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OECD Working Party on Private Pensions

30 September 2008

(By email transmission)

Dear Sirs

RE: Draft Guidelines for Pension Fund Governance

1. I refer to the invitation by the Directorate for Financial and Enterprise Affairs of the OECD for views on the above.
2. My comments below are made in my personal capacity, and these comments are not those of this firm, any of my clients or any pension fund on whose governing body I sit. My comments are informed by my experience as a specialist pension lawyer to various pension funds, primarily in South Africa, which cover the entire spectrum of the different types of pension funds (occupational, multi-employer and voluntary saving), as well as my experience as a trustee on a number of different pension funds.
3. The draft OECD Guidelines for Pension Fund Governance are in two parts: the first part deals with the governance structure, and the second part deals with the governance mechanisms. The governance structure part has provisions relating to the identification of responsibilities, the governing body, delegation and expert advice, auditor, actuary, custodian, accountability and suitability for the office of the governing body; whilst the governance mechanisms deal with risk based internal controls, reporting and disclosure.
4. The draft OECD Guidelines are most helpful but in my view it would benefit those Guidelines if there was to be stated in them, as a paradigm for giving guidance on good governance, what the rights and responsibilities of the stakeholders are in respect of pension fund governance; and also for the purposes of good governance to be set out. I amplify on each of these aspects further below, and then make some comments about representivity on the governing body.

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The Stakeholders

5. The pension fund stakeholders are the fund membership, those beneficiaries of fund benefits who are not members (such as those who receive a benefit on the death of a member), the sponsor of the fund, an employer participating in a fund (if different from the sponsor) and the regulator. All have a role to play in requiring accountability for the good governance of the pension fund, and it should be clear from the governance arrangements what the rights and responsibilities of each such stakeholder are in relation to the governance of the fund.
6. The fund membership is the most important stakeholder group because it is principally for their benefit that the fund provides the promised benefits. Accordingly, the primary accountability (a function of the fourth governance purpose below) should be to this group, and what that form of accountability may include is set out in para 31 below. What is important is that the governing body demonstrates its intent to fulfil the pension promise to this stakeholder group, which intent must clearly override any other consideration such as the commercial proposition (if there is one) of the sponsor or the exposure of an employer to its balance of cost obligation in a defined benefit arrangement.
7. With regard to the fund's sponsor, if this is not an employer participating in the fund but an entity sponsoring the fund for a commercial purpose, there should be clearly delineated what that commercial purpose is so that it can be achieved without compromising the governance purposes. For example, it would compromise the governance purposes (specifically the fourth governance purpose) if such a commercial sponsor were to be able to access, without the consent of the fund membership, the membership data in order to market products which such membership may not otherwise consider purchasing. There is considerable commercial value in such membership data, and it should not be exposed to abuse.
8. The employer is also an important stakeholder in respect of an occupational fund because it is usually through the employment arrangement that the pension promise is made, whether or not that is a pension promise made through the vehicle of a third party (the pension fund, insurer or other entity, such as a trust) or through the employer itself. The employer has an interest in the good governance of a pension fund because that good governance will enhance the pension promise as a benefit of employment, thus making employment with that employer more attractive.
9. However, the delicate line between what the employer may properly require of the pension fund, and what are the sole responsibilities of the governing body, must be clearly understood. In a defined benefit arrangement it is not appropriate for the governing body to adopt an investment policy which exposes the employer to an unreasonable risk through the balance of cost obligation, and it is clearly appropriate in this circumstance for the governing body to seek the employer's views on the fund's

investment policy, even if the governing body is not bound by the view of the employer. Similarly, the investment structure in a defined contribution arrangement is one which the governing body should seek input from the employer, not for the employer to have any responsibility in that regard, but for the employer to express a view because it is the employer which makes the pension promise and thus has an interest in what is delivered in terms of that promise.

10. Furthermore, the employer should be entitled to require of the governing body, whether the fund be of a defined benefit or defined contribution nature, and without compromising the independence of that governing body, that a proper risk management process is undertaken, that there is an appraisal of the governing body, and that the costs associated with the management of the fund are reasonable. In short, the employer has an interest in the governance of the fund and should be entitled and encouraged to demand good governance.
11. The regulator plays an important role in ensuring that there is good governance of pension funds by giving guidance as to what such good governance is; adopting an effective risk based supervisory approach; requiring disclosure of costs; and being able to intervene in the management of a fund to bring back to health any fund whose governance displays some pathology. Of course, self-regulation through good governance is always preferable to over-regulation, and managing this delicate balance will always be a challenge.
12. I now turn to the purposes of good governance of pension funds.

Governance Purposes

13. The importance of setting out what the governance purposes are is to establish a way of assessing whether the governance structures and mechanisms fulfil their object. Put differently, merely describing a good governance structure is not helpful enough. There needs to be stated what the outcome should be of such good governance. Such an outcome should be more tangible than merely enhanced retirement savings; it should instil in the stakeholders confidence and trust in the governance structures and mechanisms.
14. In my view the purposes of good governance, of every type of pension fund, are to ensure that :-
 - 14.1. the benefits promised in the constitution of the pension fund are actually delivered (“the first governance purpose”);
 - 14.2. those benefits are optimal, and the associated risks are minimised; with these contradictory concepts being appropriately balanced (“the second governance purpose”);
 - 14.3. the process involved in providing these benefits warrants the costs associated with that, and is transparent to the stakeholders (“the third governance purpose”); and

- 14.4. the process of delivering these benefits is credible, that is that there is a demonstrably trustworthy process of delivering the benefits (“the fourth governance purpose”).
15. Thus, every aspect of the governance arrangements in a pension fund should be assessed according to how it enhances one or more of these purposes; and, by the same token, whether or not it detracts from one or more of these purposes. An example of this may be the circumstance where in a fund it is not the governing body which determines the investment offering in the member choice arrangement of that fund, but an independent third party of investment experts. Such an arrangement may assist in ensuring that the second governance purpose is achieved, but it may also detract from the fourth governance purpose (ensuring that the process of delivering the benefits is credible) if such an independent body is not accountable to the governing body or fund membership. As such, this would not be an optimal arrangement from a governance aspect.
16. I now expand further on each of these governance purposes.

The First Governance Purpose: Delivery of the Benefits

17. This must be the first object of the governance of a fund and should be understood clearly in relation to both the defined benefit basis and the defined contribution basis.
18. In the defined benefit basis the nature of the benefit promised is usually clearly understood: a pension which is typically a function of final salary multiplied by an accrual factor multiplied by years of service or something similar. What is typically not clear, however, is the inflationary adjustment to such a pension so promised, nor any indication of the investment approach in relation to the assets from which the pensions are paid (as distinct from the assets building up the amount to be paid in the future as pensions). In my view both of these aspects should be specified in order to fulfil this governance purpose, and that as a minimum pensioners should be entitled to receive at least a full inflationary adjustment to pensions in payment.
19. In respect of the defined contribution basis it is more difficult to determine, from a governance aspect, what the delivery is supposed to be of the benefits promised. This is because of the nature of the employment arrangement, which is simply that there is the promise of contributions in a certain amount. Notwithstanding that this may be the promise from an employment aspect, I submit that from the aspect of the governance of a pension fund something more is required. This is that the governing body must understand what the retirement needs are of the pension fund membership: without this the adequacy of the pension arrangement is uncertain, and members need to make financial provision on an informed basis for their retirement.
20. Much of the thinking in the defined contribution environment has been around ensuring that there is an adequate income replacement in retirement, typically expressed as a percentage (say 70% retirement income to replace occupational income pre-retirement). This is simply an extrapolation of

the defined benefit promise to the defined contribution situation. In my view a more constructive approach, at least in the defined contribution environment (which is not possible in the defined benefit arrangement because of the nature of that arrangement) is for the adequacy of the retirement arrangement to be tested according to whether it makes adequate provision for expenses in retirement. On this basis one is able to assess more accurately whether such retirement income actually meets the retirement needs. Thus, lower income workers who would typically spend less on the education of their children and more on food and transport costs than higher income earners, would have a greater need on retirement for an income which meets those expenses (food and transport). By contrast, higher income earners would not have certain expenses in retirement which they had whilst working (such as the educational costs of their children and the payment of mortgages on their home), but may well have other costs which may be as important (such as higher health care costs). The differing needs of various components of pension fund membership should inform the investment approach in a different way than in the defined benefit arrangement.

21. More specifically, the investment approach in the defined contribution arrangement should not assume that there is a universal template, either in the context of member investment choice or not, which works for every category of member: Without understanding the expense provision needs of the membership, and structuring the investments accordingly, the defined contribution arrangement will not deliver a benefit which is meaningful to the member.

The Second Governance Purpose: Balancing the Optimisation of Benefits with the Management of Risk

22. The point of this purpose is that the pension fund governing body does not simply manage the risk but must seek actively to ensure that the benefits promised are optimal. Thus, ideally, the governing body should endeavour to ensure that members receive more than the bare promise. The importance of this in the defined contribution arrangement is clear because of the difficulty of knowing whether the defined contribution promise will be adequate. However, in the defined benefit arrangement, such an approach should not, because of a balance of cost obligation, impose any greater risk on the fund's sponsor than would otherwise have been the case or, if there is any such greater risk, it should be with the agreement of the fund's sponsor.
23. It should be noted that this second purpose is not restricted to investments: the optimisation of benefits extends to insured benefits (such as might be payable on death or disability), and the promptness with which benefits are payable.
24. Nor, from a governance aspect, is the management of risk limited to investments: the governing body must endeavour to manage every type of risk which may or may not have an adverse financial consequence for the fund, including legal risk, administration risk, actuarial risk and, importantly, governance risk. The management of governance risk is a significant area of risk management because the very object of good governance would not be achieved if, despite exemplary

governance structures and mechanisms there was no confidence by the stakeholders in those governance structures and mechanisms.

The Third Governance Purpose: Transparency and Justification of Costs

25. Where there is a large concentration of wealth (in the form of the assets of the pension fund), it is understandable for such a situation to attract a commercial or profit making proposition; and the point of the above purpose is to make it difficult, through transparency, for such a proposition to be capable of exploitation at the expense of the fund membership. This purpose also brings to the fore the responsibility of the governing body for ensuring that the costs are reasonable.
26. There should thus be a disclosure to the stakeholders of the costs involved in the pension fund, which should include specifically and separately the costs of administration, the investment costs, the costs of the governing body and the costs of expert advice.
27. In respect of multi-employer funds, this need for transparency around costs is of particular importance. The reason for this is that the direct costs at employer level are easily attributable to the membership of that employer; but less easy to attribute are the costs at the macro fund level. Thus it should be clear to the employers and the fund membership how such macro fund costs are allocated, such costs being those which relate to the auditor, valuator, the governing body, PI insurance and other costs not capable of direct attribution to the membership of an employer. And where there are legacy issues in such a fund, it should also be clear who bears the costs of those, which can be a particular problem in mature funds.

The Fourth Governance Purpose: Credible Pension Delivery

28. In the face of a history of numerous pension fund governance failures globally, and the inundation of complaints to pensions ombuds (much of which are a function of the lack of trust in the delivery of private pensions), this purpose is vital. It is as important to demonstrate that the governance arrangements and mechanisms in a pension fund are appropriate and that those who depend on them can trust them to be effective, as it is to have good governance arrangements and mechanisms in place.
29. This governance purpose relates to a fundamental governance issue, which is that of accountability. The governance of a pension fund must reside in the governing body; but it is notionally possible for external parties also to have some governance responsibility without compromising the governance arrangements. However, this proposition (of external parties also having some governance responsibility), can only be valid if that external party is accountable to the governing body or to the fund membership for the exercise of that governance responsibility. It will not suffice, for example, for a pension fund sponsor, which sponsors that pension fund as a commercial proposition, to be able to remove and appoint members of the governing body without some form of accountability to

the fund membership when exercising that power. The difficulty is in establishing the form of such accountability, and with credibility, in such a situation

30. By extension, this governance purpose precludes any member of the governing body having any responsibility for the success of a commercial proposition of any party, such as the sponsor, associated with the pension fund.
31. To a large extent, this purpose can be fulfilled by demonstrating an accountability, principally through communication which not only informs stakeholders of the governance health of the pension fund but also reports on actions, at least annually, of the governing body on matters such as :-
 - 31.1. an annual review of the risk management process;
 - 31.2. governing board appraisal;
 - 31.3. whether the pension fund is engaged in any litigation or complaint before any pension fund ombud;
 - 31.4. reporting not only the annual financial statements, actuarial valuation results (if applicable) but also on the costs both of the fund as a whole and on a per member basis;
 - 31.5. giving full information on the investments, including the investment policy, performance according to the performance benchmarks and inflation, the costs of the investments and the form of the investments;
 - 31.6. changes in the governing body; and
 - 31.7. details of the service providers.
32. Of course, such an accountability needs to have teeth: the stakeholders need to be able to enjoy rights enforceable in law for the failure to be accountable. And it would be preferable, at least in respect of the fund membership, for such rights to be capable of being exercised in a judicial forum which carries with it no threat of an adverse order of legal costs.
33. Primarily such accountability should be towards the fund membership, but should also be directed to the fund sponsor and the employer participating in that fund (if different from the sponsor).
34. It is also important, in the furtherance of this governance purpose, that confidentiality around the membership data is protected. Such membership data has a commercial value which, if it is permitted to be exploited without the consent of the fund membership, would compromise the integrity of the governance arrangements.

Comment on Representivity in the Governing Body

35. In my view it is beneficial for the governing body to be comprised of persons drawn from stakeholders (members, sponsor or employer) but only as an aid to the fourth governance purpose. It is not beneficial for this to be understood as conferring a form of representation of stakeholder interests on the governing body. The reason for this is that the nature of the office attaching to the governing body is one of trust; and accordingly suitability for the office (ie fit and proper requirements) should be the primary criterion, and there should be no implicit or explicit mandate to promote the interests of any stakeholder constituency over the other, except the supremacy of the membership interests within the paradigm of the governance purposes referred to above.
36. It would be deeply problematic for members of the governing body to see the governing body simply as a forum for asserting the interests of one stakeholder body over another. That would imply different obligations amongst those members where there should be one primary obligation, to the fund membership; and it would result in the subservience of that primary obligation to a form of politics where the force of the stronger constituency holds sway irrespective of whether that is in the interests of the fund membership generally.
37. By contrast, it should be clearly understood that drawing members of the governing body from the stakeholders is not to promote representivity, but to confer credibility on the governance process, and is a far healthier basis from a governance aspect on which to constitute the governing body.
38. I have no objection to these comments being posted on the OECD website. I should, however, be grateful if communication about the development of the Guidelines could be emailed to me.

Yours sincerely

JONATHAN MORT