PBSA Update

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Special Edition on Pension Plan Governance and Self-Assessment

In this Issue

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Note to our Stakeholders

When we started to discuss this edition of *Update*, and the suggestion was made that we make it a special edition to cover only pension plan governance issues, a debate ensued. It was argued by some that all stakeholders must have heard about self-governance as a result of our discussions with the pension industry over the past three years. Others felt that, notwithstanding our *Guideline for Governance of Federally Regulated Pension Plans* which was issued in May 1998, and the *Recommendations of the Association of Canadian Pension Management*, the *Recommendations of the ACPM, PIAC, OSFI Joint Task Force on Pension Plan Governance and Self-Assessment*, issued in January 2000, in addition to a governance paper issued by each of the ACPM (Association of Canadian Pension Management) and PIAC (Pension Investment Association of Canada), we have not had an opportunity to discuss, informally, the benefits of good governance with many plan administrators. This is because, for the most part, our audiences at seminars and industry conferences have consisted mainly of representatives from large plans.

Continued on page 2

I Governance and Self Assessment

1. Pension Plan Governance

What is pension plan governance? The terms governance and self-governance are used interchangeably. They comprise the tenets of corporate governance and the recent advances in the realm of investment fund governance. Pension plan governance refers to the roles and responsibilities of everyone involved with the running of the pension plan. The most important concepts of plan governance are the legal and fiduciary responsibility of the decision maker(s), who are often referred to as the plan fiduciaries.

Continued on page 2

Continued from page 1 "Note to Our Stakeholders"

After reading *Update 21*, we hope that administrators of medium and small plans will feel that they have "caught up" on the topics of governance and self-assessment. For those familiar with the topic, it will provide a review of the issues. Our goal is not to make our readers governance experts, but rather to pique an interest in plan governance which will encourage further investigation.

Self-assessment of plan governance was an initiative driven in large part by the pension industry. However, OSFI recognizes that it has a role in promoting self-assessment and was pleased to join two pension organizations, ACPM and PIAC, in developing some basic guidelines for the pension industry.

Included in this special edition of *Update* is a survey which plan administrators are asked to complete and return to us. OSFI will not impose a penalty on administrators who have not implemented good governance and self-assessment practices. We are simply trying to establish a benchmark against which future surveys can be measured. Please note that a copy of the survey has been sent to plan administrators only. Other interested parties may view the survey on our website.

We feel strongly that good governance is essential and we are depending on the industry to adopt good governance practices. To that end, OSFI is prepared to play a role in helping plan administrators, as required.

Although we stated previously that the survey would be on a no-name basis, that is no longer the case. The reason that the survey is now mandatory is that OSFI must have sufficient data to report to the Standing Senate Committee on Banking, Trade and Commerce which intends to hold hearings to determine whether regulations are needed to ensure that plans are well governed, or whether voluntary compliance with the governance guidelines is satisfactory. Therefore we require that plan administrators complete and return the governance survey to OSFI by October 31, 2000.

In two years we will survey plan administrators again to determine the progress that has been made. It is at that time that we hope to inform the industry that administrators are voluntarily practising good governance and self-assessment, making legislation of such practices unnecessary.

Continued from page 1 "Pension Plan Governance"

Good governance promotes the timely and cost-effective delivery of pension benefits and promotes the administration of the plan in the best interests of plan members and beneficiaries. Good governance requires appropriate control mechanisms that encourage sound decision-making, proper and timely execution and regular review and assessment. Good governance imposes additional obligations on many plan administrators who have historically seen their role as merely making timely contributions to the pension fund. While good governance imposes additional obligations, it also provides for additional freedom, such as the ability to use discretion when making decisions without checking with the regulator.

In our *Guideline for Governance of Federally Regulated Pension Plans*, OSFI identified some basic principles of good governance of pension plans. They include:

- clearly stated objectives;
- independence of the governing body from the plan sponsor(s);
- separation of governance from operations;
- clearly defined roles and responsibilities;
- accountability and internal controls;
- adequate knowledge and skill sets;
- due diligence in decision-making;
- supervision of delegated work;
- controls for expenses;
- controls for conflicts of interest;
- transparency and disclosure.

Good governance is directed at fulfilling the pension promise. It applies to plans of all sizes and types – from the very large, complicated plans to the small, simple executive plans. It is growing in importance because of the ever-present risks in the financial environment, the increasing complexity of working relationships and the risk-based approach to supervision by the regulator.

2. Risk-Based Supervision – OSFI's Role

A *Draft Paper on OSFI's Risk-Based Supervision of Pension Plans* was issued in May 1998. The paper explained that the new approach, which was a result of changes in the pension industry, was an attempt to find a balance between the protection of members' pension benefits and the plan sponsor's ability to operate efficiently without undue restrictions or unnecessary costs.

Risk-based supervision means less supervisory emphasis on issues that are more appropriately the responsibility of plan administrators, such as ensuring continuing compliance with the *PBSA*. With such an approach, OSFI faces the challenges of identifying areas of concern early and intervening, when necessary, to minimize losses to plan members. To meet these needs, OSFI has developed a Risk Assessment System (RAS) that rates each plan's ability to meet current and future obligations to members. In other words, it provides OSFI with a high-level risk profile of each pension plan.

We have received comments on our risk-based approach from individuals and various organizations and associations, including the Canadian Institute of Actuaries and the Canadian Bankers Association. OSFI has also made some presentations on the topic. All comments are being considered as we further develop our system.

When the draft paper was issued in 1998, supervision of pension plans was done by two distinct groups – analysts and examiners. As we continued to refine the risk-based approach to supervision, we looked at ways to use our resources more effectively. This led to the merging of the analysis and examination functions into a portfolio approach. OSFI's pension supervisors (formerly analysts) now conduct on-site examinations as part of their supervisory duties. This has allowed them to focus on high-risk plans, both from our Ottawa office and on-site, in a more efficient manner. The portfolio approach is beneficial to all stakeholders.

3. The Principles of Good Governance

The Joint Task Force, in its *Recommendations on Pension Plan Governance and Self-Assessment*, concentrated on six principles of governance which apply to all types of pension plans – defined benefit, defined contribution and combination. These principles cover all aspects of delivering the benefit promised by the plan – plan administration, funding and investments. Although there may be several ways to implement them, the basic principles are essential to achieving effective governance. The following is a synopsis of the six principles:

1. **Pension Plans Should Have a Clear Mission Statement**

The plan's mission statement defines why the plan exists; it reflects the plan sponsor's reasons for establishing and maintaining the plan; it facilitates the adoption of measurable goals. The plan's mission statement should be distinct from those of the company and the union.

2. **Pension Plans Have a Primary Fiduciary Duty to Plan Beneficiaries**

Pension plan governors and administrators owe a duty of loyalty to the plan and its beneficiaries over and above all other interests. A code of conduct, including conflict of interest policies and procedures, covering all aspects of the pension plan should be defined, disclosed and monitored.

3. **Responsibilities and Accountabilities Should be Allocated Clearly**

The plan's governors should identify the stakeholders, allocate responsibilities and define roles; they should identify the stakeholders to whom they are accountable. For example, the benefits manager may be responsible for paying benefits and accountable to the plan's governors who in turn are responsible

Continued on page 4

Continued from page 3 "The Principles of Good Governance"

for delivering the pension promise to the plan beneficiaries. At the same time, the plan governors will be accountable to the company's board of directors, which in turn is accountable to the shareholders. Accountability is enhanced through disclosure and transparency.

4. Performance Should be Measured and Reported

The plan's governors should measure performance – plan administration, funded status and investments – against pre-defined goals, which may be adjusted over time. Results should be reported to the appropriate stakeholders. Measuring performance facilitates the separation of the oversight of operations from the administration of the plan.

5. Plan Administrator Should be Qualified and Knowledgeable

Everyone involved in the administration of the plan should have, or acquire, the current and appropriate knowledge and skills which are required for the assigned responsibilities.

6. Governance Self-Assessment

The governance process should be reviewed and modified over time to ensure its effectiveness; the results should be disclosed to the appropriate stakeholders.

4. SPECIAL GOVERNANCE ISSUES FOR DEFINED CONTRIBUTION PLANS

This is a reminder to administrators of defined contribution plans that all of the principles of good governance apply to their plans as well. Some sponsors of small to medium defined contribution plans assume that their governance responsibilities are diminished or eliminated because the investment risk is shifted to the plan members. However, this shift in risk imposes additional responsibilities on the plan sponsor. These include the selection of investment options offered, the disclosure of investment performance of the options, and an education and communication program for members.

5. GOVERNANCE PROBLEMS

OSFI regulates pension plans by means of a supervisory process which depends on required filings such as the Annual Information Return, the Financial Statements and the Valuation Report as well as plan documents which cover special situations such as plan conversions and sales, spin-offs, etc. The supervisory process also includes on-site examinations. Whether from our office in Ottawa, or on-site, OSFI has discovered a variety of governance problems.

Governance problems in underperforming plans often underscore the need for more education and training of those who are responsible for the pension plan. Problems are evident, for example, when there is confusion about responsibilities and expectations; the inability to deliver promised pension benefits; mismanagement of pension assets; legal actions against parties involved in the plan governance. We have found practices that would fall under the shoddy, if not the shady, school of governance. However, we recognize that most plan administrators try very hard to meet the ever growing expectations that are imposed on them and, as might be expected, most problems are sins of omission. What follows is a sampling of the types of governance shortfall that we have found:

- Investments not in accordance with the Statement of Investment Policies and Procedures
- Involvement of the pension committee in the day-to-day activities of the plan
- Lack of written policies
- Conflicts among plan documents and/or governance documents
- No provision for training of the responsible staff
- Dumping devalued company stocks into the pension fund as contributions
- Extravagant charges for training trips
- Secret kickbacks on investments
- Using the pension plan as a tool for constituency interests rather than for the best interests of the beneficiaries

- Inappropriate expenses such as charging the plan for Christmas cards, bibles, hockey tickets, art, match boxes etc.

6. SELF-ASSESSMENT

As an industry best practice, the Joint Task Force on Pension Plan Governance and Self-Assessment recommended that pension plan administrators conduct assessments on the governance of their pension plans and report the findings and action plans to correct deficiencies to interested plan stakeholders, including plan members. The aim of the Task Force was to propose a cost-effective self-assessment and reporting regime, which focuses on high-level issues rather than processes, one that would be flexible and applicable to all pension plans.

While we have had complaints that the self-assessment proposed by the Task Force does not suit all plans, that was never the intent. The proposed self-assessment is a template and was intended as a place to start. OSFI expects plan sponsors to modify the template to suit their individual plan.

7. WHAT OSFI HAS LEARNED

OSFI does not know first-hand the successes and challenges of implementing good governance practices. When we attend conferences, seminars and on-site examinations, we learn by talking to plan administrators and consultants who have been eager to share their experiences. We believe that it is worth while sharing these experiences with our stakeholders. The following observations come from the pension industry, all of which are endorsed by OSFI.

- Pension plan governance is in its infancy but it is growing and evolving. Regulation is not the way to accomplish good governance.
- Good governance reduces legal liabilities by highlighting areas of exposure; increases the security of the pension promise; has been known to increase return on investment; and keeps the government away.
- When considering a change in the way that a plan is governed, the administrator should ask if there is a need for change. The answer can be determined by assessing the current governance practices. If changes are required, it is important to first determine the organization's culture. A pension administrator cannot bring in changes that fly in the face of long-established company practices; rather, goals for the pension plan should be set against the organization's cultural backdrop.
- Governance goals should be set, the current status determined, the gap measured and procedures set in place to bridge the gap.
- Trust and confidence must be developed in relationships with all stakeholders. To this end, it is preferable to introduce a realistic plan and implement it well than to aim for an ideal plan that is not realistic. Progress should be slow and incremental rather than quick and dramatic (the latter will be forgotten as quickly as it was introduced).
- Recognition that skills in dealing with people are more important than technical skills as technical skills can be taught.
- Flexibility whenever possible but governors should not compromise on important issues.
- The governance process should be assessed and reviewed on a regular basis.
- Good governance is about power sharing.

II Other Items

We thank those who pointed out the printing **error in *Update 20*** in the chart at the bottom of page 2 — Return on Investments. A corrected version is on the OSFI website.

We have been asked to clarify the various **dates used in our reports**. OSFI's fiscal year is from April 1 to March 31. The *PBSA* requires that we report to Parliament on the operation of the *PBSA* at the end of each fiscal year. Therefore the data we used was from April 1998 to March 1999. The next reporting year will be 1999–2000. Our data is compiled from the information provided on the Annual Information Return, Financial Statements and Valuation Report. These reports are not due until six months after the plan year end, which, in about 80 per cent of the plans, is December 31. That means our data cannot be compiled until several months after OSFI's fiscal year end.

For those who were concerned that **fees collected** from plan sponsors were being used to produce statistics for *Update*, that is not the case. OSFI is able to use the data which is collected and analyzed for the Annual Report, as required by legislation.

The Minimum Funding Paper proposals have been sent to defined benefit plan sponsors and other interested parties. If you did not receive a copy but would like to have one, please refer to the OSFI website or call Kathleen Hunter at 990-8124.

PBSA Update 22 will be issued in the fall of 2000.

If you have **suggestions** for content, or wish to add to the information presented in previous issues, please contact Nancy Hrischenko at (613) 990-8032.

OSFI Website

The OSFI Website contains a number of pension-related documents. These include:

- The *Pension Benefits Standards Act, 1985, Regulations* and Directives
- Required Pension Forms
- Pension Guidelines
- Issues of *Update*
- Other Pension Documents