

## **GUIDELINES FOR PENSION FUND GOVERNANCE\***

This document presents the OECD Pension Fund Governance Guidelines approved by the Working Party on Private Pensions, as well as the "Annotations to the Pension Fund Governance Guidelines". The guidelines are listed separately first. The "Annotations" contain the guidelines together with descriptive information. The guidelines fall into two main groups: guidelines for the governance structure, and guidelines for governance mechanisms. This structure is similar to that adopted in the "OECD Principles of Corporate Governance".

The guidelines apply to autonomous, collective and group pension funds that support private occupational pension plans<sup>1</sup>. In some countries, these principles may also be appropriate for pension funds established under personal pension arrangements. Individual pension funds<sup>2</sup> and insurance arrangements are excluded.

Autonomous pension funds may be established as special purpose legal entities (pension entities), such as trusts, foundations, and corporate entities, that own and may also control the pension fund on behalf of the pension plan/fund members. Alternatively, they may consist of separate accounts managed by financial institutions and established under a contract between the plan sponsor and the financial institution that manages the fund.

The guidelines complement the "Fifteen principles for the regulation of Private occupational pensions schemes", that were endorsed by the Working Party on Private Pensions in November 2000, and which have been approved also by the International Network of Pension Regulators and Supervisors.

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\*. The Guidelines for Pension Fund Governance was endorsed by the Working Party on Private Pensions in 2002.

## **I. Background**

The central figure in pension fund governance is the governing body, that is the person, group of persons, or legal entity responsible for the management and safeguarding of the pension fund. Where the pension fund is established as a pension entity, such entity's governing body will normally also be responsible for the management of the fund<sup>3</sup>. Where the fund consists of a separate account, the financial institution that manages the account is the governing body of the fund. In some countries, only dedicated financial institutions (pension fund managing companies) are permitted to manage pension funds.

The governing body is subject to various forms of external monitoring. At one level, plan members may carry out direct monitoring through their representatives in the governing body or in special committees set up especially for this purpose (e.g. a supervisory board or oversight committee). At another level, regulations require independent professionals such as actuaries, auditors, and custodians to monitor and report on the compliance of the governing body with relevant legislation. Finally, the governing body is subject to the supervision of relevant authorities. The regularity and detail of the oversight exerted by the supervisory authorities will vary depending on the complexity of the pension system and the specific role of actuaries, auditors, and custodians.

The guidelines outlined below address some of the regulatory concerns that arise in the establishment and operation of autonomous, collective/group pension funds. The guidelines aim to provide guidance to countries on the regulation of the governance of pension funds, which includes the legal form and structure of the pension entity as well as the interactions and relationship between the different parties involved in the management of the pension fund and the plan members.

While the guidelines identify good practice in pension fund regulation, their implementation may be conducted through other means. In particular, it may be that some of the functions identified in the guidelines such as auditing and custody may be carried out by the same entity. The underlying objective in this case is that of identifying cases of non-compliance with regulation through an independent, external check on the decisions and activities of the governing body of the pension fund.

The paper Pension Fund Governance highlights the differences that arise in the operation of pension funds in OECD countries<sup>4</sup>. These differences, however, should not obscure the fact pension funds are set up with a common objective, which is to serve as a secure source of funds for retirement benefits.

Governance regulations need to be designed under the guidance of this overriding objective.

The development of these guidelines has been based on previous work carried out by this Group in this area (including the "Fifteen Principles for the regulation of Private occupational pensions schemes"), as well as other work on the governance of related institutions, such as collective investment schemes and insurance companies. They have also paid attention to the OECD principles of corporate governance.

In 1971 the Committee on Financial Markets began the work on governance issues related to collective investment instruments by issuing "Standard Rules for the Operations of Institutions for Collective Investment in Securities". In 1994, IOSCO established a set of "principles for the regulation of collective investment instruments", which were later further elaborated. The principles do not prescribe any specific governance structure, but do require:

- the appointment of a custodian, depository or trustee of a CIS;
- standards of conduct and minimum suitability standards on the operators of CIS;
- the right of investors to withdraw funds from a CIS;
- the right of investors to full, timely, and accurate information disclosure.

Their requirements for a CIS have much in common with those for pension funds. However, it must be noted that collective investment instruments are based on the equivalent of a defined contribution principle. That is, they normally provide no insurance against financial or biometric risks.

The "OECD Principles of Corporate Governance" also provide some relevant insights for pension fund governance. The owners or beneficiaries of pension funds have characteristics that can identify them with both shareholders and the stakeholders. In particular the Principles require that both shareholders and stakeholders are granted the opportunity to obtain effective redress for violation of their rights and that they have access to relevant information.

The "OECD Principles of Corporate Governance" also identify key responsibilities for the board of a corporation that have parallels with those of the pension fund governing body. In particular, the corporate governance framework, as defined in the "Principles", should ensure the strategic guidance

of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

More recently (11/10/2000), the European Commission has issued a proposal for a directive of the European Parliament and of the Council "on the coordination of laws, regulations and administrative provisions relating to institutions for occupational retirement provision" (2000/0260(COD)). The draft directive contains several rules on the governance requirement of occupational pension institutions, which include pension funds as defined in this document. Concerning the governance structure of the institutions, there are two main proposals in the directive. The draft Directive applies to autonomous pension funds (where there is legal separation between the sponsoring undertaking and the pension institution). The draft directive requires the calculation and the certification of all technical provisions by an actuary or other specialist and, consequently, the appointment of these experts.

The draft directive's rules regarding governance structure focus on the responsibility of the administrators and suitability criteria. As part of their responsibilities, administrators should disclose certain information to both the plan participants and the supervisory agency. Sufficient information for members is required especially regarding the rights and obligations of parties participating or managing the pension plan, and the risks and the distribution of the risks in the occupational scheme. Other information that must be available to the members includes the annual accounts and report, relevant information on changes of the pension scheme rules, and information on the financing of entitlements and the investment of the assets.

The draft directive also requires Member States to ensure that the supervisory authority has power to call for a range of specified information to be disclosed to it by the scheme, including information about business matters, contracts regulating the contracted-out activities, the annual report and the annual accounts with other reports, actuarial valuation, auditor's report, etc. In addition, pension institutions would be required to disclose their investment policies, in every year or after any material change.

The draft directive also defines rules on the suitability of persons administering pension institutions, requiring them to have good reputation, appropriate professional qualifications and experience.

Among the efforts at individual country level to develop pension governance guidelines, that by the Canadian Association of Pension Supervisory Authorities (CAPSA) may be mentioned. The governance guidelines are applied to pension plans, but most of them are equally relevant for pension funds.

## **II. Guidelines for pension fund governance**

The following guidelines are applicable to *autonomous, collective or group pension funds that support private occupational pension plans*. In some countries, they may also be appropriate for pension funds established under personal pension arrangements. Their practical implementation may vary from country to country, the aim being that the underlying objectives of the guidelines are met.

*- Governance regulations need to be designed under the guidance of the overriding objective that pension funds are set up to serve as a secure source of funds for retirement benefits.*

### *Governance Structure*

*- The governance structure should ensure an appropriate division of operational and oversight responsibilities, and the accountability and suitability of those with such responsibilities.*

### *Identification of responsibilities*

There should be a clear identification and assignment of operational and oversight responsibilities in the governance of a pension fund. To the extent that a pension entity is established that owns the pension fund on behalf of plan/fund members, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in the pension entity's statutes, by-laws, contract or trust instrument, or in documents associated with any of these. If the pension fund is established as a separate account managed by financial institutions, the pension plan or contract between plan sponsors/members and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund.

### *Governing body*

Every pension fund should have a governing body or administrator vested with the power to administer the pension fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries. The responsibilities of the governing body should be consistent with the overriding objective of a pension fund which is to serve as the source of retirement income. The governing body

should not be able to completely absolve itself of its responsibilities by delegating certain functions to external service providers. For instance, the governing body should retain the responsibility for monitoring and oversight of those service providers.

#### *Expert advice*

Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities the governing body could be required to seek expert advice or appoint professionals to carry out certain functions.

#### *Auditor*

An auditor, independent of the pension entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement. Depending on the general supervisory framework, the auditor should report promptly to the governing body and - if the governing body does not take any appropriate remedial action - to the competent authorities wherever he or she becomes aware, while carrying out his or her tasks, of certain facts which may have a significant negative effect on the financial situation or the administrative and accounting organisation of a pension fund.

#### *Actuary*

An actuary should be appointed by the governing body for all defined benefit plans financed via pension funds. As soon as the actuary realises, on performing his or her professional or legal duties, that the fund does not or is unlikely to comply with the appropriate statutory requirements and depending on the general supervisory framework, he or she shall inform the governing body and - if the governing body does not take any appropriate remedial action - the supervisory authority without delay.

#### *Custodian*

Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund

assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.

#### *Accountability*

The governing body should be accountable to the pension plan members and beneficiaries and the competent authorities. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, this should be legally liable for its actions.

#### *Suitability*

The governing body should be subject to minimum suitability standards in order to ensure a high level of integrity and professionalism in the administration of the pension fund.

#### *Governance mechanisms*

***- Pension funds should have appropriate control, communication, and incentive mechanisms that encourage good decision making, proper and timely execution, transparency, and regular review and assessment.***

#### *Internal controls*

There should be appropriate controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.

### *Reporting*

Reporting channels between all the persons and entities involved in the administration of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.

### *Disclosure*

The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, supervisory authorities, etc.) in a clear, accurate, and timely fashion.

### *Redress*

Pension plan members and beneficiaries should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts that assure prompt redress.

## **III. Annotations to Guidelines on Pension Fund Governance**

The following guidelines are applicable to *autonomous, collective or group pension funds that support private occupational pension plans*. In some countries, they may also be appropriate for pension funds established under personal pension arrangements.. Their practical implementation may vary from country to country, the aim being that the underlying objectives of the guidelines are met.

*- Governance regulations need to be designed under the guidance of the overriding objective that pension funds are set up to serve as a secure source of funds for retirement benefits.*

### *Governance structure*

*- The governance structure should ensure an appropriate division of operational and oversight responsibilities, and the accountability and suitability of those with such responsibilities.*

### *Identification of responsibilities*

**There should be a clear identification and assignment of operational and oversight responsibilities in the governance of a pension fund. To the extent that a pension entity is established that owns the pension fund on behalf of plan/fund members, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in the pension entity's statutes, by-laws, contract, or trust instrument, or in documents associated with any of these. If the pension fund is established as a separate account managed by financial institutions, the pension plan or contract between plan sponsors/members and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund.**

Pension entities are established in accordance to statutes, by-laws, contract, or trust instrument. These documents, sometimes together with associated material, should define the legal form of the pension entity as well as its internal governance structure and main objectives. The main objectives of the pension entity will vary depending on the type of plan that they support. In defined contribution plans, the main objective of the pension entity may be to invest the pension assets in order to maximise risk-adjusted returns. In defined benefit plans, the pension entity may have several objectives, such as ensuring an adequate match between the pension plan assets and its liabilities and paying benefits upon the death or retirement of plan members.

Some of the operational functions of the pension entity that should be identified and assigned include collection of contributions, record-keeping, actuarial analysis, funding and contribution policy, asset-liability management (for defined benefit and hybrid plans), investment strategies (for both DB and DC schemes), asset management, disclosure to plan members, and regulatory compliance. These responsibilities and their assignment should be clearly stated in the pension entity's documents.

The role of the plan sponsor and the rights of the plan/fund members with respect to the governance of the fund should be also clearly documented. The plan sponsor normally chooses the governing body of a pension fund or appoints at least some of the members of the governing body. Where the pension fund is established as an independent legal entity, some of the professional staff of this entity, such as actuaries and asset managers, may also be employees of or external advisors to the plan sponsor. However, in general, it should be the governing body's responsibility to appoint the professional staff and the external service providers of the pension entity. Pension plan/fund members may also play a role in electing members of the governing body or the

supervisory board of the pension fund. In some countries, trade unions elect the members of the governing body on behalf of plan/fund members.

When the pension fund is established as a separate account managed by financial institutions, their responsibilities should be clearly stated in the plan or contract documents. In occupational plans, plan sponsors should sign a contract with the financial institutions responsible for the management of the pension fund, where the objectives of the fund are also clearly stated. In personal plans, the contract is signed directly between the plan member and the financial institution.

#### *Governing body*

**Every pension fund should have a governing body or administrator vested with the power to administer the pension fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries. The responsibilities of the governing body should be consistent with the overriding objective of a pension fund which is to serve as the source of retirement income. The governing body should not be able to completely absolve itself of its responsibilities by delegating certain functions to external service providers. For instance, the governing body should retain the responsibility for monitoring and oversight of those service providers.**

Pension funds are controlled by a governing body or administrator that is responsible for the operation and oversight of the pension fund. The governing body may also be responsible for other (or indeed all) aspects of the administration of a pension plan. This governing body or administrator may be a person, a committee or committees of persons, or a legal entity. In some cases, it may be appropriate to split the operational and oversight responsibilities between different committees. Hence, a separate supervisory board or oversight committee may be established whose main functions are the selection and oversight of the executive board. The supervisory board may have other responsibilities, and may for example appoint the external monitors (auditor) of the pension fund. Such a body may form part of the internal governance structure of the pension entity or it may be established externally. It may consist of representatives of the plan sponsor and plan/fund members, as well as independent professionals. In pension funds established in the corporate form, the general meeting of plan/fund members also exerts some oversight functions.

Though the governing body may delegate operational duties to the pension entity's internal staff or external service providers, it remains ultimately

responsible for ensuring that pension funds fulfil their overriding objective which is to serve as the sources of funds for retirement benefits. In particular, the governing body should retain the responsibility for monitoring and oversight of those service providers. Core functions, such as formulating the investment policy and risk monitoring should also normally rest with the governing body, though external advice may of course be requested.

The governing body's main responsibilities should include at least:

- monitoring the administration of the pension fund in order to ensure that the objectives set out in the fund by-laws, statutes, contract or trust instrument, or in documents associated with any of these, are attained (e.g. diversified asset allocation, cost-effectiveness of administration, etc);
- selecting, compensating, monitoring, and, where necessary replacing staff with operational responsibilities as well as external service providers (e.g. asset managers, actuaries, custodians, auditors, etc);
- ensuring the compliance of the activities of the entity with the pensions law (e.g. investment regulations, reporting and disclosure requirements, control of conflicts of interest situations, improper use of privileged information, etc);

While the governing body should best serve the interest of the pension plan members, he may also be required to cater for some of the interests of the plan sponsor. In particular, the pension plan/entity documents may require the governing body to carry out its activities in a way that does not impose an unnecessary financial burden on the plan sponsor (i.e. where the interest of plan members and beneficiaries could be equally best served through other means, which are more beneficial for plan sponsors). For example, where the expenses of administering the pension fund are borne exclusively by the plan sponsor, the governing body may be required to ensure that these are managed efficiently in order to minimise the cost to employers.

#### *Expert advice*

**Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities the governing body could be required to seek expert advice or appoint professionals to carry out certain functions**

Where it is appropriate to do so, the governing body should seek expert advice and may delegate functions externally. Some of the functions where the governing body may require external advice from consultants and other professional service providers include investment policy, asset-liability management, and benefit payment. The pension fund governing body may also delegate certain operational duties, such as asset management and benefit payment, to professional service providers. It may also utilise the resources of the plan sponsor, though this may not always have qualified staff to carry out specific functions, such as actuarial analysis.

The governing body should ensure that all its professional staff and, where appropriate, the external service providers have the relevant qualifications and experience required to carry out their functions in accordance with the objectives of the pension entity and the pension plan.

#### *Auditor*

**An auditor, independent of the pension entity, the governing body, and the plan sponsor should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement. Depending on the general supervisory framework, the auditor should report promptly to the governing body and - if the governing body does not take any appropriate remedial action - to the competent authorities wherever he or she becomes aware, while carrying out his or her tasks, of certain facts which may have a significant negative effect on the financial situation or the administrative and accounting organisation of a pension fund.**

The auditor is responsible for reviewing the financial accounts for the pension plans and the pension fund with an appropriate periodicity. The extent and frequency of the audit will vary depending on the nature, complexity, and size of the pension plan/fund.

Auditors should also play also a "whistle-blowing" function. If, in the course of the exercise of their duties, they become aware of any significant threat to the financial position of a pension fund or its administrative and accounting organisation, they should promptly report to the competent authorities. As part of the audit process, the auditor should be required to report every aspect of the operation of the pension fund that he or she finds is not according with the pension fund statutes and/or current legislation. In some countries, these functions may be carried out by other entities, such as the custodians.

The independence of the auditor from the pension entity, the governing body, and the plan sponsor is important to ensure the impartiality of the audit. Normally, the auditor should be appointed by the governing body of the pension entity. In some instances, the supervisory authority may appoint the auditor directly.

#### *Actuary*

**An actuary should be appointed by the governing body for all defined benefit plans financed via pension funds. As soon as the actuary realises, on performing his or her professional or legal duties, that the fund does not or is unlikely to comply with the appropriate statutory requirements and depending on the general supervisory framework, he or she shall inform the governing body and - if the governing body does not take any appropriate remedial action - the supervisory authority without delay.**

The governing body should appoint an actuary for all pension funds that support plans where the plan sponsor insures the plan member against investment or/and biometric risk. Even in defined contribution plans, however, an actuary with a limited role may be advisable, since investments should be made with the objective of providing an adequate income at retirement.

The actuary may not always be an employed member of the staff of the pension entity or the financial institution managing the fund. For example, the actuary may be employed directly by the employer or plan sponsor or he/she may be an external service provider (e.g. a professional actuary or a benefits consultant firm). Members of the governing body should not normally be appointed as pension plan/fund actuaries.

The role of the actuary should include at least the evaluation of the fund's present and future pension liabilities in order to determine the financial solvency of the pension plan following recognised actuarial and accounting methods. The actuary should also identify the funding needs for the pension plan, and estimate the level of contributions taking account of the nature of the liabilities of the pension plan. The actuary should also play a "whistle-blowing" function, and report to the governing body immediately when he or she realises that the fund does not or is unlikely to comply with the appropriate statutory requirements (e.g. minimum funding requirement). If the governing body does not take any remedial action, the actuary should report to the supervisory authority.

### *Custodian*

**Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.**

Where appropriate, it may be required that a custodian, different from the pension entity or the financial company that manages the pension fund, is appointed by the governing body of the pension fund. The appointment of an independent custodian is an effective way to safeguard the physical and legal integrity of the assets of a pension fund.

The custodian holds the pension fund assets and should be in a position to ensure their safekeeping. They may also provide additional services such as securities lending, cash management, investment accounting and reporting, and performance measurement. In some countries, the custodian also plays an external monitoring function similar to that of the auditor with respect to, for example, the investment of pension assets.

### *Accountability*

**The governing body should be accountable to the pension plan members and beneficiaries and the competent authorities. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, this should be liable for its actions.**

Accountability over governance functions is particularly important in order to allow the supervisory authority and the plan members and beneficiaries to discipline the governing body or seek other means of redress in case of mismanagement. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibilities as a benefit provider.

In order to guarantee the accountability of the governing body, this should be liable for its actions. Such liability may include in some instances personal

financial responsibility. In such cases, insurance of this liability can strengthen the ability of the pension fund to recover losses in case of mismanagement.

The accountability of the governing body also requires:

- regular meetings of the governing body;
- diffusion of decision-making power in the governing body (for example, a requirement for decisions to be taken on a majority basis);
- appropriate disclosure of the decisions reached in these meetings to plan members and beneficiaries;
- reporting of information about the operation of the pension fund to the supervisory authorities;
- transparent selection mechanisms for the members of the governing body (including the possibility of appointments of representatives of plan members and beneficiaries through a fair selection system)
- appropriate succession planning processes.

Disclosure to plan members and beneficiaries may be required for decisions that could have a material impact on future pension benefits, such as a change in the investment policy. In order to reduce the administrative burden on the governing body, disclosure could be made on a regular basis, for example, once a year, rather than after every meeting of the governing body.

The selection and succession planning structure should deal with the term, appointment/election and removal of members of the governing body of the pension fund. The term of appointment of the members of the governing body may vary depending on the type and context of particular plans.

Election through a fair voting system (e.g. majority voting) among plan members and beneficiaries is recommended in cases where there are representatives of the pension plan members and beneficiaries in the governing body. Biographical information on the member of the governing body seeking election should be provided to those involved in the selection process. The information should be provided in a timely manner and should be sufficient including age, length of time he/she has been associated with the pension fund, qualifications and experience. Having said this, existing associations of

employees (e.g. trade unions) already have internal electoral systems in place which may make these additional elections redundant.

Accountability can be also enhanced by requiring that certain members of the governing body are appointed by plan members and beneficiaries. These members of the governing body may be endowed only with oversight responsibilities, to ensure that the operational decisions taken are in the best interest of the pension plan members and beneficiaries. The election by plan members and beneficiaries of representatives in the governing body may be most suitable when membership of the pension plan/fund is compulsory or automatic as part of the employment contract (often the case for closed funds). In these cases, plan members cannot normally "vote with their feet" and choose a different pension fund (except if they leave their employer).

### *Suitability*

**The governing body should be subject to minimum suitability standards in order to ensure a high level of integrity and professionalism in the administration of the pension fund.**

Members of the governing body should be subject to minimum suitability standards. Causes of automatic disqualification could include conviction for fraud or other criminal offences, gross mismanagement of a pension fund or other fund that led to significant civil penalties, and personal bankruptcy.

The qualifications and experience required of the members of the governing body will depend on their responsibilities. Specific qualifications and experience will generally be required for those members of the governing body with operational duties, such as those involved in the design of the investment strategy, or asset liability modelling. On the other hand, members who have only oversight responsibilities, such as those selected by pension plan members, may not always be subject to such requirements, though it would be desirable that they have sufficient knowledge and experience to be able to understand the decisions of the professionals that operate the fund. Where the governing body includes a general assembly of the plan members (as is sometimes the case in pension funds set up in the corporate form), these would evidently not be subject to a fit and proper criteria.

### *Governance mechanisms*

*- Pension funds should have appropriate control, communication, and incentive mechanisms that encourage good decision making, proper and timely execution, transparency, and regular review and assessment.*

### *Internal controls*

**There should be appropriate controls in place to ensure that all persons or entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.**

The scope and complexity of internal control measures will vary according to the type and size of pension plan, fund and entity. However, there are certain basic organisational and administrative procedures that are central to risk management and control and sound business practice:

1. Regular assessment of the performance of the persons and entities involved in the operation and oversight of the pension fund;
2. Regular review of compensation mechanisms, in order to ensure that they provide the correct incentives for those responsible for the operation and oversight of the pension fund;
3. Regular review of information processes, operational software systems, and accounting and financial reporting systems;
4. Identification, monitoring, and, where necessary, correction of conflicts of interest situations;
5. Mechanisms to sanction the improper use of privileged information;
6. Implementation of an adequate risk measurement and management system including effective internal audit

## 7. Regular assessment of regulatory compliance systems

Mechanisms are needed to assess regularly the performance of the pension entity's internal staff as well as the external service providers (e.g. those providing consultancy, actuarial analysis, asset management, and other services for the pension entity). It is also good practice for the governing body to undertake self-analysis and for an independent, external person/organisations to undertake a review of the internal controls of the pension entity. Where the governing body consists of an executive and a supervisory board the latter may be assigned with the task of assessing the performance of the executive board.

Objective performance measures should be established for all the persons and entities involved in the administration of the pension fund. For example, appropriate benchmarks should be established for external asset managers. Performance should be regularly evaluated against the performance measures and results should be reported to the relevant decision maker, and, where appropriate, to the supervisory authority, and the pension fund members. The benchmarks should be reviewed regularly also to ensure their consistency with the pension fund objectives (e.g. the investment strategy).

Appropriate compensation can provide the right incentives for good performance. The establishment of a compensation committee and chairperson may optimise the process of evaluating the compensation of those responsible for the operation and oversight of the pension fund, such as asset managers, custodians, actuaries, as well as the members of the governing body.

The compensation policy of sales forces of pension plan providers may also warrant close scrutiny by the governing body, since these costs can reduce pension benefits significantly. There is a risk also that sales staff may not act in the best interest of plan members, offering products that are not suitable for certain individuals. The governing body should therefore ensure that the remuneration structure for sales staff does not create distorted incentives or lead to ill-advised decisions by consumers.

Conflicts of interest situations should be identified and dealt with in a suitable manner. In certain cases, banning the concentration of functions in a single person or entity that would otherwise lead to a conflict of interests may be the preferred solution. In other cases, disclosure of the conflict of interest to the governing body may suffice, who should be required to monitor these cases closely.

Where the conflict involves a member of the governing body, the case should be reviewed and monitored by the members of it not conflicted. Where

appropriate, the governing body may seek independent advice or guidance regarding the service or transaction. In the event of the governing body not being able to resolve a conflict of interest situation that may be judged by some of the members of the governing body as harmful to the interest of the plan members and beneficiaries, this should be reported to the supervisory authority, which will make a decision on whether they should be permitted, and if so under what conditions.

The governing body should also establish appropriate controls to prevent the improper use of privileged or confidential information. A code of conduct may be established, requiring employees to observe high standards of integrity, honesty, and fair dealing. Internal review mechanisms may be put in place to verify and sanction the compliance with the code of conduct.

An adequate risk measurement/management system and an effective internal audit should be also established. The risk management system should cover both investment and biometric risks. These control mechanisms form the basis of good business conduct, enhanced transparency, consistency as to management decisions, and for the protection of all stakeholders of the pension fund.

Finally, pension entities should have mechanisms to assess the compliance with the law. A compliance officer may be assigned to carry out this activity on a regular basis.

### *Reporting*

**Reporting channels between all the persons and entities involved in the administration of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.**

Processes need to be put in place to ensure that the members of the governing body receive appropriate, timely, accurate, complete, consistent, and easily comprehensible information so they may discharge their responsibilities effectively, in accordance with the code of conduct, and ensure that delegated responsibilities are fulfilled.

For its part, the governing body should ensure that actuaries, asset managers, consultants, custodians, and other professional service providers also receive relevant and accurate information in a timely manner in order to ensure they carry out their duties as established by the governing body.

### *Disclosure*

**The governing body should disclose relevant information to all parties involved (notably pension plan members, supervisory authorities, etc.) in a clear, accurate, and timely fashion.**

All pension plan members should receive, on joining the plan, the plan details, which should include, at least, the following items:

- contribution rates payable by the plan sponsor and the plan member;
- investment guarantees and benefit promises, if any;
- fees to be paid by members;
- in defined contribution plans (i.e. where investment and biometric risks are borne by the plan member), a simplified, easy to understand description of the pension fund's investment policy.

Material changes in these plan details should be reported to pension plan members (or beneficiaries in the case of decease of the member) in a timely manner. On request, plan members should also be able to receive for free the fund by-laws, statutes, or rules and related documents. These documents should state clearly the objectives of the pension fund and the rights of plan members and beneficiaries.

Pension plan members should also have access to information about the operation of the pension fund. In defined benefit and hybrid plans, plan members should be able to obtain, upon request, information on the level of funding backing pension promises, the pension fund's asset allocation, and other relevant aspects of the operation of the pension fund. In defined contribution plans, members should receive statements, at least annually, showing their account balances, and the investment regime and performance of the pension fund in standardised format (e.g. net of fees performance should be comparable across funds). It may be appropriate to require that the governing body disclose information about the operation and performance of the pension fund on a more regular basis when plan members are able to exercise some investment choice. For example, information on investment performance and commissions may be disclosed publicly through the local financial press.

Disclosure to plan members and beneficiaries should also be required for decisions of the governing body that could have a material impact on future

pension benefits, such as a change in the investment policy. In order to reduce the administrative burden on the governing body, disclosure could be made on a regular basis, for example, once a year, rather than after every meeting of the governing body.

### *Redress*

**Pension plan members and beneficiaries should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts that assure prompt redress.**

Access to statutory redress channels grants members the opportunity to recover losses and can be most effective in sanctioning pension fund mismanagement. In addition, pension plan members and beneficiaries may have access to other, informal sanctioning and disciplining mechanisms to ensure that the governing body of a pension fund manages it in their best interest.

Informal redress channels, such as internal dispute procedures and independent arbitrators, offer many advantages, including the lower cost to consumers, and, potentially, quicker resolution of the matter. Independent arbitration may also provide a route to self-regulation by pension fund administrators. An arbitrator may be set up by the industry itself in order to encourage public confidence and maintain efficient business practice. Litigation, while potentially highly effective in sanctioning mismanagement, can be excessively costly for individual consumers, though it may be appropriate in the case where an entire group (e.g. and employment association) is affected.

## Notes

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1. **Autonomous pension funds:** In occupational plan, a pension fund that is legally separated from the plan sponsor taking the form of either a special purpose legal entity or a separate account managed by financial institutions on behalf of the plan/fund members. The pension fund members have a legal or beneficial right or some other contractual claim against autonomous pension fund assets. **Collective and group Pension funds:** Pension funds, which, respectively, pools assets of pension plans of different plan sponsors and comprise assets of various members of the same pension plan.
2. **Individual pension funds** are excluded because the plan member manages the assets herself and, in effect, acts also as the governing body of the fund. Of course, individuals may invest such funds in existing financial products, such as banks deposits, collective investment schemes, or insurance policies, which involve delegation over the investment of these financial products in other assets. Nonetheless, the management of these products is not the concern of pension regulators and supervisors.
3. In some countries, however, the governing body of the pension entity is required to delegate the management of the fund to financial institutions.
4. See Financial Market Trends, No. 81, 2002.