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Paul Thornton and Donald Fleming
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1 Introduction

PAUL THORNTON AND DONALD FLEMING

This book has been written to bring together the thinking of leading practitioners in the field of pensions in order to provide an overview of what constitutes good governance for pension schemes. As the closing chapter indicates, the concept of pension scheme governance is something that has been changing considerably in recent years and will no doubt continue to evolve in the future. The aim of this book is to set out what is current best practice at the time of writing, in late 2010.

The book begins by setting the subject in context in Chapter 2. Whilst pension schemes in the United Kingdom have evolved in a particular way, the underlying issues of sound provision of private sector pensions are not unique to one country, and governments around the world are concerned with effective regulation and supervision of schemes.

Chapter 3 explains how pension schemes are inextricably involved in the capital markets and both affect and are affected by market trends.

This leads on, in Chapter 4, to the question of what social and fiduciary responsibilities are owed by the trustees of pension schemes.

The book moves on in Chapter 5 to the practicalities of good trusteeship, and then the issue of conflict of interest in Chapter 6, which has become of significant concern.

Pension schemes are undertaken by employers as part of a remuneration package, and Chapter 7 explores the tri-angular relationship between the pension scheme itself, the members and their employer, who is also the sponsor of the scheme.

Chapter 8 explores changing relationships with other parties and the nature of the employer support for the scheme, or employer covenant as it has become known. This leads on to the financing requirements of schemes and how they are set in Chapter 9.

Effective administration of the scheme is vital and Chapter 10 sets out best practice.

Risk manifests itself in many forms, and the Chapters 11 to 14 deal with how investment risk is managed and hedged, how longevity risk can be hedged and how the insurance market can be used for de-risking.

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All of this is viewed from the perspective of the pension scheme itself, so Chapter 15 examines pension risk from the employer's end of the telescope.

Much of the book's emphasis is on defined benefit schemes, but as such schemes are being progressively closed to future entrants, and then to future accrual, it is necessary to consider the governance issues in the defined contribution schemes which typically replace them, and this is covered in Chapters 16 and 17.

Finally, Chapter 18 draws some threads together.

Our hope is that by bringing together the combined wisdom and experience of leading practitioners across a range of relevant topics, we will enable the reader to see pension scheme governance in the round and will enable them to play whatever part they may have in fulfilment of the best principles of good governance.

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2

Regulatory and supervisory context for occupational pension provision

JOHN ASHCROFT, JUAN YERMO AND FIONA STEWART

Fundamental concepts

This chapter aims to place the discussions that follow within the context of the regulation and supervision of pension scheme governance. It starts with a brief overview of the development of and fundamental differences between private pension systems and their regulation and supervision across the world, including the development of risk-based regulation and supervision. The chapter then considers what constitutes good pension scheme governance and the main weaknesses and challenges relating to it. The chapter goes on, drawing on Organisation for Economic Cooperation and Development (OECD) and International Organisation of Pension Supervisors (IOPS) guidance, to highlight ways in which regulation can promote better governance and how supervisory authorities undertake their oversight of governance arrangements. Finally, the chapter outlines the United Kingdom's regulatory and supervisory framework and its application to governance.

It is first worth clarifying terminology. In the OECD's taxonomy, a *pension plan* comprises the promise of benefits to the members, while a *pension fund* comprises the portfolio of assets held to finance the promised benefits. The entity responsible for the governance of the assets and administration of the fund is also referred to as a pension fund, although this may be a part of or supplied by a larger organisation, the *pension provider*. In the United Kingdom, however, the plan and fund taken together are commonly referred to as a *pension scheme*.

This chapter covers pension *regulation*, the legal framework and rules that govern the design of pension plans and management of pension funds, and pension *supervision*, the enforcement by one or more authorities of such regulation.

The development of private pensions, their regulation and supervision

For over 100 years employers in developed countries have established and funded pension plans for their employees, to improve financial security in old age and as a means of deferring employee compensation. Governments

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have increasingly valued occupational pensions as a means of complementing state-financed retirement benefits and have provided tax incentives. These incentives commonly extend to private pension products sold to individuals by commercial financial services companies – a market that has grown rapidly over the last few decades. Hence we see the OECD (and EU) three-pillar model: (1) state-financed benefits complemented by (2) occupational pensions and (3) personal pensions.[1]

Occupational pensions were originally regulated through trust law in countries in the Anglo-Saxon legal tradition. In other countries, contract law, company law and employment law were applied at different times. The legal form of pension fund also varies across continental European countries – foundations and associations being the two most common forms. Occupational pension schemes can also be provided from (book) reserves in the employer's accounts, as for instance in Germany, Austria and Sweden. The potential negative impact on government tax revenues, and the cost of state provision should private pension arrangements be abused or fail, has resulted in specific government regulation of occupational pensions, spurred on by particular crises such as Robert Maxwell's looting of his UK company pension funds.

The OECD and other international organisations recommend that governments should actively promote the second and third pillars of retirement provision so as to provide financial security in retirement for populations that, worldwide, include higher proportions of older people, without unsustainable calls on public expenditure. This is particularly the case where (as in most countries) the proportion of citizens above retirement age is growing rapidly.

An increasing number of countries' governments have gone beyond reactive regulation of pre-existing pension funds and encouraged or mandated membership of private pension plans as a matter of public (welfare) policy, to help supplement pillar I provision. In the United Kingdom and Ireland, this has meant requiring employers to make pension plans available to their employees, but with no requirement to make contributions.[2] Australia has since 1992 required contributions to a licensed pension plan (currently of at least 9 per cent of salary) and New Zealand has since 2007 required contributions unless employees opt out.[3] Other Western European countries with mandatory private schemes include Iceland, Norway, Sweden and Switzerland. As a result of industry-wide collective bargaining, occupational pension schemes also achieve quasi-mandatory levels of coverage (over 80 per cent of the workforce) in countries like Denmark and the Netherlands.

1 The three-pillar models used by the OECD and the EU differ in so far as benefits financed from employer or employee payments to the state but administered by private sector pension funds are treated as pillar II by the OECD, but can be pillar I in EU terminology.
2 In the UK the requirement applies only to employers with five or more employees.
3 The New Zealand system has strong similarities with the system of auto-enrolment and personal accounts to be introduced in the UK from 2012.

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More radically, countries across Eastern Europe and Latin America have undertaken World Bank-recommended pension reforms and replaced part of the public pension system by private pension systems with mandatory participation.[4] The private pension systems are all based on defined contribution (DC) formulas and are administered by a relatively small number of commercial pension providers.[5] In most countries, pension providers run pension funds as legally separated contractual pools of assets without legal personality. In the absence of well-developed, pre-existing financial markets, and because of their role in pension provision, these systems are commonly heavily regulated.

It can be seen that private pensions are inextricably linked to governments' social welfare policies – distinguishing them from other financial services. This relationship has meant that governments have been reluctant to leave pension funds lightly regulated and have, over time, legislated for nearly every eventuality, albeit with differing degrees of prescription. Legislation tends to be particularly tight where contributions to a pension fund are to some extent mandatory. For example, the move to a mandatory system in Australia was followed by the introduction of stringent new licensing and risk management frameworks. Pension fund governance therefore cannot be understood in isolation from a country's regulatory framework.

Governments have established pension supervisory authorities to help to ensure that regulation is effectively enforced. In some countries the supervisory authority is also responsible for drafting some or all of the pension's regulation, either alongside the regulator or acting as regulator. In other countries the supervisory authority is operationally independent from the regulator (commonly a government department) and is very often within an 'integrated' authority responsible for supervising other types of financial services, most notably insurance. Where financial services are integrated using the 'twin peaks' model of separate authorities for prudential supervision and market conduct supervision, two supervisory authorities have complementary responsibilities in this area.[6] In some countries, most notably the United States, the tax authority also has regulatory and supervisory responsibilities.

Within the European Union, a further layer of regulation has been provided by the IORP Directive,[7] which establishes minimum standards on:

- the legal separation of the scheme from the sponsoring employer or a company providing other services;

4 Confusingly, the World Bank uses a three-pillar model with: (I) state-unfunded provision; (II) mandatory, privatised state provision; and (III) voluntary provision. The third pillars would therefore encompass occupational provision, a rarity in the countries adopting the World Bank model.

5 For instance, there are six providers in Chile.

6 As in Australia and the Netherlands.

7 Directive 2003/41/EC, Activities and supervision of institutions for occupational retirement provision (IORPs).

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- minimum conditions (including fitness and propriety) for registering schemes;
- annual reports and accounts;
- information to be given to the members and beneficiaries;
- the powers and duties of supervisory authorities, including information to be provided to them;
- the calculation and funding of scheme liabilities (technical provisions);
- investment rules and statements of investment policy principles;
- freedom to appoint managers and custodians from other member states; and
- cross-border schemes.

In developing the regulatory and supervisory regime for occupational pensions, the European Commission has been advised by the Committee for European Insurance and Occupational Pensions Supervisors (CEIOPS),[8] on which the United Kingdom has been represented by the Financial Services Authority and the Pensions Regulator.

The focus of regulation and supervision

Viewing the worldwide diversity in private pension systems, a distinction can be made between:

- **Occupational provision** via closed funds established by the employer, or associations of employers (sometimes also with the participation of labour unions), to provide retirement benefits to their own employees.[9] By and large, closed funds are established as not-for-profit entities owing a primary fiduciary duty to the members. They offer defined benefit (DB), hybrid or DC benefits, with regulation as a legislative overlay across pre-existing legal frameworks; and
- **Contractual provision** via insurance arrangements or open funds established by commercially run pension providers that can be joined by any individual on a contractual basis. Open funds usually offer DC benefits. Individual members can choose the provider, and hence competition between providers is expected to place some discipline on pension fund governance. In these cases, the employer's role may be limited to paying over contributions, although it may also select the provider where the member does not exercise choice.[10]

The two types of system can exist alongside each other, as indeed is the case in the United Kingdom, where employers can either offer an occupational pension scheme or facilitate employee access to a contractual pension scheme,

8 CEIOPS has now been replaced by the European Insurance and Occupational Pensions Authority (EIOPA), with strengthened powers. See https://eiopa.europa.eu/.

9 As a result of the legislation introduced in Australia in 2005, closed superannuation (pension) funds have been able to open up their membership to employees of companies unrelated to original fund sponsors.

10 As in Australia and New Zealand, but not Eastern Europe or Latin America.

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usually a personal pension provided by an insurer and equivalent of the open funds observed elsewhere.

In essence, regulation and supervision of occupational provision can rely to some extent on the fiduciary role of the governance entity (closed fund) with a legislative and supervisory focus on issues, such as the funding of DB plans, where such reliance has proved to be ineffective. The regulation and supervision of contractual plans (open funds), on the other hand, tends to be more prescriptive, with rigorous licensing of the entities, detailed rules for their administration and governance and extensive inspection of supervisory returns and scheme management, reflecting the risk of commercial considerations outweighing fiduciary responsibility. There is also commonly a focus on making competition more effective through disclosure to members.

Regardless of the system, however, regulators and supervisors have come to recognise that it is better to ensure that schemes are well governed than to prescribe the minutiae of what they should do, or hope that member choice will supply sufficient discipline. Hence, there has been increasing focus on improving risk management by pension funds and concentrating supervisory effort on the highest risks rather than compliance with legislation. For instance, the restrictions placed by many countries on the level of investment in riskier assets are being relaxed with the introduction of the 'prudent person principle' covering how scheme managers and fiduciaries should address investment risk.[11]

For funds which deliver guaranteed benefits,[12] the move to a risk orientation has meant a focus on solvency and investment risk, where the sponsoring employer does not underwrite the guarantee, or employer default risk where (as is the case in the United Kingdom) it does. Quantitative solvency models, as found in the banking and insurance sectors, have found favour in many of these countries.[13] Longevity risk is receiving attention everywhere.

For DC schemes, the focus tends to be on the management of investment and operational risks, to which members are directly exposed, together with the level of charges and risks arising from converting pension saving into annuities at retirement, where this is mandated.[14] There is also a strong focus in many countries on the accuracy, quality, accessibility and comparability of disclosure to current and potential scheme members, especially where they can choose their scheme.

11 The prudent person principle is required by the EU IORP Directive.

12 This category includes not just the defined benefit arrangements common in the UK and other developed countries, but also defined contribution plans with minimum performance guarantees as found across continental Europe and in Latin America.

13 These include the Netherlands, where a modified insurance solvency model is used, and Denmark and Germany, where EU insurance solvency rules are applied.

14 While the majority of countries with defined contribution plans require that some or all of the benefits be used to buy life annuities or regulated income draw-down products, Australia and the United States are two notable exceptions.

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Risk-based regulation and supervision also encompasses the fitness of those who run the scheme (hence the UK focus on trustee knowledge and understanding mentioned later in this chapter), the scheme's governance processes and internal controls, member representation and the management of conflicts of interest.

Pension fund governance

What is good pension fund governance?

The governance of private pension plans and funds involves the managerial control of these organisations and how they are regulated, including the accountability of management and how they are supervised. The basic goal of pension fund governance regulation is to minimise the potential agency problems, or conflicts of interest, that can arise between the fund members and those responsible for the fund's management, and which can adversely affect the security of pension savings and promises.

Good governance goes beyond this basic goal, and aims to deliver high pension fund performance while keeping costs low for all stakeholders. It can have many positive side effects, such as creating trust amongst all stakeholders, reducing the need for prescriptive regulation and facilitating supervision. Good pension fund governance can also be conducive to more effective corporate governance of the companies in which they invest, as well-managed pension funds are more likely to seek value for their investments via a more active shareholder policy. Good governance also needs to be 'risk-based' – for example, the more sophisticated the investment strategy adopted by the pension fund, the stricter the governance oversight required; or the more complex the administrative arrangements of the plan, the tighter the operational oversight needs to be.

How is pension fund governance structured?

In meeting these goals, pension fund governance is structured in different ways in different countries. All autonomous pension funds have a governing body or board, which is the group of persons (or in some cases a single person) responsible for the operation and oversight of the pension fund. The governing board is the ultimate decision-maker, having overall responsibility for strategic decisions such as setting the investment policy, choosing the investment manager(s) and other service providers, and reviewing the fund's performance.

The pension fund's governing board is the equivalent of the board of directors of a corporation, which has the ultimate responsibility for protecting the shareholders' assets. The governing body may be internal or external to the pension fund, it may have a single or dual board structure and may delegate certain functions to professionals. These features of pension funds depend on the legal form of the fund and the regulation in place and are the starting point

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for understanding differences in the quality of pension fund governance across countries.

The structure of the governing body is determined by the legal form of the pension fund. This chapter has already referred to the distinction between occupational and contractual systems. Occupational pension funds have two types of governance structures:

- The **institutional type** of fund is an independent entity with legal personality and capacity and hence it has its own internal governing board, owing fiduciary responsibility to plan members. Examples include pension foundations and associations as they exist in countries such as Denmark, Finland, Hungary, Italy, Japan, Norway, Poland, the Netherlands and Switzerland, as well as corporations such as Pensionskasse in Austria and Germany. In most of these countries pension funds have a single governing board, the members of which are typically chosen by sponsoring employers and employees (or their representatives). In some countries, like Germany and the Netherlands, there is a dual-board structure. In Germany, a supervisory board is responsible for selecting and monitoring the management board, which in turn is responsible for all strategic decisions.
- The **trust form** is used by pension funds in countries with an Anglo-Saxon legal tradition. Under the trust form it is the trustees who legally own (have the legal title to) the pension fund assets. Trustees must administer the trust assets in the sole interest of the plan participants, who are the beneficiaries from the investment of those assets according to the trust deed. While this feature of trusts is similar to that of foundations, the trustees are not legally part of the trust. Indeed, a trustee may be of the corporate type (as is usually the case in Australia, and sometimes in the United Kingdom and Ireland).

By contrast, a **contractual type** of pension fund consists of a segregated pool of assets without legal personality and capacity that is governed by a separate entity, typically a financial institution such as a bank, insurance company or pension fund management company (which may in turn be a subsidiary of a bank or insurer). The governing body of a fund set up in the contractual form is usually the board of directors of the management entity, although in some countries (for example, Spain), some key responsibilities are shared with a separate oversight committee (*comisión de control*). In Australia, contractual providers generally have to be established under a master trust, which is intended to impose a greater fiduciary discipline (and is found in a few UK providers).

The United States has an additional feature as the governing body may be the plan sponsor, the trustee and/or some third party. The Employee Retirement Income Security Act of 1974 (ERISA) requires single company pension plans to have one or more named fiduciaries who have authority to control and manage the pension plan, including its investments. The sponsoring employer and the trustee are always named fiduciaries, but it is possible for the trustee to be devoid of any major fiduciary responsibility (directed trustee), following

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instead another named fiduciary (for example, a plan committee). In addition, asset managers, financial advisers and other persons and entities that exercise some discretion over the fund's assets are considered to be functional fiduciaries, and have some legal responsibility for the pension fund.

Good governance is increasingly recognised as an important aspect of an efficient private pension system, enhancing investment performance and benefit security. Yet, weaknesses still persist. The regulatory control and supervisory oversight of this important area have therefore been strengthened in recent years.

The regulation of pension fund governance

The role of the OECD

The OECD has for some years taken a keen interest in the regulation of private pensions through its Working Party on Private Pensions, which is drawn from representatives of pensions regulators across the OECD and some selected non-OECD countries. The Working Party prepared a set of guidelines on pension fund governance in 2001, which were later (in 2005) approved as an OECD recommendation, namely, a non-binding agreement among OECD members reflecting a common and unanimous position on the topic. The recommendation was revised in June 2009, strengthening some regulatory aspects of pension fund governance.[15]

The OECD has been promoting these guidelines in conferences around the world and via its membership, and in 2007 carried out a review of their effectiveness in improving governance standards. The review, summarised in Stewart and Yermo,[16] revealed that thirteen countries had introduced substantial governance reforms since the first version of the guidelines was developed. The Working Party has also used the guidelines as part of its assessment of candidate countries for OECD accession.

Governance problems

Despite increased recognition of the importance of good pension fund governance, surveys still show that problems and weaknesses remain.[17] Firstly, in trust-based systems trustees and fiduciaries commonly lack suitable knowledge, experience or training, which additionally hinders them from understanding and questioning the advice they receive from outside experts. Secondly, conflicts of interest still remain, both within boards and in relation to independent, commercial trustees.

15 The guidelines are available at www.oecd.org/dataoecd/18/52/34799965.pdf.

16 F. Stewart and J. Yermo, 'Pension Fund Governance: Challenges and Potential Solutions', OECD Working Papers on Insurance and Private Pensions, No. 18 (Paris: OECD Publishing, 2008).

17 See Stewart and Yermo, 'Pension Fund Governance', cited above fn. 16.

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