Modernizing Pension Fund Legal Standards for the 21st Century

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Alan Greenspan at a hearing of the House Committee on Oversight and Government Reform:

‘I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity of the firm.....’

Chairman of the Committee, Rep. Henry Waxman:

‘In other words, you found that your view of the world, your ideology, was not right, it was not working.’

Greenspan:

‘Absolutely, precisely’.

Overview

The growth of pension funds and retirement savings over the last three decades into a huge global block of capital has dramatically changed the effect that pension investment practices have on the global economy. Prevailing interpretations of fiduciary duty have encouraged this pension fund capital block to “herd” around similar investment practices that have become focused on the short term. This “lemming” behavior has contributed to the severity of economic booms and busts. It has also destroyed long-term economic value, transferred wealth from younger to older pension fund participants and raised questions about compliance with the fiduciary duty of impartiality.

This paper argues for a modernized interpretation of fiduciary duty that recognizes the symbiotic relationship between the sustainable success of both corporations and pension funds. It describes the impact that pension investment practices have on both the well being of fund participants and health of the global economy. It also argues that fiduciaries should adopt pension fund governance practices found to be associated with improved investment performance, better align pension fund service provider incentives with the clients’ long-term interests and expand risk identification and management practices to consider systemic and extra-financial factors that contributed to the current financial crisis. The authors recommend development of pension fund governance best practice guidelines, combined with adoption of a “comply or explain” reporting scheme, as a way to improve the ability of pension managers to meet their fiduciary obligations and promote economic stability.

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1 October 23, 2008.
Mutual Economic Reliance Between Pension Investors and Corporations

At the end of 2008, economies throughout the world are spinning into recession, perhaps worse. Many stock markets have seen gains of the past decade completely wiped out. The value of pension fund equity holdings in the United States alone fell by $4 trillion over the past year. Workers, consumers, taxpayers, companies and retirees are facing the worst economic crisis in nearly a century.

What initially seemed like an isolated Wall Street disaster has spread to Main Streets around the globe. It now appears that treatment of this pandemic will require systemic intervention on an international scale. With the funding status of pension funds dropping fast, the future of pension promises is being re-evaluated worldwide in response to the crisis. Pension reform is likely to be considered as part of broader economic revitalization packages in many countries.

In considering reforms, changes in the role and influence of pension funds should be recognized. Many assumptions underlying the way economists, policymakers and regulators have traditionally viewed pension systems no longer apply. Among the most important changes are the growth of pension funds into huge pools of capital and the correspondingly expanded influence that pension fund management practices now have on the larger economy.

For example, in the United States, institutional investor ownership of Fortune 1000 companies has increased to 76 percent of outstanding equity. With retirement savings making up the largest block of those holdings, pension funds are central to health of the financial system and are a primary source of capital. In some countries, the aggregate value of pension fund assets even exceeds the Gross Domestic Product. Pension fund management practices clearly matter to the global economy.

This combined influence of pension funds on the financial markets has not been widely examined in the context of pension fund governance practices. However, legal standards and governance of pension funds, including practices of the complex service provider network around pension funds, have grown into a major economic force. We expect the broader economic importance of pension funds to become even more evident as the economic crisis unfolds.

As pension fund assets and annuity payments decline, a chain reaction is triggered. Companies with defined benefit plans are forced to either make higher pension fund contributions, under fund...
or terminate their plans.\(^9\) Costs will likely be added to many government budgets to meet higher public sector defined benefit plan funding requirements in the wake of massive investment losses, with resulting tax increases or reductions in funding for other government programs. Pension savings levels, consumer confidence and buying power are likely to be affected. The knock-on economic effects for companies and the macro economy could be extensive.

The converse is also true. **Pension funds rely on growing creation of wealth by companies to cover future benefit obligations.** Defined benefit pension plans in the United States, on average, allocated 63 percent of their assets to corporate stocks at the end of 2007.\(^{10}\) In countries like the Netherlands and Canada it is up to fifty percent.\(^{11}\) As a result, the financial performance of pension funds is directly tied to stability and growth of the corporate sector and broader economy. The symbiotic nature of this relationship between pension funds and corporations means that neither can succeed without success of the other. A healthy economy requires both.

This paper focuses primarily on the pension fund side of the relationship. It highlights underlying systemic weaknesses of current pension fund legal and governance standards that are evident on a global basis. It also recommends changes designed to improve performance and sustainability of pension funds.\(^{12}\) However, it must be emphasized that reforms to enhance sustainability of wealth creation are also required on the company side of the relationship. Without attention to reform and sustainability by both pension funds and corporations, each will underperform their potential.

### Market Changes Have Created a "Lemming" Fiduciary Standard

Prevailing interpretations of fiduciary duty in Europe, Australia and the United States are mired in the 1960s and 1970s, when today's pension fund legal regimes were created. As a result, they are often ill-suited for the complex investment instruments and the market-moving amount of assets being managed by pension funds in the 21st century.

Fiduciaries are generally advised, based on traditional legal assumptions about pension funds from financial markets of the 20th century, to adhere to the same practices as are used by similar institutional investors.\(^{13}\) Copycat investment behavior is encouraged by prevailing interpretations of the fiduciary duty legal standard. The result is a magnification of natural investor tendencies to engage in herding behavior, with pension funds pursuing the same strategies and investments. Given the exponential growth in pension assets since the 1970s, this produces added market volatility and new risks (even to the pension funds, themselves). In effect, what functioned as a “prudent expert” fiduciary standard 30 years ago has become more of a “lemming standard” that increases the severity of booms and busts and discourages adoption of improved practices that are.

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\(^9\) Watson Wyatt estimates that companies in the United States with defined benefit plans will have to more than double their contributions during 2009. David Hilzenrath, 2008 Leaves Pensions Underfunded, Washington Post, January 8, 2009.

\(^{10}\) Ilana Boivie and Beth Almeida, “Patience is a Virtue: Asset Allocation Patterns in DB and DC Plans,” National Institute on Retirement Security, Issue Brief, July 2008. United States defined contribution plan allocations to stocks, at 37 percent during 2007, were also substantial.

\(^{11}\) Pension Markets in Focus, Issue 5, December 2008, OECD.

\(^{12}\) We recognize that there are critical differences between countries but believe that pension funds in most national systems struggle with comparable problems and have a similar collective effect on the financial markets. However, pension fund regulatory reform should be considered on a country by country basis, although in Europe there could still be a leadership role for the European Commission.

\(^{13}\) Under 29 USC §18.1104, pension funds subject to the Employees’ Retirement Security Income Act (ERISA) must be managed “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” Under Dutch law, Pensioenwet Art 105, the term professionalism is used. In regard to investment policies, the conduct of a prudent person is referenced as the applicable standard (art 135). Furthermore, the law has delegated the interpretation of this law to the supervisory authority, the Dutch Central Bank.
not yet used by peers. Pension funds are often reluctant to pursue prudent strategies not being widely used by other pension funds for fear of exposure to liability from breach of the "lemming" standard.

One illustration of the damage contributed to by a legal standard interpreted so as to encourage lemming behavior has been the unrelenting focus on short-term results. This phenomenon was examined by the investment industry's leading global authority on investor protection and financial market ethics, the CFA Institute Centre for Financial Market Integrity, and the Business Roundtable Institute for Corporate Ethics, which represents CEOs from 160 global companies. After engaging thought leaders from the corporate issuer, investment analyst, asset manager, institutional investor and individual investor communities, the study group concluded:

“The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.”

Indeed, academic research has found that pressure on corporate managers to deliver short-term investment results has become so strong that nearly 80 percent of them report they would sacrifice future economic value to manage short term earnings so as to meet investor expectations. CEOs who fail to meet two quarterly analyst consensus forecasts in a year suffer a 24 percent lower equity award and 14 percent lower bonus than CEOs who meet analysts' short-term expectations. This also raises questions about whether fiduciaries are adequately addressing their separate legal obligation to handle conflicting interests of different participant and beneficiary groups impartially (e.g., producing current income for retirees while generating future wealth for young participants). Excessive focus on short-term investment horizons, use of short-term benchmarks and evaluation of portfolio managers primarily on short-term results, as well as inattention to risks associated with the potential long-term value destruction referenced above, should ring fiduciary duty alarms for pension funds that are managing assets to meet liabilities extending out over generations. The fiduciary duty of impartiality, which has been given little attention, needs to be dusted off and re-examined.

14 In the United States, little attention has been given to meaning of the ERISA introductory phrase in 29 USC §18.1104 which sets forth a separate, overarching requirement that fiduciaries "shall discharge their duties ‘in the interest of the participants and beneficiaries,’ imposing an obligation that is independent from the following phrase, ‘and for the exclusive purpose of providing benefits’. [Emphasis added.] It appears that excessive investment herding behaviors, obsession with short-term performance and inattention to systemic risks, raises concerns about compliance with the first prong of the ERISA fiduciary duty clause cited above, because such practices may not be in the long-term interest of participants.

15 "Breaking the Short-Term Cycle,” the CFA Centre for financial Market Integrity and Business Roundtable Institute for Corporate Ethics (July 2006).


18 The duty of impartiality is summarized in official comments to §79(1) of the Restatement of Trusts, Third, as follows: "In what might be called the 'substantive' aspects of impartiality . . . Subsection (1) directs trustees . . . to make diligent and good-faith efforts to identify, respect, and balance the various beneficial interests when carrying out the trustees' fiduciary responsibilities in managing, protecting, and distributing the trust estate, and in other administrative functions."

19 The Code of Conduct for Members of a Pension Scheme Governing Body which was published by the CFA Institute Centre for Financial Market Integrity in 2008 also recognizes that an effective trustee will "consider the different types of beneficiaries relevant to each pension scheme" and "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough to support real benefit increases for active participants who will become future beneficiaries while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners." In addition, in Withers v. Teachers' Retirement System, 447 F. Supp. 1248 (SDNY 1978), when the Court approved a New York City public pension fund investment in New York City bonds that were being issued to avoid the City's impending bankruptcy, it noted: "New York law imposes an obligation on trustees to accord impartial treatment to beneficiaries. It is more than evident, therefore, that the trustees of the TRS would have violated their fiduciary obligation had they exhausted the assets of an under funded actuarially reserved pension system on a single class of beneficiaries (retirees). Their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to
One result of adopting a more balanced investment approach that considers long-term risks and future wealth generation, would be expansion of the risks and opportunities that are seen as relevant to a fund’s investment strategy. The CFA Institute advises that pension fund governing boards, in addition to considering “typical financial measures,” must consider “all relevant risk and value factors,” which “may include environmental, social, and corporate governance issues.”\textsuperscript{20} Given the recent impact of corporate governance, systemic and intangible factors (e.g., risk management failure, automobile industry product obsolescence, regulatory agency inaction, loss of investor trust in market fairness) on pension funds in the economic crisis, there should be no doubt about the potential importance of extra-financial issues to long-term investors with broad market exposure.\textsuperscript{21}

Unfortunately, most pension fund governance regulatory guidance on fiduciary and investment issues has taken a narrow view limited to quantifiable measures. One by-product of the market crisis has been the realization that there are many investment risks that lie outside of what was traditionally quantified by mainstream investment consultants, advisors and portfolio managers. Systemic risks, which have been largely ignored, proved to be of great consequence. Now they need to be recognized and addressed as a fiduciary concern.

With most markets having eliminated statutory legal lists of allowed (or precluded) pension fund investments (a development which we heartily endorse), the task of determining appropriate investment risk exposures now falls completely on pension fund fiduciaries.\textsuperscript{22} Their collective effectiveness in fulfilling these duties will not only determine the future well being of pension fund participants but will also play a major role in allocation of capital between companies and in health of the economy. The importance of pension fund governance and investment practices in this regard cannot be overstated.

### Improving Pension Fund Governance

In most European countries and in Japan, pension funds are generally established as a separate institutional entity with its own internal governing board. Many Eastern European countries, Spain and Mexico have developed more of a contractual arrangement, in which pension funds are segregated pools of assets without legal personality that are managed by a financial institution.\textsuperscript{23} Aspects of the contractual form of pension fund management have also been extended to defined contribution arrangements, such as 401(k) and individual retirement accounts in the United States, where responsibility for selection of investment options is delegated to the participant, with limited duties held by the trustee and investment manager.

Historically, Anglo-Saxon pension fund law was founded on the law of trusts. Under that case law, trustees have generally been held to a higher standard of conduct than is required of corporate current retirees, but also to those scheduled to retire in the future, whose pension and annuity rights would have been similarly earned over their years of active service and to whom the fund therefore had a legal responsibility.\textsuperscript{20}

\textsuperscript{21} Id.

\textsuperscript{22} Some regulators might need to revisit past interpretations of fiduciary duty in order to explicitly recognize risks that did not exist when fiduciary laws were originally written and pension funds had little collective influence on the markets or the broader economy.

\textsuperscript{23} In Dutch law, the only investment restriction which still exists is a limit on investments in the company related to the fund (art 135). In Britain, Lord Mackenzie of Luton, Parliamentary Under Secretary of State for the House of Lords, representing the Department of Work & Pensions, summarized the Government’s views on responsible investing by pension funds last October, “There is no reason why trustees cannot consider moral and social criteria, in addition to their usual criteria of financial returns, security and diversification.”

directors or parties to a contract.\textsuperscript{24} In 1928, Justice Cardozo described the legal standard applicable to a trustee as follows:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."\textsuperscript{25} [Emphasis added.]

All the forms of pension fund organization place substantial responsibility in the hands of agents who act on behalf of participants and beneficiaries. The legal standards and governance structures established to control these agents are critical to pension fund success.

Recent research on pension fund governance has established that good governance is associated with increased returns. A study published in the Rotman International Journal of Pension Management found that better governed pension funds outperformed poorly governed funds by 2.4 percent per annum during the four years ending December 2003.\textsuperscript{26} The results confirmed a similar 1993–1996 study which found a one percent annual good governance performance dividend.\textsuperscript{27}

Key factors found to be associated with good governance and pension fund success included:\textsuperscript{28}

- Selection of governing board members with relevant skills and knowledge;
- Development of a board self-improvement culture;
- Clear understanding of the board's mission and its investment beliefs;
- Sufficient size to allow cost effective management of assets;
- Competitive staff compensation to permit acquisition of internal expertise;
- Insulation from conflicting political or third party agendas; and
- Clarity of board and staff roles about delegation of management responsibilities.

The legal structure and governing principles within which pension funds must operate set critical decision-making boundaries. Legal rules that fail to encourage adoption of best practices, which have been found to be associated with pension fund success (i.e., that stress conformity to current practices), not only foster inferior results but also undermine the ability of pension funds to efficiently allocate capital in the marketplace. While different approaches might be required for the different pension fund structures being used in various markets, we see the high standard of fiduciary responsibility to the interests of all beneficiaries that was espoused by Justice Cardozo as a common guiding principle that is critical to maintaining pension fund integrity and fostering the trustworthy social networks that allow capital to flow efficiently within the global financial markets.

\textsuperscript{24} For example, trust law precludes fiduciaries from engaging in self-interested transactions with the trust, though corporate directors can usually enter into related party transactions with the company if disclosed and approved by disinterested directors as fair to the corporation. Compare Restatement of Trusts, Third, §78 to §144 if the Delaware General Corporation Law.

\textsuperscript{25} Meinhard v. Salmon 249 NY 458 (1928).


\textsuperscript{27} Id.

Alignment of Interests Among Agents and Service Providers

Conflicts of interest between pension fund participants/beneficiaries and their agents in the service provider chain, including pension fund governing board members, has been a major problem in the industry. A 2008 survey of European pension fund executives and asset managers provides some insight into challenges that need to be addressed. When discussing the survey findings on alignment of interests, the report notes:

"There is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals."

A key finding was that 65 percent of pension fund respondents believe that pension consultants do not understand the long-term needs of their clients, while only 15 percent of asset managers identify that as an issue.

The report concludes that pension consultants and asset managers should develop forward-looking services that meet their clients' needs, rather than selling what fits the manager's or consultant's own interests. That is seen as the basis for a new alignment of interests. Development of a fee structure that is aligned with the value delivered is also one of the top concerns cited by funds, with 67 percent noting it as important. More alarming is the finding that the vast majority of both pension fund executives and their fund managers see current pre- and post-retirement products as woefully inadequate to deliver adequate retirement incomes.

We believe that one of the reasons why the pension service provider supply chain has become inverted is the industry's high tolerance level for conflicts of interest. Table 1 summarizes some of the main problems with misalignment of interests in the pension fund stakeholder chain.

Table 1. Main stakeholders in the pension fund service provider supply chain

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Horizon (Average)</th>
<th>Agency problem</th>
<th>General description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participants &amp; Beneficiaries</td>
<td>30+ years</td>
<td>Often have/exercise little control over either their contributions or investments.</td>
<td>Are neither involved or knowledgeable, which leads to mistrust in times of financial instability.</td>
</tr>
<tr>
<td>Trustees or Governing Board</td>
<td>4 to 6 years</td>
<td>Often union, employer or gov't representatives, with independent representatives in some countries. They are in the position for a limited time and typically have little financial or investment background.</td>
<td>May not have necessary skills and are sometimes driven by other interests (e.g., in the Netherlands employee and employer representatives also negotiate working agreements); financial incentives are usually small.</td>
</tr>
<tr>
<td>Investment Managers</td>
<td>1 year</td>
<td>Work on short-term bonuses with clients who generally evaluate performance over 1 to 3 years</td>
<td>Are incentivized by fees set on assets under management and evaluated relative to market benchmarks, which might not reflect pension funding needs.</td>
</tr>
<tr>
<td>Managers of companies</td>
<td>3 to 12 months</td>
<td>Only know a few vocal or active investors. In many countries less than 30 percent votes proxies. Little interaction.</td>
<td>Feel hunted and pressured to deliver quarterly returns by investors they do not know; are influenced by huge incentives based on stock price.</td>
</tr>
</tbody>
</table>

Given the prevalence of misaligned interests throughout the stakeholder chain, the importance of identifying, realigning and managing the interests of agents should be a priority. However, trustees often lack the skills to provide effective oversight of a complex financial organization and may not be aware of governance issues or have access to the expertise needed to address them.

Development of industry best practice standards would be one way to provide fiduciaries with practical guidance. Some markets combine best practice standards with a “comply or explain” reporting approach. This allows flexibility, while ensuring that best governance practices are considered. Comply or explain has been used in Britain and helped to improve pension fund governance practices there. While not a panacea in and of itself, best practice regimens can be helpful.

Six recommendations

Although different markets will have different issues, we provide the following recommendations as a general guide for modernization of pension fund legal standards. We recommend that regulators should:

1. **Recognize the risks of excessive investment herding behavior** for both the economy and fund participants/beneficiaries. Regulators could clarify that practices of other similar investors are merely a reference point for establishment of a prudent investment program. Pension funds should be accorded the flexibility to pursue prudent investment strategies which differ from those that have been broadly adopted, as long as they are reasonably consistent with the fund's mission, investment outlook and risk tolerances and serve the interests of participants/beneficiaries.

2. **Emphasize the duty of impartiality** and the need to balance short-term and long-term obligations. Guidance should stress the long-term, inter-generational nature of pension fund liabilities and recognize the impact of systemic risks.

3. **Encourage fee structures that better align interests** of service providers with those of fund participants/beneficiaries. Portfolio managers and advisors should have a significant portion of remuneration that reflects the sustainable value received by the fund from their services. Boards should report on alignment of fees, with review by the fund’s auditors.

4. **Confirm the importance of systemic and extra-financial risks** (i.e., items not reflected on the financial statements) that could affect the short- or long-term well-being of participants/beneficiaries. Clarify that the narrow and myopic view of risk and value that helped to fuel the current economic crisis is inappropriate for the management of pension fund assets. Encourage use of a forward-looking, comprehensive and interdisciplinary approach to the identification, valuation and management of risk and exercise of investor rights that is consistent with principles of inter-generational fairness.

We also put forth the following recommendations aimed at addressing the behavioral changes required to modernize pension fund governance practices. The appropriate oversight entities should:

5. **Convene a market-specific best practices commission** to develop and maintain general standards aimed at improving the governance practices of pension funds. Consideration should be given to use of a “comply or explain” reporting approach on compliance with best practices to provide flexibility. Issues that should be considered include:

a. Development of governing board "fit for purpose" qualifications for selection of governing board members and their continuing education. Implementation provisions could include annual board-specific inventories of trustee skills and capabilities needed to establish a “fit for purpose” pension fund board and maintain a culture of continuous improvement. Annual reports to participants/beneficiaries and to the board’s independent auditor could be required on each board’s fit for purpose evaluation and plan;

b. Creation of a process allowing beneficiaries to file a petition with the board (or with an appointing official or court) to seek resignation or removal of an unfit trustee who has been the subject of significant unresolved conflicts of interest or breaches of fiduciary duty;

c. Representation of participants/beneficiaries on pension fund boards. To discourage diversion of fund assets and unbiased governance practices, consideration could also be given to mandating an independent board chair who is not affiliated with the plan sponsor;

d. Required periodic evaluation of plan design and related regulatory, tax and legal requirements (by policy-makers, regulators and trustees), to encourage consideration of plan structures that best serve the interests of participants and beneficiaries;32

e. Annual board affirmation of a statement of investment beliefs and mission to provide appropriate focus. To encourage consistent implementation, an annual report could be required on how risk management and investment practices are designed to meet fund liabilities and foster participant/beneficiary long-term well-being;

f. Collaboration between pension funds to improve effectiveness in meeting mutual goals or provide the scale necessary to operate in a cost-effective manner. Smaller funds might be incentivized to merge or share staff resources;

g. Require that boards periodically evaluate and report on their effectiveness in meeting best practices and their plans for improvement;

h. Mandate regular external audits of each fund's conflict of interest policy, including compliance with it by the board, staff, investment managers and consultants/advisers;

i. Require that annual cost reports be made on an unbundled basis to facilitate management of expenses on a net result, transparent basis;

j. Manage investor rights and proxy votes to foster sustainable corporate success and economic stability. Require annual reports to the participants/beneficiaries and external auditor on responsible investment practices.

6. Organize educational programs to promote fiduciary professionalism. Involve the pension fund industry in development of comprehensive educational programs to improve trustee skills and adoption of best practices.

Conclusion

While trustee skills, legal standards and best practices are important, they are not the only considerations that matter. The pension promise is a shared responsibility that involves an intergenerational agreement with important implications for the economy and society at large.

Indeed, pension funds are creatures of "trust" that involve long-term commitments and relationships between beneficiaries, participants, trustees, managers, advisors, taxpayers, companies invested in,

31 See the Myners and Stanford reports, supra, for discussion of "fit for purpose" boards.

32 In recent years, plan design alternatives to the traditional defined benefit (DB) and defined contribution (DC) options have been developed. For example, hybrid plans can combine features of DB and DC plans to offer individual accounts that are aggregated for cost-effective, professional management with oversight from a fiduciary board, provide full portability of accounts between employers, and automatically convert individual accounts to life annuities upon retirement. Some countries (e.g., the Netherlands) have hybrid plans in place that could be examined as potential models for innovations in other markets.
society, countries and different generations. Those relationships form networks that require mutual reliance, shared values and responsibilities within global economic and ecological systems.

Regulatory reform in the pension industry will be more effective if it looks beyond the surface and keeps the big picture context in focus. Reforms should eliminate incentives for fiduciaries to engage in short-term herding behavior and encourage development of long-term relationships that will foster sustainable economic growth.