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Private and Confidential

Subject: Response to the consultation on the Draft OECD Guidelines for Pension Fund Governance

Dear Ms Day

I am responding to the consultation on the Draft OECD Guidelines for Pension Fund Governance on behalf of Mercer.

We are broadly in favour of the revised principles to provide guidance on pension fund governance. However, although the principles do refer to best practice for occupational pension funds, we are not convinced that all the principles can be applied in the same way to the many different types of pension arrangement that are in existence.

Our response deals mainly with occupational funds, however the principles of effective governance which underpin Mercer's governance consulting can be applied as effectively to contract based funds.

Perhaps clarity can be provided to the principles to enable providers of employer-sponsored, individual, trust and contract-based arrangements to interpret them in a way which is best applicable for their circumstances.

We agree with the separation of responsibilities between operational and oversight bodies, thereby ensuring that good governance can be implemented. We have particular comments on the detail of the principles and we have included these in an appendix to this letter.

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serves more than 25,000 clients globally. These include not only most of the world's leading companies and governments, but also many rapidly growing organisations, including those in some of the world's fastest-growing economies.

We are truly a worldwide organisation, with 60 percent of our clients located in Europe, Asia Pacific and Latin America. These include nine of 10 Fortune 100 firms, three of four Fortune 1000 firms, two of three FTSE 100 firms and a majority of Nikkei 225 firms. Mercer also has a strong market presence serving midsize companies.

Yours sincerely

Rosanne Corbett

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Appendix

Consultation response to the Draft OECD Guidelines for Pension Fund Governance 2008

Mercer's point of view on best practice for pension fund governance is based on five key principles underpinned by an enterprise-wide risk management framework:

- Effective Committee;
- Written Plans and Policies;
- Appropriate Accountability;
- Effective Information Flow; and
- Rigorous Supervision and Monitoring.

Our practical experience and years of working with pension funds, trustees and companies all over the world to design and implement effective governance frameworks focuses our comments in this response on considering how the principles will work in practice.

A key reason for having good governance is to mitigate risk of loss through agency issues and inefficiencies, and to create and protect value.

Having an effective organisational structure helps to achieve this. Such a structure consists of three key entities which all play an essential role in the overall management and governance of the plan, thereby ensuring that the principles outlined above are followed. These entities are:

- A governing body;
- A managing body; and
- An operating body.

The governing body is responsible for establishing the organisational structure and making strategic decisions. It:

- Establishes vision, strategy, goals and policies;
- Designs decision making processes;
- Delegates day-to-day responsibilities to managing and operating bodies and holds them accountable for performance;
- Monitors structure and pension plans; and

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- Fulfils any fiduciary responsibilities.

Managing bodies manage the pension fund and are responsible to the governing body. They:

- Act as advisers to the governing body;
- Devise strategies for achieving objectives and implementing policies;
- Organise and monitor plan operations;
- Manage and monitor operating bodies;
- Are appropriately incentivised with defined metrics to be accountable for performance.

Operating bodies make day-to-day decisions and implement strategy under guidance of the managing bodies. They:

- Manage plan operations;
- Monitor risk;
- Manage information systems;
- Report; and
- Interface with the membership.

The draft guidelines suggest a similar structure, however there is some ambiguity with respect to the nature of the governing body as true governors or administrators.

This structure is a best practice aspiration and is likely to suit larger funds which may have more resources to accommodate it. However, the five principles of effective governance can and should apply for all funds from the smallest to the largest. For small funds, or funds in developing countries we welcome the risk based approach which the OECD encourages. We understand that it is not always practical to entirely separate out the governing, managing and operating functions. However, the draft principles are best practice so our stance is based on achieving this.

We would recommend reordering the principles so as to clearly establish who is responsible, for what, to whom they are accountable, delegations and the relevant advisory and provider relationships. For example, we would suggest the following order:

1. Governing body
2. Suitability
3. Identification of responsibilities
4. Accountability

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5. Delegation and expert advice
6. Actuary
7. Auditor
8. Custodian.

We have made observations with respect to each of the draft principles and set out our observations below which cover the technical aspects of the content and also our views on the impact of each principle in practice.

Governing body

Footnote 2 talks of the governing body being responsible for all strategic decisions and possibly also being an administrator. Also, in a two-tier board system, involving a managing and a supervisory board, the managing board is considered the governing body.

We agree that the governing body should be responsible for strategic decisions. However, we think there may be confusion as to what the role of the governing body and the administrator actually is.

In some jurisdictions the administrator means the body responsible for the actual administration of the plan e.g. collecting contributions, record-keeping, payment of benefits etc, as is described in the annotations section in paragraph three of the Identification of Responsibilities. We believe this is a language/interpretation issue and would suggest the terminology is altered to make a clear distinction between what is meant by the governing body and the administrator.

As mentioned above, we agree that the first statement in the Identification of Responsibilities principle (that there should be a clear separation of operational and oversight responsibilities in the governance of the pension fund) is best practice for governing bodies. However, it will not be achieved if the governing body is also the administrator.

There appears to be some confusion about what supervision and management actually entail. In a two-tier board system, the managing board and supervisory board would have clearly defined responsibilities as suggested by the titles. The supervisory board would be the body responsible for oversight and governance and therefore be deemed the governing body. The managing board would be the body responsible for executing tasks and strategy

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just as in a corporate board where the directors devise business strategy and expect the CEO and his/her management team to implement it.

The Governing Body principle states: “The governing body should not be able to completely absolve itself of its responsibilities by delegating certain functions to external providers.” This point can be reworded to express better the requirement for the governing body to retain responsibility and oversight for the management and operation of the pension fund whilst delegating essential tasks to appropriate external providers.

Having a professional, motivated governing body that has clearly defined roles and responsibilities and delegations and an effective structure means that accountability for the pension fund and to stakeholders is effective with the risk of loss through agency issues and inefficiencies being well managed and value being both protected and created.

Suitability

Minimum suitability requirements would be sufficient to determine membership of the governing body. The non-suitability requirements referred to in brackets are unnecessary and likely to cause confusion as they have negative connotations.

In addition to all the points mentioned in the first sentence e.g. integrity, competence etc. knowledge and understanding of pensions and the relevant laws, funding and investment practices are also vital. (This is covered in the annotations but missing from the principle.)

We would also suggest removing the reference to professionalism in the administration of the pension fund and replace it with professionalism in the governance of the pension fund.

In the later section on suitability (8. in the annotations) the consultation document suggests that members of the governing body should be selected to provide a ‘balance’ of skills. In some cases, quite appropriately, members of the governing body might be elected from the scheme membership, so this could be difficult to achieve. It should be sufficient that the governing body as a whole has the appropriate skills.

Having the right balance of people on the governing body with the right knowledge, understanding, expertise and skills is essential for the body to fulfil its responsibilities. Stakeholders must have confidence that these people are able to supervise the fund and act in members’ best interests.

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Identification of responsibilities

As discussed above, we strongly agree, where feasible, that there should be a clear separation of operational and oversight responsibilities in the governance of the pension fund. Added to this, best practice would be to aim for clear separation of managerial responsibilities.

It may be helpful to clarify the difference between these responsibilities, therefore making it obvious to those reading the principles what is covered by governing (oversight), operational and managerial responsibilities (as we have outlined at the beginning of the paper).

Yes, we agree that risk management is fundamental to good governance. We are unsure of how responsibilities would be divided in accordance with the risks posed as suggested by the draft principle. Typically, the governing body would be responsible for the overall risk framework of the pension fund, including the identification of risks, their quantification, implementation of appropriate controls and ongoing review. The managers and operators would input into the risk process and the operators would take delegated responsibility for monitoring risk on an ongoing basis. The responsibilities of each body would remain the same, however each would be aware of the risk implications to each and the best method by which to manage these risks.

The last paragraph of this section refers to contracts in occupational schemes being between plan sponsors and the institution responsible for managing the fund. The UK experience is that the sponsor would only have a 'contract' with the governing body (or alternative, depending on the legislative regime), and it would be for the governing body to have and maintain contracts with the providers.

However, in contract based plans, where they are established on a group basis, there is likely to be a contract between the sponsor and the provider, since the sponsor often meets the expenses of the arrangement.

Roles and responsibilities of all those involved in the governance, management and operations of the fund should be clearly articulated and documented to ensure that resources are effectively allocated, efficiencies maximised and risks mitigated.

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Accountability

Again, the clarification over the governing body and supervisory board could cause confusion as the governing body would typically supervise the fund. If this is referring to a supervisory/regulatory body, possibly slight rewording would clarify this.

The point should also be made that the governing body remains ultimately accountable for the overall governance, management and operations of the fund.

The bulleted list of accountability of the governing body in the annotations is important information, albeit with some changes necessary, and could be useful to include as a footnote.

Transparent accountability leads to effective decision making and better management of conflicts of interest.

Delegation and expert advice

We agree that where the governing body lacks sufficient expertise to make fully informed decisions it would seek expert advice or appoint professionals. However, to ensure it does fulfil its responsibilities, the governing body will seek relevant training and education to ensure that it is able to challenge advice and understand how best to use advice so as then to make fully informed decisions.

Advice is a valuable resource and should be used carefully, with all delegates being reviewed for performance to ensure that the quality and provision of the advice is meeting the needs of the governing body. The governing body is ultimately responsible for all decisions regardless of the advice received so needs to be confident in its advisers and its own decision making capabilities.

Actuary

The description of the Actuary's role makes it appear that the Actuary should be able to take decisions regarding the funding of the scheme without reference to the governing body. We believe it would be more appropriate to position the Actuary's role as providing advice to the governing body, to enable it to take decisions on the appropriate funding strategy and funding needs of the scheme.

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(We are aware that further details on the role of the actuary, auditor and custodian are included in the annotations, however it may be useful to include high level responsibilities in the principles as many readers may not reach the annotations section.)

Under the Governing Body principle, the monitoring and oversight of external service providers is mentioned. As actuaries are likely to be seen as advisers, a point could be added on the governing body's responsibility to monitor the advice and performance of the actuary on a regular basis.

Auditor

Reference could be made to the governing body's responsibility to monitor the independence and performance of the auditor on a regular basis

Custodian

Reference could also be made to the governing body's responsibility to monitor the advice and performance of the custodian to ensure assets are being maximised on a regular basis

Governance Mechanisms

Risk-based internal controls

We would suggest including managerial responsibilities along with operational and oversight when referring to the internal controls that should be in place.

We would also recommend that the controls do not just cover the basic organisational and administrative procedures but also more solid detail on the organisational structure of the governing body, managers and operators and the actual workings of the pension fund e.g. funding, investment, member communication, member records, data systems and reporting. Otherwise the governing body will not be fulfilling its governance responsibilities sufficiently as key areas could be missed out due to interpretation of what organisational and operational procedures mean. This is actually explained well in the annotations, but it does not come across in the principle.

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With respect to the point on the conflicts of interest policy, this should also include any party with managerial responsibilities.

In the UK it is still traditional for members of the governing body to be volunteers, so the comments on compensation policy might not be universally appropriate. Similarly, the comments on sales forces will not apply universally. If these are to be generic principles, then some of the problems identified need to be raised at a higher level.

Risk management is fundamental to good governance and without it the governance framework would be ineffective as risks would arise and need to be managed on an ad hoc basis leading to inefficiencies, expense and frustration of all involved.

Reporting

Reporting channels should be established between all those involved not just in the administration of the fund but in every aspect of the fund's management, operations and oversight. For example, information sharing between advisers, providers and the governing body, communications with members, sponsor communication, reports from the administrator on service standards and performance etc. Again, this point is actually covered in the annotations, but it does not come across in the principle.

Formal reporting and functioning communication channels enable timely and reliable sharing of information which support the governing, managing and operating bodies in fulfilling their responsibilities.

Disclosure

There may need to be more clarification over the need to disclose information to the 'public at large' as this may not necessarily be the case for all personal pensions. A distinction between the requirements and personal data issues of private pensions and employer-sponsored personal pensions should be drawn.

General comments

A key observation is the confusion over the separation of administration i.e. operations and governance i.e. supervision/oversight.

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Our comments on each of the principles explain where we believe the separation can be clarified.

Key advisers and providers such as the actuary, auditor and custodian are mentioned. However, there is an obvious gap with respect to the administrator and investment provider.

These two areas are most visible to members, particularly given the current climate. To ensure that governing bodies and pension providers understand how vital getting these two areas right is, we strongly believe that they should be included as two further principles.

Administration should focus on the role of the administrator from an operational perspective and the responsibility it has to members and the governing body. Also, it should be made clear how the governing body must review the administrator's performance by ensuring service standards, key performance indicators and regular reporting against these is maintained.

Investment should focus on the different roles of the investment provider in a defined benefit and defined contribution plan. The governance aspects of defined benefit and defined contribution with respect to investment are different and this difference should be made clear especially with regards to the role of the governing body to monitor investment performance and investment choice.