely manner, by the appropriate body, and in accordance with any regulatory requirements.
 - any complaints are properly handled.
 - any significant events relating to the fund are reported to the relevant authority in accordance with legislative/regulatory requirements.
 - annual fund budgets are appropriately estimated and monitored.
 - the board has copies of appropriate professional advice and sufficient information to make properly informed decisions;
 - a training plan is maintained for all board members which adequately meets their needs.
- ensure that the appropriate body has a procedure in place to monitor and manage the risks to which the fund is exposed, and that this is regularly reviewed;
 - be satisfied about the arrangements for the auditor to report on the outcome of each review with any recommendations on measures to be taken to remedy any issues identified;
 - ensure there is a file comprising copies of all key fund documents and that copies are made available if requested by relevant authorities;
 - on behalf of the board, ensure that any necessary returns are forwarded to relevant authority;
 - ensure there is a procedure in place for receiving, checking and onwards transmitting all incoming fund expenses.

The above points are not an exhaustive list of the duties of the Secretary, but it can be seen that the position is of crucial importance to the success of the board and its relationships with other parties.

The professionalism of the range of duties required of the Secretary and the complexities of the Secretary's responsibilities is a critical factor in the ongoing operation of the fund's business plan and governance procedures.

Nevertheless, the board is ultimately responsible for the governance of the fund and any more exhaustive lists in respect of the Chairman and Secretary will only serve to illustrate the increasingly onerous responsibilities put on pension fund governing boards, and where there is a substantial “lay” involvement, it has again brought into question whether there is a weak link in the chain that now needs to be scrutinised.

Understanding the Risks

Everywhere, the pensions sector has undergone an unprecedented transformation over recent years. Gone are the days where pensions are considered benevolent gestures from an employer. Today's employers and governing boards have to ensure that funds are run in accordance with stringent rules and regulations so that meaningful pensions can be provided to retired employees.

Governing boards face liability which is following the same trend as almost all other forms of managerial liability. In terms of both potential exposures and offences, those responsible for the governance of pension funds face the increasing nature of our society to seek recompense for failures or inadequacies. This overwhelming burden "to get things right" has been exacerbated by government intervention and regulatory overload.

Governing boards have an overriding duty to the fund's beneficiaries which is paramount. Potential conflicts of interest are now commonplace and it is sometimes difficult for fund members who have been appointed to their fund's governing body to understand the full implications, particularly when they have to take care of a full-time job with the sponsoring company. Also, potential conflicts of interest can be highlighted where a governing board member is also a director of the sponsoring employer company with duties to the company and its shareholders.

The plethora of legislation and regulation directing the activities of governing boards on a daily basis has now ensured that they have a mass of potential exposures, including [but not limited to] the following:

- administrative error
- improper advice
- violation of fund documents
- denial or changes to benefits due
- misleading disclosures or advice
- default on obligations to contribute to the fund
- imprudent investment
- conflicts of interest

Perhaps in no other industry would a person be held so individually responsible for a job without mandatory insurance. Has the time arrived when protection for governing boards, and others involved in the administration of the fund, should be required to be provided at all times? To be of value, however, it is important to ensure that any insurance policy provides effective insurance protection with cover at corporate and personal level for all the parties involved in the governance and management of the pension fund.

Therefore, all those involved – sponsoring employer, governing board, administrators and fund officials – should be covered by the insurance policy. If there are technical difficulties over the “legal persona” of the pension fund, it is sensible to verify that costs or liabilities, which fall to be paid out of the fund’s assets, can form claims on the insurance policy. Therefore all parties should be entitled equally to the protection of the insurance so that it is not in the interest of any party to create a liability on the pension board purely to get the benefit of the insurance.

However, in the event of problems arising, individual board members should be satisfied that the insurance policy will pay for their interests to be separately represented if appropriate and that they will not be overridden by the interests of other parties covered by the policy.

The coverage of any appropriate insurance should satisfy the geographical operations of the fund concerned, e.g. nationally, European, worldwide in order to be competent to deal with civil and criminal proceedings, formal investigations, regulatory investigations etc.

The main exposures to defined benefit funds include:

- fund deficits
- inadequate investment decisions
- poor governance procedures
- conflicts of interest with the sponsoring employer
- changes to the benefit structure
- winding up the fund

The main exposures to defined contribution funds include:

- administration
- member understanding
- cost of contributions [member and company]
- inadequate advice/options regarding investment strategies
- education to members regarding their retirement options

The purchase of properly drafted and comprehensive insurance can be a cost-effective means of protecting members benefits, the sponsoring company, pension boards, pension managers and internal administrators from losses resulting from claims, be they well-founded or not. Concerns that pension boards would have a false sense of security as a result of any mandatory insurance requirement are unfounded. For example, does a person driving a car act less carefully because they have insurance? Regulators would still demand the highest standards and diligence, but the huge burdens placed on these individuals in the current climate would be eased by the fact that they have a “safety net” should a breach of duty occur.

Effective risk management procedures can play a significant role in minimising liabilities, which should be favourably taken into consideration by insurers. Compulsory levels of cover are something that would have to depend on the size of the fund – it would be unreasonable to demand a small fund to have a limit of €1m whereas this limit for a large fund may not be enough. A regulator’s risk assessment procedure could be sent to all funds to be discussed annually at fund board meetings – the level of cover could then be determined from the results of this risk assessment.

A regulator’s aim is to protect the benefits of members of work-based pension funds and to provide support and guidance to pension boards in their work in running their funds. Appropriate insurance cover would help them to do exactly this.

“... and then, getting the right balance”

Part Two

Introduction: Risk versus Reward

In recent years, employers have seen the gradual transformation of pensions from a “best endeavours” gratuity into a binding contractual promise with pension funds operating against a backcloth of increasing regulation. As an example, it is probably fair to conclude that the UK pensions market – particularly in respect of defined benefit [DB] funds – is the most legislated pensions environment in Europe. If this is so, then others are not far behind.

The move towards greater transparency has put the actions of governing boards firmly into the limelight and pensions on to the boardroom agenda. Many companies are now looking to limit the potential risk associated with their occupational pension funds. As such, there is now an increasing cultural shift from DB to defined contribution [DC] funds. The process of fund replacement, however, is not straightforward and numerous potential pitfalls could give rise to claims against the fund’s governing body and/or the employer.

The role of the governing board has expanded significantly over the years, with the pressure increasing further by the escalation in legislation and regulation and the requirement for governing boards to adhere to “knowledge and understanding” requirements.

Conflicts of interest have always been an area of risk for governing boards. These bodies are required to act in the best interests of members, and a company director owes similar loyalties to the company. A conflict could result in resignation and consequently loss of skills. In mitigating the risk this poses, governing boards must have alternative strategies that can be adopted in the event of a conflict.

Choosing the right people to be appointed to governing boards is crucial, and against the current backcloth this has never been more important. The most suitable individuals, however, are only too well aware of the onerous responsibilities, personal liabilities and necessary qualifications attached to the role.

In certain circumstances, governing boards who breach their increasingly complex responsibilities may find themselves at risk and liable for civil and criminal penalties. Employers can also bear the brunt of disgruntled pension fund members’ claims where they have endeavoured to balance their paternalistic approach with their business needs.

Add to this a generally more litigious society, fund members becoming more aware of their pension rights – as well as the ever-increasing profile of pensions in the media – and it is easy to understand why pension fund sponsors are thinking twice about whether the risk/reward ratio is appropriate.

The Art of the Possible

With the changing regulatory environment, the increased complexity of capital markets and the requirement to generate higher returns to meet pension liabilities, there are even more pressures on companies to focus their attention on all things pension related. This can be a significant drain on resources and it is a distraction away from the company's core business and, in turn, its core competencies. As a result, many companies and their pension funds are exploring possible structural changes to pension fund governance systems as a means of addressing this issue. A drain on resources can directly affect governing boards who often have other core responsibilities in other parts of the company.

After all, pension fund members and company executives did not really sign up to be governing board members. In reality, they accepted a job with their employer who provided a pension fund. The majority of these individuals are not in their roles because of their specialist pensions knowledge. They are guardians of the pension fund whose key role is to exercise a fiduciary duty.

There is also a governance issue. Governing boards who come from the company management may know a lot about their part of the business, but those who know a lot about every part of the business will find it impossible to avoid the risks of trying to balance conflicting interests. Do they want the best for the company or the members and pensioners? The two agendas do not mix easily and political pressures can make it difficult for a chairman of the governing board to negotiate robustly if they are not independent.

Are there any solutions that can be developed?

- One possible solution may be to adopt the practice of Fiduciary Management that is increasing in popularity in The Netherlands where pensions have a good image and have a big impact on both the research and educational side.

Fiduciary Management involves outsourcing the design, implementation and oversight of a pension fund's investment programme to one provider – the “fiduciary manager”. There are a number of complex issues in running a pension fund, often inter-dependent.

As part of the overall management role, the fiduciary manager –

- provides strategic investment management services
- efficiently builds portfolios
- identifies external portfolio managers
- monitors the investment performance
- provides customised and consolidated reporting

As in all aspects of pension fund governance, it is not a case of a “one size fits all” approach. The fiduciary manager must have a detailed local knowledge of the environment in which the client fund operates, be fully up to date with the regulatory requirements and be able to provide each client with an essential individually tailored solution. Because of these complexities it is about a long-term relationship, with one manager responsible for the five key elements mentioned above, so providing long-term continuity for the pension fund.

The pension board’s main role is to put in place the actual fiduciary mandate and to assign the fiduciary manager. In conjunction with the fiduciary manager, the board would establish the pension fund’s investment policy statement containing the investment objective, and investment guidelines for the fiduciary manager. It also includes the asset allocation, levels of desired risk and return, and any prohibited investment types. The board holds the fiduciary manager accountable for achieving the long-term goals and meets with the manager on a regular basis.

Much of the popularity of this approach derives from the fact that it dramatically frees up a board’s time allowing it to concentrate on setting, and monitoring, the pension fund’s policy leaving the details to the fiduciary manager. This can allow the board to concentrate on the bigger picture – for example, do we want to be DB or DC or other type of arrangement that suits the company’s employment profile?

However, in most jurisdictions the pension board is essentially where the buck stops because, as is well known, the overall responsibility cannot be delegated. Having overall responsibility is a fact that cannot be ignored, but adopting a fiduciary manager practice may well be an approach that eases the burdens on board members thereby enabling them to develop and implement overall pension fund controls and that sometimes elusive big picture.

With many service providers involved in pension fund management, there is a result that no single provider accepts full responsibility for the overall outcome. Is this an argument for re-centralising management rather than devolving it, and centralising via a fiduciary model? The trend to fiduciary management clearly still has a long way to run, but there are some large transitions in the pipeline.

→ If the objective is to relieve the existing governing body of some, or indeed all, of the pressures, are there any other functions that can be partially or totally out-sourced?

A well run pension fund will be underpinned by a robust governance framework. Such a framework will support the pension board in fulfilling their role in acting in the best interests of the fund’s beneficiaries. It is essential that decisions are not affected by conflicts of interest so that valid decisions are made, and are seen to be made, in the beneficiaries’ best interests.

A conflict of interest may arise when a fiduciary is required to take a decision where the fiduciary is obliged to act in the best interests of the beneficiary or principal and at the same time the fiduciary has or may have a separate personal interest or another fiduciary duty owed to a different beneficiary or principal in relation to that decision, so that there is a conflict with the first fiduciary duty. This can inhibit open discussions or result in decisions, actions or inactions that are not in the beneficiaries' best interests. This in turn may result in the governing board acting improperly, lead to a perception that the board has acted improperly and may also invalidate a decision or fund transaction.

Having directors of the sponsoring company on the governing board can bring advantages to the overall effectiveness of the fund, but they must be aware that they can have a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. Having employees of the company on the governing board may also bring benefit to the effectiveness of the board, but it must be recognised that such individuals may face conflicts of interest both as members of the fund and employees of the company.

Whilst each governing board should be able to determine the correct mix of individuals to suit the fund's circumstances, there is much to be said for the practice of employing, for example, independent members. Such persons will [almost by definition] ordinarily have no conflicts of interest and will bring knowledge and expertise to bear on the issues to be decided by the governing board.

Consideration should be given to the potential benefit that appointing an independent, and in particular an independent chairman, could bring to the effectiveness of the governance process.

→ Can the principle of "outsourcing" be taken a stage further? For example, can the board function itself be completely outsourced?

Managing a pension fund is time consuming and expensive. The responsibilities can worry board members and there are clearly risks for them. Conflicts of interest can, and do, arise but it is always better to identify and manage conflicts, rather than try to avoid them altogether. Having sponsoring company directors on pension boards brings so much to the table, so should their presence be encouraged, not denied because of potential conflicts? A more difficult issue is the need for lay board members to fully understand financial information about the company when this is often organisation sensitive and sometimes share price sensitive. This can put employee board members in a very difficult position.

Sometimes infrequent meeting cycles can result in a slow decision making process and for investment matters, in particular, this can be damaging. Investment decisions need to be understood and discussed fully, and often implemented quickly. A delay can mean that the moment is lost – market opportunities do not wait for scheduled meetings.

Implementing a governance model involving direct member involvement is costly to implement both in time and resources, for all but the “mega funds”. Many functions can be delegated or outsourced if internal resources are not adequate, but this can also be costly.

Putting any legal requirement for member involvement to one side, the responsibilities could be handed to an independent Corporate Trustee as full time “sole trustee”. Is this an attractive alternative?

The sole trustee will have the necessary expertise and will recruit suitably qualified people. Many functions can be standardised with the amount of detail kept at an appropriate level. This should bring a high level of governance at an affordable cost. Day to day decisions can be implemented without waiting for the next scheduled meeting. Internal expertise will reduce to the need for external advice but not take the place of external independent advisers and service providers completely. However, introducing some standardisation to the process will bring significant cost savings.

There would seem to be a number of advantages to this model, but there are also some drawbacks. The professional sole trustee would be detached from the company and the fund members. This gap has to be bridged as understanding the company and employees is crucial. Links need to be established with member representatives as well as company directors. A committee constructed along the lines of many existing governing boards can work well. This need not duplicate effort since it would be a reporting/reviewing body and not an operational and decision making one.

This model has already attracted attention in many quarters, but can it be done within the letter and spirit of existing national legislation? In many cases, legislation would have to be changed – but for the better. Revised legislation could set down precisely what the Corporate Trustee is responsible for. Associated legislation could set out what a committee is required to do including, at this level, any rules for member and company representation.

An Ideal Structure

As previously stated, fund members and company executives did not really sign up to be members of pension fund governing boards. In reality, they accepted a job with the employer who provided a pension fund. The majority of these individuals are not in their roles because of their specialist pensions knowledge.

The principles involved in different national systems are still relevant to the governance of pension funds. However, it is when we seek to incorporate a structure of lay involvement into the system that the debate becomes less clear because of the ever-increasing onerous responsibilities.

Governance is one of the key issues of our time. Required standards of corporate governance in companies continue to rise and so must pension funds also apply high standards. Traditional models of pension fund governance in many systems have generally worked reasonably well. But in today's continually changing pensions environment, new business models are needed. But important issues must first be addressed:

- defined contribution funds are growing in number and are likely to continue to do so. Many of these funds are contract-based and, as a result, there is no effective mechanism to represent the interests of the employer and funds members;
- the burden on existing members of governing boards is increasing and the very large number of small pension funds cannot effectively deal with these onerous challenges;
- effective, and high, governance standards must apply to all pension funds, irrespective of nature and size. This requires significant expertise.

For pension fund governance to work well, and to acceptable high standards, in today's pensions environment, there is a need for effective governance standards to apply to every pension fund.

Pension provision can only progress to meet the challenges ahead if effective policies are implemented and well managed. This applies at all levels, not just within government or occupational pension plans. Good governance in pensions begins with acknowledging that pensions, and the governance of work-place funds, are long-term matters. Consider, for example, that decisions made this decade could potentially have ramifications for people born throughout this century.

Governance in the 21st century inherits a major challenge: how to alter long-standing traditions with new policies that are more than temporary measures. "Quick-fix" solutions usually prove to be no solution at all when dealing with pensions and can often prove a hindrance yielding hasty new regulations. Preparing strong foundations for the decades ahead requires consensus-building, gathering and maintaining support from stakeholders, electorates and the workforce. This can be a delicate and even perilous process.

In the responses to this review, there was overwhelming consensus that the role of lay fiduciaries should come under greater scrutiny, given the growing complexity of financial markets and media focus on the performance of pension funds.

Governing and managing pension funds are separate activities and this is increasingly being recognised by many sophisticated pension funds around the world.

Management is a day-to-day activity that first and foremost involves devising and monitoring strategy, both on benefits and investments. One of the major causes of shortfalls in returns is the limit on managers' ability to act without 'sign-off' from the full governing board. This impediment is absent from the best-run funds where executives are empowered to pursue strategies as their own professional opinions see fit. Whilst variations on such empowerment can include, for example, the creation of a small investment committee of the governing board, this can only begin to work effectively if committee members have suitable investment experience and can take decisions at short notice.

Governance should be about supervising the overall operation of the pension fund to ensure that operations are being implemented in accordance with transparent and up-to-date policies, determined by agreement between fund management and governing body.

Unfortunately, in many pension funds the issue has become increasingly clouded and confused because those responsible for the governance of the pension fund are also inextricably linked to the day-to-day management in a number of ways. Some of these can create considerable conflicts of interest that are increasingly impossible to eradicate. The time has arrived for many pension funds to adopt a more rigorous attitude towards eradicating conflicts of interest.

One prime example – but there are others – of the potential for conflicts of interest is where the pension fund has directors of the sponsoring company on the existing governing body. In some countries, there is growing recognition that such individuals who fail to discharge their duties to fund members because of their responsibilities to shareholders are increasingly at risk of being sued for breach of trust. Arguably, the most obvious single category of director most likely to have to deal with conflicts of interest are the finance directors who have to grapple with such conflicts due to their knowledge of how decisions to direct more money to pension funds may undermine shareholder value. Any number of activities that a finance director might pursue in the interest of shareholders can conflict with the interests of pension fund members. Whilst many directors do their level best to manage these conflicts, it is becoming an increasingly precarious balancing act.

However, if those members of a governing board who are appointed by the company are perceived to be subject to increasing conflicts, so the same must be said of those members of a governing board who are nominated by the fund membership. There will always be occasions when issues affecting the future of the members [as the company workforce etc] come up for decisions, thus making it increasingly difficult for these elected members to effectively manage conflicts of interest.

Pension funds often say that most part-time members of governing boards are not pension experts and have little time to gain the necessary financial knowledge to deal with issues that can be crucial to the pension fund, such as assessing the investments risk of the pension fund. The heavy reliance on finance directors' competencies is, therefore, claimed to be unavoidable.

But the substantial pressure that has been building on pension funds to reduce conflicts of interest is becoming irresistible. The message is clear: pension funds should act to relieve the pressure on themselves. The conflict of interest issue can no longer be ignored.

In recent times, the role of lay fiduciaries has come under great scrutiny, given the growing complexity of financial markets and media focus on the performance of pension funds. Perhaps this trend reflects the growing complexity of pensions and the financial resources needed to comprehend all aspects of fund management.

It would be welcome if all pension funds [and their national governments and regulators] could simplify their regulation to fewer pages. However, the likelihood is that rules governing pensions will grow longer, thus necessitating the need for more experts.

It is regularly reported that the increasing amount of assets now in DC funds reflects the continuing move away from DB funds – with defined contribution funds becoming the sole pension offering for many companies. As the DC market becomes more mature, many employers and pension funds are now realising the need for more effective governance plans for all types of pension funds to ensure an effective governance framework is in place for the future.

An employer's investment in pensions is large, particularly as a proportion of total spend on their employees' total benefits package. For this reason it is important that employees understand and appreciate the quality of the pension fund. To do this effectively the fund needs to meet employees' expectations. If the fund is run in accordance with an up-to-date governance plan then confidence is maintained.

Providing a pension fund can be one of the most challenging, yet rewarding, decisions an employer can make. The employees participating in the fund, their beneficiaries and the

employer can benefit when a pension fund is in place. Administering a fund and managing its assets, however, require certain actions and involve specific responsibilities.

In some countries, a pension fund has certain key elements including a trust fund to hold the fund's assets. However, if a fund is set up through an insurance contract, the contract does not need to be held in trust. Many of the actions involved in operating a pension fund make the body performing them a fiduciary and fiduciary status is based on the functions performed for the pension fund, not just the body's title.

Therefore, every type of pension fund should have a recognised body that has important responsibilities and is subject to high standards of conduct because they act on behalf of the fund's beneficiaries and the sponsoring company.

The fund's members need reassurance that there is a system in place to safeguard their interests and to make sure the investment and other choices they have are appropriate for them. There are arguments, for example, that a trustee or governing board would identify, at an early stage, any problems with investment performance or administration and make appropriate decisions to address them. One of the criticisms of contract-based funds is that they offer too much investment choice and possibly unsuitable defaults, and that these are not reviewed as often as they are under a fund with a trustee or governing body. The counter argument is that contract-based funds can address these issues equally as well through a fully engaged employer or monitoring committee.

The sponsoring company wants to be seen to be proactive in fund design, investment strategy and choice, and communication and guidance to employees. When the fund is viewed as an employer arrangement then culturally it fits better with some employers as it projects paternalism. The employer should want to monitor how the funds are being used to justify its pension spend and to ensure that the fund is well run in the best interests of the members.

In the UK for example, with the increased movement towards DC funds, the choice of whether a DC fund is trust-based [or equivalent] or contract-based depends on the employer's level of engagement. Larger companies with a history of trust-based pension provision are more likely to favour continuing with a trust-based fund. Smaller employers, and companies with no previous pension provision, are likely to welcome the reduced "red tape" that contract-based funds offer.

While the lack of governance inherent in many contract-based funds is increasingly recognised, it is argued that any steps to increase regulation are likely to turn companies away from providing a pension altogether. Regulators may have no preference for one type of work-based pension fund over another. The decision whether to offer a trust-based [or equivalent] or contract-based arrangement is for the employer. More broadly

the employer has an interest in the fund as part of its overall remuneration package to its employees.

But the fact remains that members and beneficiaries have a right to expect their pension fund to be subject to sensible and practical governance and regulation. A company's move to any particular type of arrangement should not be influenced by the apparent lack of regulation and governance requirements.

In some jurisdictions, as the trend towards contract-based DC pension funds continues, some employers are putting in place voluntary arrangements to address governance issues in the form of monitoring committees. Like [for example] a trustee or governing board, this committee can be drawn from senior management and employees, as well as outside experts. While lacking [in many cases] the legal responsibilities of trustees or governing boards, these committees can undertake many of the roles of a governing body and provide similar levels of governance. Having such a monitoring body in place removes many of the perceived disadvantages of contract-based funds.

But in the same way that contract-based funds can learn from, say, funds with a trustee or governing board, so can we learn from these more recent attempts to accommodate good governance in DC funds.

The major question thus arises:

As representatives of pension fund beneficiaries and fund sponsors, how can lay individuals [whether they are fund members or company executives] continue to have a role to play in the governance and supervision of their pension funds?

Governance has many different forms and the time has now arrived when we must consider new business models that will enable these lay representatives to continue to hold the professionals, from actuary to trader, accountable.

The voices of fund members and their employers need to continue to be represented, but at a supervisory level that is responsible for appointing, and monitoring the policies of, a managing body whose role is to manage the money and the fund. This method will create a symbol of trust and connection between the beneficiaries and the professionals responsible for the continuing operation of the fund.

Let us put the legal sense of a fiduciary into a wider practical relationship:

A fiduciary [e.g. a fund's trustees or pension/managing board or contract provider such as an insurance company] is someone who has undertaken to act for and on behalf of another [e.g. members/beneficiaries/sponsoring company] in a particular matter [e.g. the management and administration of the fund] in circumstances which give rise to a relationship of trust and confidence.

- Consider, for example, a two-tier approach to pension fund management and governance.
- a **Fiduciary Body** [comprising of professionally qualified individuals or institution] appointed and supervised by

 - a **Board of Governors** [comprising of elected & appointed individuals who are representative of fund members and the employing company]

In summary:

The pension fund would be the responsibility of a Fiduciary Body – comprising of appropriately qualified professionals [internal and/or external to the organisation] – whose role is to manage the fund, which means, amongst other things, that it is responsible for achieving the fund’s aims, strategy and policy, and the related results. The Fiduciary Body is accountable for this to a Board of Governors and to the fund membership. In discharging this role, the Fiduciary Body shall be guided by the interests of the pension fund, taking into consideration the interests of the fund’s stakeholders. The Fiduciary Body shall provide the Board of Governors in good time with all information necessary for the exercise of the duties of the governors. The Fiduciary Body is responsible for complying with all relevant legislation and regulations, for managing the risks associated with the fund’s activities and for the fund’s investment, administration and accounting activities. The Fiduciary Body shall report related developments to, and shall discuss the internal risk management and control systems with, the Board of Governors. The Fiduciary Body shall be appointed by the Board of Governors and comprise of appropriately qualified professionals who the Board of Governors considers suitable. The Fiduciary Body can include members who are both internal and external to the pension fund and the sponsoring organisation, the emphasis being on the experience and qualifications of the appointed individuals.

The role of the Board of Governors is to supervise the policies of the Fiduciary Body and the general affairs of the pension fund, as well as to assist the Fiduciary Body by providing advice. In addition to appointing and supervising the Fiduciary Body, the Board of Governors shall comprise of members nominated by and from the fund membership and members appointed by the sponsoring organisation. In discharging its role, the Board of Governors shall be guided by the interests of the pension fund and shall take into account the relevant interests of the fund’s stakeholders. The Board of Governors is responsible for the quality of its own performance. The fund’s governance plan shall include provisions for the Board of Governor’s relations with the Fiduciary Body, fund members and the sponsoring organisation. Each Governor shall be capable of assessing the fund’s broad policy and shall be required to follow an induction programme which, in any event, covers general legal, financial and pension affairs, specific aspects relating to the pension fund and the sponsoring organisation and governance responsibilities of the Board of Governors. The Chairman of the Board of Governors determines the agenda, chairs its meetings, monitors the proper functioning

of the Governors and any committees, arranges for the adequate provision of information to Governors, ensures that there is sufficient time for making decisions, arranges for the induction and training programme for Governors, acts on behalf of the Board of Governors as the main contact for the Fiduciary Board, initiates the evaluation of the functioning of the Board of Governors and the Fiduciary Body and ensures the orderly and efficient conduct of any meetings with members. The chairman is assisted in this role by the Secretary of the Pension Fund.

The responsibilities of the Fiduciary Body and the Board of Governors can be detailed in a Code of Pension Fund Governance. The Fiduciary Body and the Board of Governors are responsible for compliance with the code. They are accountable for this to the pension fund members and sponsoring organisation who should take careful note and make a thorough assessment of the reasons for any non-application of best-practice provisions of this code by the pension fund.

A Code of Pension Fund Governance should be developed to illustrate the responsibilities of the Fiduciary Body and the Board of Governors to ensure that the members of these bodies have a very clear understanding of what constitutes good governance. Boards can comply with those standards and report to fund members that good governance is being applied. An important feature of this Code would be concerned with the way boards should govern themselves – it is in this area that self-assessment can play an important part – in the functioning of their duty to manage and supervise the fund in the interests of the fund’s members and beneficiaries [which may include the sponsoring organisation]. This would involve not just the appropriate governance procedures – as important as they are – but also getting the relationships between all the respective parties right. It is important to emphasise the need to develop a governance code that can be applied to the circumstances of all funds. It is also relevant to emphasise that the application of the Code must be in association with the fund’s governing documentation and that, on occasions, this may override the Code.

The application of the Code should be on a voluntary “comply or explain” basis. This approach offers flexibility and, as has happened in other sectors, will lead to improvements in practice and higher standards of pension fund governance.

The “comply or explain” basis would require pension funds to disclose, say, annually its application of the Code [in full or in part] and providing explanation that enables the members and the sponsoring organisation to understand and evaluate how the principles have been applied.

With universal support from all parties, this approach would not be another layer of regulatory burden on pension funds. Properly developed, supported and applied it would provide sufficient scope to cut back on much of the regulatory requirements currently imposed on pension funds. This degree of flexibility would also allow for the easier review and modification of the Code as governance practices develop.

What should a Code of Pension Fund Governance cover and how should it be used?

The Code should be relevant to different types of pension funds. This report identifies that gaps exist in good governance procedures and standards in different funds – e.g. large, small, DB, DC, trust-based, contract-based etc.

The following topics illustrate some of the issues to be developed in the Code:

- Fiduciary Body and Board of Governors - their responsibilities and obligations;
- structure and composition of the Fiduciary Body and Board of Governors – the right composition and representation to ensure professionalism, experience and skills;
- appointment and removal of members of the Fiduciary Body and Board of Governors;
- appointment and duties of board chairmen and sub-committees;
- procedures to determine that appointed and elected members are “fit and proper” for the purposes of their appointment;
- procedures for the Board of Governors’ evaluation of their own performance (i.e. self-assessment);
- managing conflicts of interest;
- internal controls – from the Fiduciary Body’s and Board of Governors’ perspective;
- relationships with the fund members and sponsoring organisation.

The above principles are not exhaustive, but illustrate some important aspects of pension fund governance that, properly developed, can ensure that all pension funds can demonstrate good governance systems that can effectively protect the interests of fund beneficiaries and, as a result, help in the process of restoring confidence in all types of retirement benefit arrangements.

Is There a Will?

Reading through the almost daily news articles – and reports from many pension organisations and governments – about pensions, it is significant how much of the material relates to governing boards and pension regulators.

If we look back to ten or so years ago, pension fund governing boards were lucky to receive a passing mention. Many of these individuals were then no more than enthusiastic amateurs; formal training, for example, was the exception rather than the rule.

These days, governing board members sit – often uncomfortably – in the centre of the pensions stage, having to deal at a high level of competence with complex issues ranging from mortality assumptions to investment strategy, whilst keeping an eye open for potential conflicts of interest and reviewing the strength of the “employer covenant”.

Is it any wonder that so many news articles and reports are aimed more at governing boards than at employers?

And to take the matter further, national regulators seem to pop up everywhere in the same articles and reports. This, too, is hardly surprising considering the regulatory role to ensure the security of members’ benefits.

Governments are now seeking to revise and refresh their pension legislation and “simplification” has now become headline news. But, it is very often the case that when changes are made to simplify pension systems, things become even more complicated and complex than before.

We are seeing new requirements introduced on a regular basis, although in many cases these are being “bolted on” to an existing structure, thus making the overall system even more complicated and without taking the time to review the “bigger picture” to ensure that long term objectives can be satisfied.

The EU Pensions Directive is being implemented differently in member states across Europe. A report earlier this year from the Committee of European Insurance and Occupational Pensions Supervisors [CEIOPS] found that although there is considerable diversity of implementation, because of member states’ limited experience of its practical implementation in some areas, it would be premature to recommend any change to the directive.

We must, however, realise that the ultimate purpose for having a first class system of pension fund governance – regularly monitored and updated – is to protect the pension fund and, thereby protecting the interests of the fund members and wider beneficiaries.

Whilst the intentions of some of the objectives of recent legislation and regulation have been reasonably clear, its practical implementation has resulted in some issues becoming even more blurred than they were before. One particular issue arises from the increasing complexities of pension fund governance.

Much of this recent regulation and the principles behind it are very relevant to the good governance of occupational pension funds. However, it is when we seek to incorporate a structure of lay involvement into the system of running pension funds that the debate becomes less clear because of the ever-increasing responsibilities. Is there a need to look at the “bigger picture” of pension fund governance and to develop a structure that puts lay involvement in a new and more business-like position?

This approach will undoubtedly involve change. Is there the will to change?

The nature of a democracy means that politicians of all shades tend to be driven by short-term considerations. Whether governments can or cannot afford change depends on how badly they want it. There is always competition for time and attention [and funding] from other areas such as health, education and welfare. Pensions, until recently perhaps, are largely seen as problems far away in the future and they do not have the motherhood attributes of these more immediate issues.

There is still a lack of realisation that governance is not working as it is and, perhaps, as it was intended. In many ways regulation has become unmanageable. It would be in everyone’s interests to co-operate and think what kind of regulation and pension fund governance we really need. Even de-regulation, although an important issue to consider, is not the solution. It is only part of the problem.

It is doubtful whether governments have finished trying to make things even more complex, despite the pretence of simplification. After all, there is an army of politicians and civil servants who must inevitably add to the amount of regulation that is around; otherwise they would talk themselves out of a job!

All sorts of solutions are possible, including enabling employers to provide good and innovative pension solutions rather than heaping disincentives and red tape on them. But to achieve an overall solution for pension fund governance that acknowledges, and provides for, the involvement of pension fund stakeholders in a practical manner may involve additional [albeit minimal] spending. Whether or not governments and the range of vested interest pension parties can afford change depends on how badly everyone wants it.

We may well be on the brink of a new era in pension fund provision across Europe. The prudential supervision of pension funds to protect members and beneficiaries

includes the requirement for competent people of good repute with professional qualifications and experience. This must involve an opportunity to update existing principles and develop a comprehensive suite of authoritative best practice tools giving further assistance for pension funds to improve decision-making and governance.

Conclusion

“That government is best which governs the least, because its people discipline themselves” –
Thomas Jefferson

[3rd President of the US 1801-1809 & principal author of the Declaration of Independence]

At the beginning of this report I expressed the hope that whatever your interest – politician, academic, professional, trustee, pension board member, employer, fund member, or simply someone with an interest in effective pension fund governance – you will read it with an open mind and ready to consider how good governance can be taken forward in a genuinely transparent manner that can best protect the interests of all beneficiaries.

From one country to another, pension systems are the product of local culture which gives rise to that country’s national system. It is not sensible to suggest that the wholesale transfer of one country’s pension system to another will resolve today’s problems, even when pension funds are seeking to cope with similar issues. One such issue is pension fund governance.

Elsewhere in this report I have acknowledged the time and effort given by a range of people involved in, or interested in, pension fund governance. Respondents were willing to give their views and opinions in a detailed and confidential manner. I am convinced this method enabled respondents to give honest and forthright views on a range of related governance issues. I stand by the decision to give respondents that freedom and confidentiality.

Whether in pensions, or any other form of savings, if individuals do the responsible thing, but lose out, through no fault of their own, when they are led to believe their contributions are safe, then their benefits must be effectively and adequately protected. If prudence is not respected, then the incentive to save will be dangerously undermined.

Pension fund governance principles and practices need re-balancing.

We live in a world obsessed with efficiency measures on CO₂ emissions, global warming, transport, education, public health and safety, to name but a few. In the world of pensions, the pressure on governing boards to make their pension fund perform effectively has never been greater. Anyone perusing the news headlines cannot fail to notice the extent to which the debate surrounding pension funds and pension crises has, again, moved centre stage.

As the proportion of retirement income provided by private pensions becomes increasingly important, the quality and effectiveness of their supervision becomes more and more crucial. Too much regulation, enhanced by market insecurity and interest developments is undermining the development of a universally acceptable set of governance principles and thus the affordability, feasibility and continuance of many pension funds. If the trend towards more complex regulation continues, the direct involvement of lay individuals in

the ongoing management and administration of complex and sophisticated vehicles for the investment of funds may become a relic of a bygone age. It is actually the top-tier pension professionals who make pension funds successful, not trustees and pension boards. Occupational pension provision needs to be simpler, more flexible and return orientated.

Pension governance standards still fall short and everyone has a solution and is ready to voice an opinion on what should be done!! There is no shortage of people willing to express an opinion on the shortcomings of present systems. All are well-intentioned, even if many are expressing vested interests, but the global pensions industry does seem to lack a degree of joined-up thinking and is often at odds over the best way forward.

In the wake of the credit crunch and the turbulent capital markets, for both DB and DC pension funds, two of the biggest issues are risk reduction and governance. Indeed, taking account of the increased take-up of DC funds, governance ability is an aspect that seems to be getting little attention compared to the attention of governance for DB funds.

The headache of identifying and subsequently managing risks and the related governance systems continues to grow for pension funds worldwide. The specific risks might vary from one organisation to another, but the simple fact is that financial executives are continuously challenged by the uncertainty of controlling these risks.

The results around changes to fund design highlight a flaw with the current pension management model in many countries, where a lack of continuous and dynamic oversight means decisions are made and implemented very slowly, thus impacting on results.

Pension funds must not get side-tracked by some of the suggestions for change that are governed by short-term considerations that may be interesting but in practice will make minimal difference to pension fund members. These do not always make a difference and can be described as “re-arranging the deck chairs on the Titanic”!

Governments must turn back the tide of, what in many cases has turned out to be, poorly justified regulation. Companies must be provided with greater stability in terms of costs etc and be given the freedom to design funds that worked and then be left to run them, as long as the funding and covenant were met.

Chapter 12 [The Art of the Possible] outlined a number of suggestions to assist pension fund governing boards. These involved, in one way or another, the addition of professional services to provide more expertise to those responsible for fund governance.

One of these suggestions raised the trend that Fiduciary Management is taking across Europe. This trend has taken hold in the Dutch pension industry and is now starting to make inroads into the German and UK pension industries with others, such as

Switzerland, Scandinavia and Eastern Europe, taking interest. It is, of course, necessary to understand the concept and the advantages and disadvantages for pension funds, and to be aware what Fiduciary Management is – and is not.

What does Fiduciary Management offer?

- Is it the solution to the increasing complexity of pension funds?
- Can it relieve the pressure on companies and enable them to focus on their core business?
- Does it provide the ideal governance structure with pension fund [investment] responsibility delegated to a single source?
- How does it differ from other multi-manager models?
- How can governance structures and conflicts of interest be resolved?
- What sort of institutions suit Fiduciary Management?
- What will a cost/benefit analysis reveal?

Perhaps the current trend has increased demand for overall services that are not limited to asset management, but begin with understanding the risks associated with the liabilities, risk budgeting and risk management and reporting.

In reviewing pension fund governance, a significant fact emerges. The majority of respondents made the comment – many with great passion and conviction – that the increasing volume of legislation and regulation has now become counter-productive and is not only failing to maintain the confidence of many companies and employees in continuing occupational pension funds, but is also working against the continuing involvement of lay [non-professional] individuals in the high profile role of responsibility for the successful governance of pension funds.

Therefore, the question that continues to be asked, and which needs to be answered is: How can a workable and sustainable structure be developed to continue to accommodate the involvement of lay individuals in the governance and supervision of their pension funds?

The framework outlined in Chapter 13 [An Ideal Structure] is there to build on skills and experience and to promote further improvement. This will ensure that updated principles are more effective and provide the framework for more flexibility for different types of pension funds in terms of their size, benefit type and strategy. In particular, it represents a suitable starting point for developing a governance model that is applicable regardless of jurisdiction and type of pension fund, which can be used to address the highest governance standards and best serve the interests of participants and beneficiaries.

Although European Union regulations and the EU Pensions Directive have been in place for some time to enable the creation of cross-border pensions, it is the efforts of a small number of countries that are making this a real possibility. The first issue to understand is that the establishment of cross-border pensions is not primarily a cost saving exercise. There may be some economies of scale, and naturally companies will be looking for any potential tax advantages, but these are not the main drivers. Instead the rationale behind cross-border plans is much more focused on governance. By running a number of countries' pensions arrangements in a single plan, companies stand to gain a much better overview of their pension plans, investments and commitments. This prospect of improved governance will be the key driver behind this trend.

Groucho Marx [US comedian with Marx Bros 1890 – 1977] once said:
“Age is not a particularly interesting subject. Anyone can get old. All you have to do is live long enough”.

However, this “particularly uninteresting subject” has occupied the minds of millions of people – whether as providers of pensions, recipients of pensions or advisers on pensions – and will continue to do so for many years to come.

A European Pension Fund Governance Forum

The establishment of a European Pension Fund Governance Forum will go a long way in exchanging views and solutions on the ongoing, and continually changing, governance scene and the relationships between the respective parties.

The governance of work-based pension funds requires fundamental reform as a result of the changing regulatory environment and the increased complexity of capital markets. In many cases, regulation is now massively disproportionate to the market failure which inspired it. A more modern and dynamic approach to pension fund governance is needed.

This report should be the catalyst to ensure that we have a co-operative framework for pension fund governance that takes account of new realities, and enhances stability, whilst retaining the appropriate involvement of pension fund stakeholders. Moreover, as part of this fresh focus, a greater emphasis must be placed on creating and promoting a new culture of risk awareness and financial education because the world is moving to a situation where individuals bear more and more risks without being necessarily able to cope with them.

However, Groucho Marx also said:
“Those are my principles – if you don't like them, I have others”!!

Pension Fund Structure in Selected European Countries

The following is an example of some of the relevant pension fund arrangements in various European countries:

Austria

Joint stock company

Bulgaria

Joint stock company

Finland

Company pension fund

Industry-wide pension fund

Germany

Joint stock company

Foundation

Mutual insurance association

Public law corporation/institution

Mutual pension fund association

Ireland

Trust-based fund

Latvia

Joint-stock company

Liechtenstein

Foundation

Joint-stock company

Co-operative society

Malta

Trust & contract arrangements

Norway

Foundation

Portugal

Externally governed pension funds

Slovakia

Joint-stock company

Spain

Pension institution

United Kingdom

Trust-based

Contract-based

Belgium

Non-profit organisation

Mutual insurance association

Organisation for Financing Pensions

Denmark

Company pension fund

France

Stock company

Mutual insurance company

Mutual company/institution

Greece

Non-profit organisation

Hungary

Joint stock company

Italy

Association/Foundation

Lithuania

Association

Public/private/European company

Luxembourg

Co-operative company

Mutual insurance association

Non-profit making association

Savings association/company

Netherlands

Foundation

Poland

Joint-stock company

Mutual insurance company

Romania

Joint-stock company

Slovenia

Joint-stock company

Sweden

Foundation

Limited/Mutual company

Source: Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

IPE Survey

Governance: fit for purpose?

Brian Holden MBE, Chairman of TRM's Advisory Service, has been commissioned by IPE to undertake a major independent review of the governance principles and structures of European occupational pension funds. The review is supported by Pioneer Global Investments Limited and will be published in November. It will also be in the subject of a seminar presentation to be given in Barcelona on 20 November.

The review will focus on a wide range of pension governance themes, including the role of lay (non-professional) trustees and board members and the strengths and weaknesses of trust, foundation and contract models and whether they should be replaced.

If you would like to make a submission, please click here.

governance.review@ipe.com

All views will remain confidential.

Name

Country

Company

Email Address

Job Title

If you are happy for IPE to contact you should we have questions regarding your response please tick the box. Your details will not be passed to any third party, nor will they be used for any marketing purposes.

Fundamental points to be reviewed

Q 1. What are the main objectives in any model of pension fund governance?

Q 2. What is the governance method for your fund?

- Trust-based
- Pension Board
- Supervisory Board
- Other

Q 3. What is the board constitution? How many representatives from employer(s), employees, others?

- | | | | | | |
|-------------|--------------------------------|-----------|--------------------------------|--------|--------------------------------|
| Employer(s) | <input type="checkbox"/> 0 | Employees | <input type="checkbox"/> 0 | Others | <input type="checkbox"/> 0 |
| | <input type="checkbox"/> 1-5 | | <input type="checkbox"/> 1-5 | | <input type="checkbox"/> 1-5 |
| | <input type="checkbox"/> 6-10 | | <input type="checkbox"/> 6-10 | | <input type="checkbox"/> 6-10 |
| | <input type="checkbox"/> 11-15 | | <input type="checkbox"/> 11-15 | | <input type="checkbox"/> 11-15 |
| | <input type="checkbox"/> 16-20 | | <input type="checkbox"/> 16-20 | | <input type="checkbox"/> 16-20 |
| | <input type="checkbox"/> 20+ | | <input type="checkbox"/> 20+ | | <input type="checkbox"/> 20+ |

Q 4. What are the main strengths of this method for pension fund governance?

Q 5. What are its weaknesses?

Q 6. How do you think that it might be improved?

Q 7. What are the main strengths of contract-based models?

Q 8. What are their weaknesses?

Q 9. How do you think these might be improved?

Q 10. Do you think that current governance models need replacing?

- Yes
- No

Q 11. If so, what would you replace them with?

Q 12. Should any particular distinctions be made between defined benefit and defined contribution funds when determining an appropriate governance model?

Q 13. Should smaller companies/pension funds be subject to any particular considerations?

Some of the issues raised so far include:

Q 14. What is pension fund governance?

Q 15. The fiduciary responsibilities of the trustees, the pensions board and the company. What do you think these are?

Q 16. Pensions from the company perspective. What is it?

Q 17. Pension fund regulation and supervision. Is it working?

Q 18. The experience and qualifications of trustees and pension boards. What are they? What should they be?

Q 19. Ensuring workable governance processes and internal controls. How can we do this?

Q 20. The role of the Chairman and Secretary of Trustees or Pensions Board. What should they be?

Q 21. Protecting the fund and the trustees/pension board members. How can this be done?

Q 22. Getting the risk/reward ratio right. How do we do that?

Q 23. What are the alternative governance structures and systems?

Q 24. Is there an ideal structure?

Q 25. Is there the necessary will for change?

Q 26. Can pension funds, their trustees and pension boards help each other?
