International Organisation of Pension Supervisors

Supervisory Oversight of Pension Fund Governance

Mandatory Provident Fund Schemes
Authority, Hong Kong, China

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ABSTRACT

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This working paper mainly analyses the responses of IOPS members to a survey on supervisory oversight of pension fund governance. The survey and responses cover the current focus, issues and problems as well as future developments. A few case studies are also included in the paper to illustrate the different types of issues that pension fund systems may face and the means that may be adopted by the relevant supervisory authorities to resolve these issues.

Keywords: pension fund, governance, supervision, fiduciary, trustees

http:/www.iopsweb.org

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I. Introduction

A. Purposes

Over the last decade, governance has become a key issue in the administration of pension funds. In the light of the growing pension fund industry and the changing regulatory and market environment, how to ensure that pension funds are properly run has become a great concern to supervisory authorities. This working paper analyses the responses of IOPS members to a survey on supervisory oversight of pension fund governance. The survey and responses cover the current focus, issues and problems as well as future developments. A few case studies, given in Annex A, are also included in the paper to illustrate the different types of issues that pension fund systems may face and the means that may be adopted by the relevant supervisory authorities to resolve these issues.

B. Pension Fund Governance

In most jurisdictions, corporate governance rules exist for general purpose corporations, which may, subject to the legal structure, also apply to the governing body[1] of a pension fund. Often, however, it is necessary to establish additional or different requirements, through legislation, that deal with matters of specific relevance to pension funds. There is a fundamental difference between concepts of corporate governance and pension fund governance. Corporate governance mechanisms are necessarily focused on the interests of shareholders (at least while the corporate is a going concern), whereas pension fund governance is focused on a different set of stakeholders (usually plan members and beneficiaries although including employers under some structures) that will in some instances have interests quite different to, and in some instances opposed to, the interests of shareholders or other “owners” of the governing body. This difference is most obvious in those systems where the governing body is a commercial corporate entity.

In the context of pension plans and funds, governance refers to the framework by which the governing body, whether individuals or a body corporate (through its board of directors and senior management), makes decisions about the pension fund’s business. It encompasses:

- the structure of the governing body (including legal basis and segregation of functions);
- the decision making processes within the governing body (including internal controls, risk management, compliance functions and internal oversight structures);
- the requisite skills and competency of the governing body; and
- the means by which the governing body is accountable to stakeholders (principally plan members and beneficiaries, but also a wider stakeholder set including employers, supervisory board, supervisors, regulators and government).

[1] The governing body is the group vested with the power to administer the pension fund and which is ultimately responsible for ensuring adherence to the terms of the pension arrangement and the protection of the best interest of plan members and beneficiaries (See OECD Guidelines for Pension Fund Governance). In a two-tier board system the managing board is considered the governing body.

The goal of pension fund governance is to minimize the potential agency problems, or conflicts of interests that can arise between the fund stakeholders and the governing body which can adversely affect the security of pension savings and promises. Good governance is crucial in that it helps create trust between the governing body and stakeholders and should improve the performance of the fund or scheme.

The Working Party on Private Pensions of the Organisation for Economic Co-operation and Development ("OECD") developed the Guidelines for Pension Fund Governance, which were approved by the OECD Council in July 2005. The Guidelines are set out in Annex B for information.

II. Legal Structure of Pension Funds[2]

A. Legal Forms of Pension Funds

Pension funds in IOPS member jurisdictions have different legal forms which may have different governance implications. There are two types of autonomous pension funds[3]. There is an ***institutional type*** where the fund is an independent entity with legal personality and capacity and hence it has its own internal governing board. Examples of pension funds of the institutional type include pension foundations and associations as they exist in countries such as Denmark, Finland, Germany (only associations), Hungary, Italy, Japan, Norway, Poland, the Netherlands, and Switzerland, as well as joint-stock companies as they exist in, for example, Austria and Germany. In most of these countries pension funds have a single governing board, whose members are typically chosen by sponsoring employers and employees (or their representatives). In some countries, like Germany and the Netherlands, there is a two-tier board structure. In Germany, there is a supervisory board which is in general responsible for selecting, monitoring and supervising the managing board, which in turn is responsible for all strategic decisions.

By contrast a pension fund of the ***contractual type*** consists of a segregated pool of assets without legal personality and capacity that is governed by a separate entity, typically a financial institution such as a bank, insurance company or a pension fund management company. The governing body of a fund set up in the contractual form is usually the board of directors of the management entity, though in some countries (e.g. Spain) some key responsibilities are shared with a separate oversight committee ("comisión de control"). Other examples of pension funds set up in the contractual form include those in the Czech Republic, Mexico, Portugal, Slovakia, Turkey, and the open funds in Italy and Poland.

The trust, which is the legal form used by pension funds in countries with an Anglo-Saxon legal tradition, does not fit comfortably into either category. It has characteristics of both the institutional and the contractual type. Under the ***trust*** form it is the trustees who legally own (have the legal title to) the pension fund assets. Trustees must administer the trust assets in the sole interest of the plan participants,

[2] This section is mainly taken from Yermo and Marossy (2002) and Rocha et al (2001).

[3] Autonomous pension funds are independent legal entities, different from insurance undertakings, or segregated pools of assets without legal personality that are dedicated primarily to the provision of retirement and related benefits. Non-autonomous pension funds consist of reserves and other assets that are not legally separate from the plan sponsor or administrator (e.g. book reserves) and other pension assets over which the plan sponsor has legal ownership.

who are the beneficiaries from the investment of those assets according to the trust deed. While this feature of trusts is similar to that of foundations, the trustees are not legally part of the trust. Indeed, a trustee may be of the corporate type (as is sometimes the case in Australia and Ireland) which makes the pension fund resemble a contractual arrangement.

The United States has an additional feature as the governing body may be the plan sponsor, the trustee, or/and some third party. ERISA requires single company pension plans to have one or more "named" fiduciaries who have authority to control and manage the pension plan, including its investments. The sponsoring employer and the trustee are always named fiduciaries but it is possible for the trustee to be devoid of any major fiduciary responsibility (directed trustee), following instead another named fiduciary (e.g. a plan committee). In addition, asset managers, financial advisors and other persons and entities that exercise some discretion over the fund's assets are considered "functional" fiduciaries, all of whom have some legal responsibility for the pension fund.

The legal form of the pension fund has a bearing on the governance arrangements of the governing body. Institutional funds (which have independent legal entities) have internal governing bodies. In the corporate form the governing body is usually a board of directors (one-tier board system) or a managing board (two-tier board system). In the trust form the trustees are the governing body of the fund.

Contractual funds, on the other hand, are administered by external governing bodies, which may be a standard financial institution, or a specialised pension fund managing company, and whose assets are legally separated from those of the pension fund. With the individual contractual form, the funds are managed by pension fund managing companies, which are entities dedicated exclusively to the management of pension funds.

There is no a priori reason to prefer one legal form over another, the decision being based normally on the type of pension plan (occupational or personal), the legal tradition of the country, and tax considerations. However, the different types of legal form, and therefore the governing body, do pose specific governance challenges. With the corporate form involving internal governing bodies, the main challenge is to ensure that trustees and board members are adequately knowledgeable and understand any advice they receive. With the external governing bodies (managing contractual type pension funds), the challenge is to overcome any conflicts of interests.

B. Other Classifications of Pension Funds

Another important classification of pension funds, which can also affect their governance, is based on the nature of membership. Closed pension funds limit membership to certain employees (e.g. those of an employer or group of employers), whilst open pension funds have no restriction on membership. Again, the different nature of these funds raises specific governance issues. Unlike in open pension funds, where individuals can switch frequently, with closed pension funds portability is more limited (normally only when the employee changes jobs). The inability of market forces to impose any discipline on the pension fund governing body when members cannot exit the fund is therefore a challenge in closed pension funds. These funds can, however, have a significant cost advantage over open funds as they do not require marketing and advertising expenses to attract membership (open funds having to rely on costly distribution channels, such as agencies and sales agents as well as advertising campaigns). Since expenses are to some extent passed onto plan members and beneficiaries in the form of fees and commissions, the way the distribution channel is managed can impact significantly on retirement benefits. The monitoring of these costs can be a major governance challenge for open pension funds.

The type of plan also has important implications for pension fund governance. In the case of occupational plans, there are two parties involved in the administration of the pension fund: the employer or plan sponsor and the pension fund governing body. Avoiding conflicts of interests and ensuring that the governing body is truly operating in the interests of plan members and beneficiaries is a governance challenge, which supervisory authorities need to be aware of with these types of plan. In the case of personal pension plans, on the other hand, there is only the governing body of the fund itself. The contract is between the pension fund provider and an individual, allowing a "governance vacuum" to arise where the interests of the beneficiaries collectively are not considered - a governance challenge which needs to be addressed in many jurisdictions. Whether the pension plan is of a defined benefit ("DB") or defined contribution ("DC") nature will also have implications for the legal form and governance structure of the pension fund. Actuaries and other insurance experts will be required in funds that support DB plans in order to ensure their solvency. Yet the specific governance challenges relating to DC funds also need to be considered (e.g. offering adequate and suitable investment options, ensuring these are understood by members etc.), and may deserve increased attention by supervisors as DC funds become more widespread.

The World Bank has also classified pension funds by their governance structure, identifying:

- Accounts in banks or insurance companies;
- Participants in insurance company funds;
- Accounts with pension fund administrators; and
- Foundations, trusts and mutual arrangements.

According to the World Bank classification, with accounts in banks and insurance companies, the quality of governance and administration depend on the quality of the institution and the regulatory framework for banks and insurance companies with the main governance challenges being those involving conflicts of interests. An insurance company fund is set up with a separate profit-making firm with shareholders and plan participants. There is a board of directors, but those buying into the fund are not represented unless they are also shareholders. Ensuring that the board truly acts in the interest of members is again the main governance concern. Pension fund administrators operate more or less like mutual funds, but without the right to vote. The quality of the governance depends on the legal and regulatory requirements imposed on the administrators. As mentioned, with foundations, trusts and mutual arrangements, the main issue is to ensure that trustees are suitably knowledgeable and trained.

Supervisory authorities need to be aware of the governance challenges posed by different governance structures. The survey responses and case studies in this paper look at how some IOPS members have been addressing these issues.

III. Basic Elements of Pension Fund Supervision

Supervisory authorities have to ensure that proper structure and mechanisms for pension fund governance are not just in place but also working efficiently and effectively. In respect of the supervision of pension fund governance, different supervisory methods and means could be adopted by supervisory authorities. According to a report published by the World Bank[4], there are six basic elements of pension fund supervision, which are licensing, monitoring, communication, analysis, intervention and correction. These supervisory elements could be used as a framework for analyzing the supervision of pension fund governance.

Licensing: Licensing aims to restrict and control entry to the pension fund market through procedural requirements and criteria. These requirements and criteria are commonly applied to the governing body and may be extended to other pension fund service providers ("service providers"). Licensing requirements may vary among different pension systems. In cases where licenses are issued, they may be issued only once or on a periodic renewal basis.

Monitoring: Supervisory authorities collect information to enable them to track the performance and actions of the governing body and service providers. Monitoring commonly takes the form of regular submission of information and periodic reports to supervisory authorities. Monitoring may also be a pro-active function in which supervisory authorities periodically conduct on-site inspections of the governing body to collect specific or supplementary information.

Communication: Supervisory authorities may communicate with the governing body and service providers by providing regular reports to the industry, announcing their priorities and compliance strategy, or publicizing compliance actions. They may also engage in interactive communication by conducting on-site inspections to or holding regular meetings with the governing body and service providers.

Analysis: Analysis can be part of the monitoring and communication processes. Supervisory authorities may analyse and evaluate the information they receive from the governing body and service providers to decide whether or not to take any actions. They may conduct quantitative analysis on the funds' financial status and evaluate pension funds against benchmarks of the entire industry.

Intervention: Depending on the scope of their authorities, supervisory authorities in some countries have the authority to intervene by imposing sanctions when there is any non-compliance on the part of the governing body and service providers. Supervisory authorities may intervene through less directive processes such as consultation, notification and negotiation either because they have little power to unilaterally impose sanctions or they find it more effective to resort to these means under certain circumstances.

Correction: There are essentially three types of corrective actions: punitive, remedial, and compensatory. Punitive actions are designed to impose penalties on the responsible party for any actions deemed to be adverse to the interests of plan members and beneficiaries. Remedial actions may simply require the responsible party to return to the previous status or to stop certain practices. In some cases, it may involve financial sanctions. Compensatory actions would seek to compensate aggrieved parties for both direct and indirect effects of violations on the part of the governing body or service providers.

[4] Hinz and Mataoanu (2005), pp.6-12.

IV. Supervisory Oversight of Pension Fund Governance in IOPS Member Jurisdictions

With a view to understanding the current practices of IOPS members in respect of supervisory oversight of pension fund governance, a questionnaire and a supplementary questionnaire were sent to IOPS members in August 2007 and April 2008 respectively. Altogether 24 IOPS members (i.e. Australia, Austria, Belgium, Bulgaria, Chile, Czech Republic, Finland, Germany[5], Hong Kong, India, Jamaica, Kenya, Luxembourg, Macedonia, Namibia, the Netherlands, Poland, Romania, Republic of Korea, South Africa, Spain, Thailand, Turkey and the UK) have responded to the questionnaire. A copy of the questionnaire is attached as Annex C. A total of 11 IOPS members (i.e. Australia, Bulgaria, Germany, Hungary, Jamaica, Macedonia, the Netherlands, Poland, Republic of Korea, Thailand and Turkey) have answered the supplementary questionnaire. A copy of the supplementary questionnaire is attached as Annex D.

Four case studies (attached as Annex A) are included in this working paper to help illustrate that different supervisory authorities may face different governance issues and for those facing the same issue, they may resort to different ways to resolve it. These case studies are contributed by the relevant supervisory authorities in Australia, the UK, Chile and Hong Kong.

According to IOPS members' responses, the major governance issues relating to pension funds are competence/expertise, accountability and internal control of the governing body. Some driving forces were stated by IOPS members, which made these governance issues the focus of their supervision. Among other things, the increasing complexity of the operations and investments of funds and the changing legislative environment have raised the level of competence/expertise required of the governing body. These developments have also compelled the governing bodies to disclose information transparently and clearly to plan members and beneficiaries so as to reinforce accountability.

Another development was a shift from DB to DC arrangement for the occupational pension plans in many countries. As discussed previously, whether the pension plan is of DB or DC nature has implications for pension fund governance. The transition from DB to DC not only shifts the investment risk of pension funds from employers to plan members (i.e. employees), but also the nexus of supervision from controlling agency risks to managing systemic financial and operational risks.[6] Supervisory authorities are therefore under increasing pressure to ensure that the governing bodies have adequate internal control of risks.

Conflicts of interests is an issue of concern particularly for pension funds managed by external governing bodies (e.g. pension funds of contractual form). With financial conglomerates assuming a variety of functions relating to pension fund management, there may be an increasing scope for circumstances involving real or potential conflicts of interests. In this connection, related party transactions of the governing body that may pose a threat to the interests of pension plan members and beneficiaries may be of particular concern to supervisory authorities (e.g. Chile). To deal with this issue, supervisory authorities have to ensure that the governing bodies

[5] Germany's answers to both questionnaires cover those occupational pension entities that fall under the scope of the EU IOPR Directive (2003/41/EC), namely Pensionskassen and Pensionsfonds.

[6] Brunner et al (2008), p.2.

disclose properly any transactions which may give rise to conflicts of interests and that they have put in place proper internal control mechanisms.

These three major governance issues (i.e. competence/expertise, accountability and internal control) will be discussed in greater details in the following sections. While this paper focuses on the supervisory oversight of pension fund governance, the regulatory approaches adopted by supervisory authorities are also examined. However, it should be noted that in some cases there may only be a fine line between regulation and supervision.

A. Competence and Expertise

Fit and Proper Requirements

Regulatory Approach

According to Guideline 8 of OECD Guidelines for Pension Fund Governance, 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. In this regard, it is a common regulatory requirement that the governing body has to be "fit and proper" for the positions.

The basic criteria of fitness and propriety for the governing body are usually set out in the regulations in many jurisdictions, which generally cover the following areas:

- Whether the key officer of the governing body has been convicted of criminal or civil offence, particularly an offence involving fraud or dishonesty;
- Whether he is an undischarged bankrupt; and
- Whether he meets certain requirements in respect of qualifications, skills, knowledge and professional experience.

The first two criteria serve to disqualify those people who may not have the requisite integrity and honesty to manage pension funds. The third criterion is related to the minimum competence standards of the governing body.

As mentioned previously, the competence and expertise of the governing body is an issue of concern particularly for pension funds of institutional form. In the past, fewer jurisdictions imposed minimum competency standards, but there has seemingly been a move in this direction. For example, before 1995 no specific legislation was laid down in the UK as to who might become a trustee or how a trustee might be chosen. The Pensions Act 1995 only introduced a requirement that plan members should have the right to nominate one-third of the trustees. In this sense, "lay trustees" were allowed to operate pension funds. In 2001, the Myners Report[7] proposed that there should be a legal requirement that where trustees were taking a decision, only those with the necessary skills, information and resources should make those decisions. The proposal was adopted in the Pensions Act 2004. Since then, trustees have been required to have appropriate knowledge and understanding of the law relating to pensions and trust, schemes funding and investment of scheme assets and to be conversant with their own scheme.

[7] Institutional Investment in the United Kingdom: A Review, March 2001.

Likewise, in Australia, before the introduction of the universal licensing regime for superannuation funds in July 2004, only retail and public offer trustees were licensed or "approved" trustees. For the vast majority of entities in the industry, there were no entry-level tests of competence or capacity. Under the new universal licensing regime, trustees have to fulfill certain conditions before receiving a license from Australian Prudential Regulation Authority ("APRA") to operate a superannuation fund. These conditions would include requirements for trustees to meet minimum standards of competency, and to have adequate resources, fraud control plans, and proper systems for managing risk and outsourcing.

While minimum competence standards are generally required of the governing body in most if not all jurisdictions, different standards of competency and skills exist based on different local situations. In the UK, a large number of occupational pension schemes are set up as trusts which are diverse in operational structures, size, asset levels and complexity of governing rules. There are individual as well as corporate trustees. Instead of setting out specific formal qualifications and professional experience applicable to all trustees, the supervisory authority adopts a flexible approach by requiring the trustees to have an appropriate knowledge and understanding of pension and trust law and be familiar and conversant with their own scheme documentation; and of any documents relating to the administration of the scheme. The degree of knowledge required would depend on the nature of their scheme and their own role within it.[8]

In some other jurisdictions, specific and formal qualifications and experience are required of the key officers of the governing body. Such requirements are common among the jurisdictions where the governing bodies are specialised corporate entities. For instance, in Poland, the law sets out that, among others, a member of the management board should possess higher education and a track record of employment of seven years or more (no less than two-thirds of the management board members have to satisfy this requirement). No less than two management board members, including the president of the management board, should have mastery over the Polish language. No less than one-third management board members should have higher education in law or economics, or be approved investment advisers.

Supervisory Oversight

In the majority of jurisdictions, licensing is the primary means employed by supervisory authorities to ensure that the governing body possesses the requisite competence and skills. In its application for a license to operate a pension fund, the governing body is normally required to submit a number of documents to the relevant authorities prior to commencement of its operation, and these documents must show that certain legislative requirements (e.g. academic qualification and professional experience of the governing body) have been met. In the application, the governing body may be required to demonstrate how they are going to meet the fitness and propriety standards on an ongoing basis. The supervisory authority normally reviews the documents submitted by the applicants to assess if they satisfy the legislative requirements on fitness and propriety.

For instance, in Germany, the Federal Financial Supervisory Authority ("BaFin") checks that the members of the managing board are qualified or, in the words of the legislation "reliable and suited for the job". This means having held a managing position within an insurance company or a Pensionsfonds for at least three years and,

[8] The Pension Advisory Service, http://www.pensionsadvisoryservice.org.uk/Occupational_Pensions/Trustee_Knowledge/

if possible, knowledge of the portfolios for which they will be responsible. Each member of the managing board is required to sign a statement as to whether criminal proceedings are pending against him, whether criminal proceedings have been instituted against him on account of a crime or other offence and whether he was responsible or involved as a debtor in insolvency proceedings. Furthermore, BaFin may consult the Federal Central Register of Previous Convictions (Bundeszentralregister) and the Federal Central Register of Trade and Industrial Offences (Gewerbezentralregister) to check the trustworthiness of the members of the managing board.[9] Any shortcomings in this regard may, for example, result in the refusal or the dismissal of the members from the managing board.

Likewise, in Jamaica, for registration purposes, an applicant is required to submit certain documents/information along with the application form, including police records and references from previous employers. The applicant is also required to complete a "fit and proper" questionnaire . One of the conditions for continued registration is that the person remains "fit and proper" on an on-going basis.

Licensing processes are particularly stringent in jurisdictions with specific professional and skill requirements prescribed in their regulations. In the Netherlands, as part of the licensing process, anyone nominated for appointment to a position involving policy-making at a financial institution is subject to an integrity and competence assessment by the De Nederlandsche Bank ("DNB"). The integrity test has to be completed only once. DNB may however require an individual to repeat the test if there is cause for concern that his integrity is compromised since completion of the test. In the area of competence, DNB has established six focus areas for assessment of the competence of the members of the governing body, including management of an organisation, relevant laws and regulations, pension schemes and types, technical financial and actuarial aspects, internal control and communication. In 2008, DNB plans to select about 50 out of about 700 appointments or reappointments for an interview to assess the competence of a member.

In addition to conducting reviews during the licensing process, the supervisory authority performs on-going monitoring to ensure that the governing body continue to fulfill the fitness and propriety requirements. In this connection, the governing body is often required by regulations to monitor the fitness and propriety of its members. For instance, in Australia, APRA's guidance on trustees' implementation of the "Fit and Proper" policy and procedures states that "The trustee policy should include a process for regular checking that trustees and responsible officers are not disqualified persons, such as an annual declaration by individuals that there is no change in status. Such a regular process is important as failure to act in respect of a disqualified person may result in the licensee not meeting the standard".

Apart from the self-assessment of the governing body, supervisory authorities generally conduct periodic assessments in the form of on-going monitoring, quarterly risk evaluations, regular correspondence and communication with the governing body. Generally, the on-going assessment of the governing body's fitness and propriety is often included as part of the monitoring of supervisory authorities. Review and

[9] As a joint-stock company or a mutual insurance/pension fund association, each Pensionskassen and Pensionsfonds in Germany has a two-tier board structure, consisting of a supervisory board and a managing board. There is also a general assembly (meeting of members/shareholders or representatives) which is the highest body of the company. The supervisory board consists of three members. However, the articles of association may specify a larger number of members that can be divided by three. The maximum number of board members is 21. The managing board must consist of at least two members. The applicant must indicate how many members will be on the board.

analysis of information and documents filed by the governing body during desk-based reviews as well as information and observations gathered during on-site visits allow supervisory authorities to identify risks and make appropriate responses.

Supervision of the competence and expertise of the governing body is often covered in the overall risk assessment framework of the supervisory authority. Thailand is a case in point.[10] The Securities and Exchange Commission ("SEC") assesses potential risks associated with the business operations of the management company by means of the "risk-based approach" ("RBA"), which covers four major risk areas: prudential risk, operational risk, customer relationship risk, and portfolio management risk. The outcome from the RBA assessment is to be used for prioritizing inspections or examination plans to be applied to the company in response to its exposure to risks. Frequency of inspection depends on the level of risks assessed in previous inspections and reports. Routine inspection is conducted at least once every three years for normal cases, and at least once a year for those companies with high to medium risks.

A more pro-active and "interventionist" approach may be employed by some supervisory authorities to ensure that the governing bodies possess the requisite skills and knowledge to perform their roles. In the UK, the Pensions Regulator ("Regulator") routinely questions trustees about their learning activities and steps taken to maintain their knowledge and understanding. The answers provided form part of the Regulator's risk assessment of the pension scheme. If a scheme is considered "riskier" than the norm, it is likely that the Regulator may check the competency of that scheme's trustees on a more regular basis.[11]

Communication between supervisory authorities and the governing body not only helps enhance the latter's compliance with statutory requirements, but also assists the former in assessing the competence of the governing body. In Thailand, quarterly compliance meetings have been carried out since 2005. The meetings provide a platform for the SEC and compliance officers to exchange views and information on a regular basis regarding such issues as rules and regulations, industry updates, problems and concerns relating to fitness and propriety, etc. In the Netherlands, DNB regularly provides presentations to the industry on sound pension fund governance and the importance of the competence of the governing body.

If necessary, supervisory authorities may interfere and take corrective actions to ensure the governing body's compliance with competence requirements. In the UK, the Regulator expects a scheme to review the knowledge and understanding of their trustees on an annual basis. Trustees therefore need to be ready to display their achievements in training, knowledge and understanding, e.g. examination results, courses attended etc., if asked by the Regulator. If the Regulator reached a decision that a trustee was not up to the required standard, it has the powers to have him/her removed, and to bar the trustee from taking up a trustee role in future.[12] In Thailand, where there is any non-compliance on the part of the management company, the SEC has the authority to impose a range of sanctions according to the severity of the situation, records of previous non-compliance and willingness to rectify non-

[10] In Thailand, pension fund is known as 'provident fund' which has a status as a legal person. The fund is managed by an external governing body which is a securities company with private fund management licence.

[11] The Pension Advisory Service, http://www.pensionsadvisoryservice.org.uk/Occupational_Pensions/Trustee_Knowledge/

[12] The Pension Advisory Service, http://www.pensionsadvisoryservice.org.uk/Occupational_Pensions/Trustee_Knowledge/

compliance practices, etc. The sanctions available include an order to undertake certain actions, rectify or refrain from taking certain action, disqualification of directors or CEO from any management company, fine and imprisonment.

Expert Advice

Regulatory Approach

With the pension fund industry becoming increasingly complex, and the investment products becoming increasingly sophisticated, it is difficult for the governing body to be experts in all areas of pension fund governance. Where it lacks sufficient expertise to make fully informed decisions and fulfill its responsibilities, the governing body could be required by the regulator to seek expert advice or appoint professionals to carry out certain functions.[13]

Regulations may be laid down to enable or require the governing body to seek expert advice, particularly on investment issues. In many jurisdictions, investment advice can only be sought from a licensed investment adviser. Regulations may also set out that all securities transactions related to the management of pension fund assets, with certain exceptions, have to be executed by an investment manager.

However, where expert advice is sought, the governing body is usually held responsible for the actions of the external expert. This might in some cases involve strict liability for the acts of the expert, or in other cases a responsibility to adequately monitor the work of the expert. In funds of trust form, trustees are liable to the plan members under the principle of fiduciary duties and have to work in their best interests. In some jurisdictions, regulations may require that the governing body should carefully select persons suitable for the tasks to be delegated, and should ensure that such persons perform their tasks in compliance with the law. For instance, in Thailand, although those functions have been delegated to a third party, the governing body remains legally accountable and liable for the actions taken by the delegated party. In Germany, if the managing board employs external asset managers, it has to ensure that it is able to monitor their performance, e.g. with reference to the guidelines laid down by the managing board. The investment regulations must be specified in the contractual agreement with the asset manager.

In some jurisdictions, certain functions such as investment could not be outsourced. In Macedonia, pension companies (i.e. the governing bodies) are responsible for administrating and managing the pension fund assets (including investments) and are required by law to manage the fund by itself, including making investment decisions for the pension fund. As such, the investment activity cannot be outsourced, with the exception of investing abroad.

Supervisory Oversight

Some supervisory authorities do not proactively oversee expert advice, and the governing body is primarily held responsible for acting in the best interests of plan members and beneficiaries (e.g. Austria, Germany, the Netherlands and Turkey). However, where reliance is placed by trustees on advice given in a professional capacity, some jurisdictions require that such advice must be put in writing and if given orally it should be subsequently confirmed in writing. This gives the supervisory authority opportunities to inspect, evaluate and comment on the advice given during the desk-based reviews and on-site visits (e.g. Jamaica). In some jurisdictions, the

[13] Guideline 3 of OECD Guidelines for Pension Fund Governance.

governing body may be required to notify the supervisory authority of the activities and/or services that they have outsourced and, upon request, to provide the authority with the relevant contracts. The supervisory authority is entitled to check such contracts to assess whether or not they meet relevant statutory requirements (e.g. Hungary).

During on-site inspections, the supervisory authority may require the governing body to make available copies of documents relating to any expert advice. The management board, supervisory board and relevant employees of the governing body are required to provide the required information or explanations (e.g. Poland).

With the objective of ensuring that the governing body receives proper expert advice, some supervisory authorities would scrutinize the expert advice given by external parties in certain circumstances. In Australia, audit and actuarial reports are reviewed by the supervisory authority as part of off-site analyses and/or on-site reviews, which are conducted on a cycle according to the risk rating of the fund concerned. In Macedonia, the Agency for Supervision of Fully Funded Pension Insurance ("MAPAS"), during its regular on-site audits, checks all of the governing body's contracts with service providers (especially consultancy services contracts) and the outputs provided by the service providers, and inspects any possible conflicts of interests.

If the supervisory authority discovers any irregularities in respect of the expert advice given to the governing body and the third party (if applicable), it is a common practice that it would notify the governing body and request an explanation. If the supervisory authority is not satisfied with the explanation, it would require correction of the irregularities within a given period of time. If the irregularities are not corrected within the given period, the supervisory authority may impose punitive penalty on the governing body or the third party (e.g. Poland).

B. 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, it should be legally liable for its actions.[14] In a two-tier board system, the governing body has to be accountable to the supervisory board.

In funds of trust form, trustees are liable to the plan members and beneficiaries under the principle of fiduciary duties and also as supplemented in specific legislation (e.g. Hong Kong). General fiduciary duty requires that trustees be responsible for acting in the best interests of plan members and beneficiaries. Trustees' general duties at law and their responsibilities as fiduciaries provide a framework for ensuring that the trustees are liable for any losses caused to the pension scheme as a result of a breach of trust. A breach of trust can happen when the trustee performs an act as a trustee which it is not authorised to do under the trust deed and rules; when the trustee fails to do something which it should have been done under the trust deed and rules; or when the trustee does not perform the duties that it has to perform under trust law or pension law or does not perform them with sufficient care.[15]

[14] Guideline 7 of OECD Guidelines for Pension Fund Governance

[15] The Pensions Regulator (December 2007), p.12.

In addition to the general fiduciary duties of trustees under trust law, the legislation may outline the general duties of the governing body, including disclosure of relevant information to plan members and their beneficiaries, agents and supervisory authority on a periodic basis; safeguarding of plan assets; making decisions on a fully informed basis and in good faith in the interest of plan members and beneficiaries; and being financially prudent in the management of the plan (e.g. Jamaica).

Other systems usually set out the responsibilities and duties of the governing body by direct statutory mechanism/provisions, with which the governing bodies have to comply. For instance, regulations may stipulate that the governing body has to maintain an adequate level of funding to meet pension promises and performance guarantee; to invest pension assets according to certain prudential principles; and to disclose relevant information timely to pension plan members and beneficiaries.[16]

For Pensionskassen and Pensionsfonds in Germany, the Insurance Supervision Act also lays down that managing board members are responsible for good and sound business practices. In case any circumstances occur which may be relevant to the fitness and propriety of its managing board members, the managing or supervisory board has to take appropriate measures immediately to remedy the situation in order to comply with the principle of good and sound business practices. Members of the managing board in particular are liable for damages if they act contrary to the law. Similar provisions and arrangements are in place in Hungary and Bulgaria.

In Macedonia, each governing body is liable to plan members for damages resulting from any failure to perform its obligations under the law unless such performance is due to the circumstances which are out of the governing body's control and which could not have been altered by the governing body even though it has exercised the highest degree of diligence.

Representation

Regulatory Approach

Accountability could be reinforced by having an independent voice or a voice representing the interests of pension plan stakeholders in the governing body or on the supervisory board. In a one-tier board system the requirement of an independent director on the board of directors of the governing body is one such arrangement.

The arrangements of independent director can be made in different ways. In Hong Kong, the law stipulates that one of the directors of the trustee must be an independent director with no past or present association (financial or otherwise) with the trustee, its controllers or associates that could affect the impartiality of the director's independent judgment. In Australia, industry and company funds are required to meet equal representation requirements. The equal representation rules also provide for (but do not mandate) an independent director of the trustee board to be appointed. The alternative to equal representation arrangements is to have an independent trustee company. Public offer (retail) funds are required to have an independent trustee company.

In certain pension funds of corporate form, the objective of having independent views in board meetings is achieved by its built-in structure. For instance, a two-tier system is adopted in a joint-stock company or a mutual insurance/pension fund

[16] Yermo and Marossy (2002), pp. 155-156.

association (i.e. Pensionskassen and Pensionsfonds) in Germany in which the managing board forms the governing body. The supervisory body is expected to bring to the managing board an independent view on issues such as strategy, performance and accountability. In Poland, no less than one-half of the members of the supervisory board should be appointed from those who are not shareholders of the governing body or entities related to the governing body.

Another way to enhance accountability of the governing body is to allow plan members and beneficiaries to vote for representatives to the board of the governing body. Some jurisdictions require that representatives of plan members be appointed to the board of directors of the governing body, though arrangements may vary from one to another. The role of a member representative is different from that of an independent director. An independent director is appointed to bring to the board an independent view on issues such as strategy, performance and accountability whereas a member representative serves as the voice of plan members on the board. Member representation in the governing body is suitable if membership to the pension plan is mandatory (often the case for closed pension funds), in which case plan members cannot "vote with their feet".[17] As such, member representation may be an effective method to ensure that the governing body would listen to the voices of plan members.

For the industry funds in Australia, there is a requirement of equal member and employer representation on their trustee boards. Member representatives are usually drawn from relevant unions or elected by plan members, while employer representatives are usually drawn from relevant industry associations or participating employers. In Jamaica, there must be at least one member-nominated trustee; and a pensioner-nominated trustee where there are 30 or more pensioners and deferred pensioners. In Thailand, the fund committee must consist of the representatives elected by the employees and appointed by the employers, without specific limitation on the number of representatives from either side. In the UK, the governing body has balanced representation and is accountable by having member-nominated trustees comprising at least one-third of the trustees. In Poland's occupational pension funds, no less than one-half seats on the supervisory board of the governing body should be filled by those elected by the plan members of the fund whose account contributions have been paid within 12 months immediately preceding the election day.

In pension funds of corporate form, the requirement for member representation is different. In Germany (i.e. Pensionskassen and Pensionsfonds), in addition to the supervisory and managing board, there is a general assembly (meeting of members/shareholders or their representatives). The managing board is responsible for managing the company, and its members are jointly accountable for the management of the company. In general, the supervisory board appoints, supervises and advises members of the managing board and is directly involved in decisions of fundamental importance to the company. As the managing board is appointed by the supervisory board which itself is elected by the general assembly, it represents to a certain extent the members/shareholders of the Pensionskasse/Pensionsfonds. Depending on the size of the joint-stock company or mutual association, representation of employees may be required. It is also possible for the sponsor to be represented in the supervisory board, subject to certain conditions. In the case of small mutual insurance associations, the articles of association may foresee the appointment of the members of the managing board by the general assembly (meeting of members or their representatives).

Similar to Germany's Pensionskassen and Pensionsfonds, the pension savings companies with variable capital ("SEPCAV") in Luxembourg are also a corporate type

[17] Yermo and Marossy (2002), p.159.

structure, whose members are its shareholders. These shareholders are represented at the annual general meetings ("AGMs") held by the SEPCAV, which have the broadest powers to order, carry out or ratify acts relating to the operations of the SEPCAV. The directors are generally appointed by the general meeting of shareholders unless the SEPCAV's articles of association provide for a certain number of members to be appointed by the sponsoring undertaking. Given the powers of the shareholders and in particular their power to appoint the directors, there is a balanced representation of the governing body which is consequently fully accountable to the members.

The requirement for member representation is different in another pension fund vehicle in Luxembourg, the pension savings associations ("ASSEP"). The ASSEP is a new type of company in the form of mutual insurance associations, organised like a partnership. The beneficiaries of an ASSEP are not shareholders or owners, but creditors. The ASSEP must have a minimum of three associates and must include at least one member representative, one beneficiary representative and one representative of the contributor(s). If there is no beneficiary, the ASSEP should have at least two member representatives among its associates. It follows that the stakeholders and the governing body are to be represented at the AGMs. The directors are appointed by the general meeting of shareholders. An equal representation of different parties (sponsoring undertaking, members, beneficiaries) is set out in ASSEP's articles of association.

Supervisory Oversight

Supervisory oversight of compliance with representation requirements starts at the licensing stage during which the requirements in respect of independent directorship are checked by the supervisory authority. For instance, in approving a pension plan, the supervisory authority may examine the constitution of the governing body to ensure its compliance with the representation requirements.

The governing body is generally required to provide the supervisory authority with relevant information in respect of the members of the board on a regular basis. The governing body may be required to provide the supervisory authority with a statement of independence of its board member. Whenever it comes to the notice of the supervisory authority that new circumstances could affect the independence of a member on the supervisory board, it could request the supervisory board to appoint a new independent member (e.g. Poland). In certain circumstances, the governing body may be requested by the supervisory authority to provide minutes of the general meeting and other documents showing changes in personnel and other material conditions (e.g. Hungary).

In addition to the information provided by the governing body, the supervisory authority can make use of the information provided by third parties to assess whether or not the governing body complies with the representation requirements. In Australia, compliance with the equal representation requirements is one of the areas on which the independent auditor must focus and express an opinion in the annual audit report.

Intervention and corrective measures may be taken when the governing body is in breach of the regulation in respect of representation. A case in point is Hungary in which Hungarian Financial Supervisory Authority ("HFSA") has a comprehensive power to take measures to ensure fulfillment of the requirements of member representation/independent directorship which includes:

(i) issue a notice and set a deadline if necessary for the implementation of the provisions specified in law relating to member representation;

(ii) initiate the dismissal of any executive officer involved in a case of serious managerial or operational impropriety;

(iii) order the suspension of admission of new members;

(iv) convene an extraordinary general meeting;

(v) levy a fine;

(vi) revoke the license that authorises a fund's activity;

(vii) impose restrictions on the fund's activities;

(viii) impose a ban on benefit payments;

(ix) suspend the operation of the fund;

(x) appoint a regulatory commissioner; and

(xi) initiate the liquidation of the fund in court.

Although the HFSA has the power to take any or all of the above-mentioned measures, only summons and penalties are invoked in practice in issues relating to governance.

However, not all supervisory authorities would conduct pro-active inspection of compliance with representation requirements. In Thailand, the SEC does not conduct on-site or off-site inspection to the fund committees since the SEC, as the registrar, does not have the power by law to supervise the fund committees directly. However, the fund committees have to inform and register with the SEC when they change their funds' articles of association or asset management companies. In the Netherlands, although the governing body is required to provide information on their compliance with the guidelines for pension fund governance which include the requirements for an accountability body (with equal representation) and internal supervision, DNB currently performs no additional active supervision over these specific requirements. The current focus of supervision over pension fund governance is on the competence of the government body.

Disclosure

Regulatory Approach

To be truly accountable there is a strong need for good transparency to those to whom the entity is accountable. This would include disclosure of certain information (e.g. fees, investment performance, financial position, and service benchmarks) to members, supervisors and external reviewers such as auditors. Most disclosure requirements are about improving the information position of the member. In the pre-joining phase plan members are at a huge disadvantage vis-à-vis the providers unless there are some regulations about what information the providers must give.

According to Annotation 11 to OECD Guidelines for Pension Fund Governance, plan members should be given the details of contribution rate payable by the plan sponsor and the plan member; investment guarantees and benefit promises, if any; fees to be paid by plan members; and in defined contribution plans, a simplified and easy to understand description of the pension fund's investment policy. After plan members join the plan, it is obvious that plan members need information to understand the progress of their savings, what decisions they can make, etc. Therefore, plan members and beneficiaries should have access to information of the operation of pension fund and be informed of any events having material impact on their pension benefits.

In addition to disclosing information to plan members and beneficiaries, the governing body is required to provide information to supervisory authorities regularly (i.e. the reporting requirement). Generally, the governing body is required to report the following categories of information to supervisory authorities: basic fund information, financial conditions, governance, conduct of business and investment.

While disclosure requirements are generally relied upon to facilitate plan members and beneficiaries and supervisory authorities' access to relevant information, there may be some variations from country to country. Differences mainly lie in the frequency of reporting and methods of fund valuation. Supervisory authorities in Argentina and Chile require daily reporting of the financial status of funds with assets valued on a mark-to-market basis. Account statements also have to be made available to plan members several times a year. European and Anglo-American supervisory authorities are more likely to require annual reporting and allow greater discretion in valuation. Latin American countries mainly rely on the direct verification by the supervisory authorities for accuracy of information, while many other countries rely on the opinions of external independent auditors.[18]

In addition to frequency of reporting and methods of fund valuation, the amount of information disclosed to plan members and beneficiaries and supervisory authorities varies considerably from one jurisdiction to another.

In Germany, all Pensionskassen and Pensionsfonds must annually provide detailed and substantial information to members and where relevant also to beneficiaries on the target level of the retirement benefit; the available types of investment and the structure of the investment portfolio as well as information on potential risks and all costs borne by members; a benefit statement and information concerning the extent to which ethical, social or ecological criteria have been taken into account in investment decisions; brief particulars of the status of the Pensionskasse/Pensionsfonds as well as the current level of members' accrued benefits. Further information requirements to members and beneficiaries - at the beginning of membership or on request of the members and beneficiaries - are laid down in legislation. In addition, Pensionskassen and Pensionsfonds must regularly provide BaFin with detailed information inter alia on the allocation of assets (together with information on the basic risk calculation, risk management and valuation methods) and any major changes in asset allocation as well as the audited annual financial statement (together with the auditor's report).

In Bulgaria, each retirement insurance company is required to transmit to the insured persons (members) free of charge an annual statement of their individual accounts for the previous year. Contained in a standard form, the information of the annual statement includes the rate of return of pension investment and the amount in individual account. The pension insurance company is also required to publish annually on its website details of investment such as types of investment and asset allocation of investment funds. The annual financial statements of the retirement insurance company and the pension funds under its management would have to be promulgated in the State Gazette.

In Hungary, the fund is required to publish the necessary information, including number of members, member contributions, rate of return, opening and closing balance of the fund in the Pénzügyi Közlöny (i.e. Financial Gazette) every year. In addition, the fund is required to publish its balance sheet, income statement and auditor's statement in Magyar Közlöny Hivatalos Értesítő (i.e. Bulletin of the Official

[18] Hinz and Rao (2003), p. 171.

Gazette). The fund also has to publish the date of the AGMs and its resolutions in the Pénzügyi Közlöny and the annual report with a full list of managing board and supervisory board members.

In Jamaica, trustees and their agents have to provide certain information to plan members and their beneficiaries, such as an information folder (in the case of a retirement scheme) or a member's handbook (in the case of a superannuation fund) to be given to each member upon joining a plan; a benefit statement within four months of the end of each plan year for active members and to a deferred member upon request; and an annual report within nine months of the end of each plan year.

In Macedonia, each pension company is required to publish prospectus of the pension fund annually which must contain updated information regarding the pension fund and pension fund company; details of the custodian and changes relating to the custodian; the basic investment principles; and the fees charged to members of the pension fund, etc. Pension companies are also required to publish quarterly un-audited financial reports and the annual audited report of the pension fund and the pension company in a newspaper. Besides, the pension company is required to send to members their account information twice a year and detailed information about pension fund assets and investment once a year.

In Turkey, to ensure that a viable investment advice is provided to members, pension companies are required to provide members with a risk-return profile form before they enroll in the plan.

In the Netherlands, all pension funds are required to publish an annual report. The annual report should include a balance sheet, profit and loss account and a "risk management paragraph". The "risk management paragraph" includes information of the strategy and policy of the fund, risks and associated risk management strategies adopted. Both qualitative and quantitative information is required.

In Thailand, the fund committee will be informed of the fund's position on a monthly basis. Members will be informed of their savings, contributions from their employer, benefits acquired from investments and net asset value per unit twice a year. Members will also be informed of the fund performance on a yearly basis.

Supervisory Oversight

Ex-ante authorisation of documents is normally required in most jurisdictions, though there are different requirements as to the types of documents to be authorised. At the extreme of the spectrum (e.g. Macedonia), all information regarding pension fund that the pension company is required to disclose to the general public has to be sent to MAPAS for approval before publishing. MAPAS checks the accuracy and consistency of all data contained in the documents that are to be disclosed to the public.

On-site and off-site inspections are the supervisory tools often employed by supervisory authorities for disclosure requirements. During on-site visits, documents including information sent to plan participants may be reviewed to ensure that pertinent, accurate and complete information is sent to participants. Desk-based reviews of reports filed by the governing body are essential if more in-depth analysis of the disclosed information is required, such as information about investments, daily transaction records, valuation of investment units, and changes in the management and ownership structure of the governing body.

Auditor's report is also an important source of information used by supervisory authorities for overseeing the governing body's compliance with disclosure requirements. For instance, in Australia, compliance with disclosure requirements is one of the areas on which the independent auditor must focus and express an opinion in the annual audit report.

Apart from auditor's reports, declarations and notifications provided by the governing body are considered by some jurisdictions (e.g. Germany) as major sources of information for supervisory action. Interviewing the governing body on specific aspects could also supplement the information for supervisory action if needed.

Instead of relying on the information submitted by the governing body, supervisory authorities may adopt a pro-active approach. A case in point is Hungary. In order to ensure that the pension fund companies comply with the requirements of AGM announcements, the HFSA searches their announcements on a daily basis. In 2007, the HFSA started to gather all announcements to be disclosed by pension fund companies regarding their AGMs from all pension funds and published them in one single edition of Financial Official Journal.

In most circumstances, supervisory authorities may not be able to allocate resources to verify every piece of information disclosed by the governing body. For example, in Turkey, the supervision regarding the disclosure of information is conducted on a complaint and random check basis. During the handling of complaints, the supervisory authority requests copies of the documents in dispute and assesses whether or not the pension company has complied with the relevant disclosure requirements. Random checks are conducted during on-site inspections. In addition, the supervisory authority often checks the speeches/disclosures (usually on a daily basis) of the pension company officials through a specialised media-watch website in order to identify whether there are any breaches of relevant disclosure regulations.

Communication with the governing body and service providers can be an effective way to enhance their understanding of relevant disclosure requirements. In Jamaica, the Financial Services Commission ("FSC") has conducted numerous workshops and seminars to educate trustees and other pension stakeholders about the content of the benefit statement. If there is an issue with the accuracy and other aspect of the information, the Senior Pensions Analyst in charge of the supervisory team which has responsibility for that plan liaises with the trustees or their agents to discuss the issue.

To ensure compliance with disclosure requirements, supervisory authorities may interfere with the information disclosed by the governing body and requests rectification. For instance, in Poland, the supervisory authority may, by administrative decision, forbid the governing body from disclosing misleading materials. It may also order the governing body to make suitable corrections of the content of the materials. If the governing body fails to make the necessary corrections, the supervisory authority may impose a fine of up to 500,000 Polish zloty.

It is noteworthy that some supervisory authorities may not give supervision of disclosure requirement a high priority. In the Netherlands, the current focus of supervision over pension fund governance is on the competence of the governing body. Supervision over compliance with disclosure requirements in respect of governance issues is currently not a priority.

Whistleblowing

Regulatory Approach

Third parties may exert independent oversight over the governing body and thus enhance the accountability of the governing body. The role of third party oversight often hinges on the robustness of the professional standards of these third parties. The most common third party oversight in the pension industry is the periodic auditing performed by external independent auditors. It is generally a mandatory requirement for DB plans to have periodic actuarial reports prepared by independent actuaries.

By acting as whistleblowers, third parties may exert independent monitoring of the governing body. Whistleblowers may report non-compliance incidents to the governing body. They may also have a duty to report to the supervisory authorities if the governing body fails to take remedial action.

Although it has been suggested that, compared to the jurisdictions of civil law (or code law) tradition, those of common law system tend to rely more on whistleblowers in the exercise of pension supervisory activities[19], the requirement of third parties to perform whistleblowing role is widely practised across different jurisdictions. In Australia (i.e. trust form), the whistleblowing role of auditors and actuaries is set out in legislation and supported by protection provisions. Information about whistleblowing is made available to the public including service providers on the supervisory authority's website. In Belgium and Germany (i.e. corporate form), the supervisory board has to arrange for the auditor to report all facts and events of importance, which arise during the performance of an audit. In Turkey, a "fund auditor" appointed by the pension company to execute the oversight of the fund board has the obligation to notify the supervisory authority of any circumstances that may endanger the existence of the fund and the benefits of the plan members.

Similar to external auditors, actuaries are also required to perform the whistleblowing role. In Germany, if the appointed actuary recognises a possibility that circumstances will preclude the granting of a certification or allow only a limited certification, he should inform the managing board and, if the managing board does not immediately remedy the situation, the supervisory authority without delay. In the event that, in the performance of the duty as an appointed actuary, facts are discovered which could threaten the going concern status of the undertaking or seriously hinder its development, he should immediately inform the managing board and the supervisory authority. In Jamaica, the actuary must submit a written report to the trustees, sponsor and the FSC if there are reasonable grounds to believe that the circumstances of the plan have changed, are changing or are likely to change in such a manner as to materially and adversely affect the solvency of the plan.

In certain jurisdictions, the duty of whistleblowing is not confined to auditors and actuaries alone, it may be extended to other parties as well. In the UK, there is a duty to report breaches of the law. This duty is required of the trustees or managers of an occupational or personal pension scheme, a scheme administrator, the employer of an occupational pension scheme and any professional advisers in relation to such a scheme. They must give a written report of the matter to the supervisory authority as soon as reasonably practicable. The role of whistleblowing may also be extended to depositories and custodians in certain jurisdictions (e.g. Czech and Poland). The depository bank may be required to inform the supervisory authority of any

[19] Mataoanu (2004), pp. 21-22.

discrepancies in calculation of the net asset value and rate of return of the pension funds (e.g. Poland).

To protect the whistleblowers (e.g. external auditors) from any repercussions, regulations may set out that disclosing information to the supervisory authority in good faith by an auditor does not constitute a breach of professional conduct on confidentiality or any other contractual restriction on confidentiality (e.g. Luxembourg).

However, some jurisdictions do not impose any obligation regarding whistleblowing on external auditors (e.g. Macedonia). Instead, the law in Macedonia requires a separate internal audit department in the pension company which reports directly to the supervisory board and MAPAS.

Supervisory Oversight

The compliance with whistleblowing requirements is often monitored by regular on-site and/or off-site inspections. The major differences lie in the coverage of monitoring. Some jurisdictions may require internal auditors to play the whistleblowing role and thus monitoring of their performance is necessary. A case in point is Turkey. The assessment as to whether the internal auditor's role of whistleblowing is performed properly is usually done by means of comparing the results of on-site visits and off-site supervision with the reports submitted by the internal auditors. In some other jurisdictions, the performance of the whistleblowing role of the custodian and depository bank is monitored as well (e.g. Thailand and Poland).

Communication between supervisory authorities and auditors/actuaries would facilitate the former in acquiring a deeper understanding of certain issues. Such approach is adopted in the Netherlands. DNB holds meetings with all relevant audit and actuarial firms, during which all pension funds would be discussed with their respective auditors and actuaries.

Since whistleblowing plays an important role in safeguarding plan members' and beneficiaries' interests from any fraud or malpractices of the governing body, intervention and corrective measures are sometimes invoked against those in breach of such responsibility. In Jamaica, in determining whether the actuary or auditor is a suitable person to perform the duties of actuary or auditor of an approved superannuation fund or approved retirement scheme, the FSC may take the prior failure of the auditor or actuary to whistleblow into consideration. The FSC may also report actuaries and auditors to their professional governing body if they fail to whistleblow. In the Netherlands, DNB has the authority to declare an accountant or actuary incompetent to provide services to a pension fund.

Some supervisory authorities may impose fines if the relevant party fails to perform the requisite whistleblowing role. In the UK, civil penalties may be imposed on any person who, without reasonable excuse, fails to comply with a whistleblowing obligation imposed on him/her by law. In Turkey, the breach of this duty is subject to administrative and judicial penalties. In Poland, a failure in performing whistleblowing functions result in penalties. Such penalties have been levied on a depository bank two times already - one for mishandling a transfer of money to a pension fund and another for failing to notify the supervisory authority of miscalculations of fees charged by the governing body to the assets of the managed fund.

C. *Internal Controls*

Regulatory Approach

Close monitoring is often required to ensure the effectiveness of the governance structures/mechanisms, i.e. the governing body and other parties involved in the operation and oversight of pension funds are in compliance with relevant practices, regulations and law. Since it is impossible for supervisory authorities to closely monitor all management decisions and operational effectiveness of the governing body and other service providers, it is crucial for supervisory authorities to ensure that these parties have put in place appropriate internal controls.

According to Guideline 9 of OECD Guidelines for Pension Fund Governance, appropriate controls should be 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, trust instrument, etc. Such controls should cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan. These controls include performance assessment, compensation mechanisms, information systems and processes, and risk management procedures.

Although varying among different jurisdictions, internal control requirements are widely adopted in the regulation of the governing body. In Australia, the supervisory authority requires the trustees to devise a risk management framework for assessing their own operational risks as well as those of their funds. Trustees are also required to describe the manner in which the relevant risks are managed and monitored. The risk management framework must set out reasonable measures and procedures to identify, manage and monitor risks. Likewise, in Germany, Pensionskassen and Pensionsfonds must have a proper business organisation, which includes sound administrative and accounting procedures appropriate to the company’s business operations, development of risk strategy, organisational and operational rules, and establishment of an appropriate internal management and control system.

Some jurisdictions extend the internal control requirements to the service providers. In Jamaica, the governing body is required to review internal control policies and procedures at least annually and also regularly evaluate and report to the supervisory authority on the performance of their agents and advisers. The agents appointed by the governing body are also required by law to report to the supervisory authority on whether adequate control systems have been established to identify, monitor and manage the risk of pension plans under their management.

Some jurisdictions may also require the governing body to set up a specialised unit on internal controls. In Austria, every Pensionskasse should set up an internal auditing unit that reports directly to the management board. The purpose of the internal auditing unit is to continuously and comprehensively verify that the business and the operation of the Pensionskasse are lawfully, properly and expediently conducted. Likewise, in Bulgaria, the pension insurance company is required to establish a specialised internal controls unit, which should be appointed and dismissed by the managing body. In Germany, an internal audit system, which audits the company’s entire business organisation, has to be set up. Internal auditing must be an independent function. It must be carried out by experts who also understand the risks that are inherent in the investments of the portfolio. Any concerns about the investment activity must be reported to the head of investment management and the managing board.

Supervisory Oversight

In performing supervisory oversight of internal controls, supervisory authorities would generally assess the internal control structure and mechanism of the governing body during the licensing process (e.g. Hungary, Poland, South Africa and Turkey). In Thailand, as part of the licensing criteria, the SEC has to ensure that the governing body has in place proper internal control system which consists of but not limited to operation manuals, check and balance system, complaint-handling process, control environment and activities, information and communication, monitoring and risk assessment.

On-going monitoring is often needed to ensure that the parties involved in pension fund administration implement and practise the rules and procedures in respect of internal controls. It is a common practice for supervisory authorities to conduct on-site and off-site inspections of the internal control system of the governing body and/or other service providers. In Hong Kong, the supervisory authority regularly reviews the internal control reports submitted by the trustees and periodically conducts on-site inspections on the trustees' operations to ensure adequacy of internal controls. In Turkey, adequacy of internal controls is checked during on-site inspections by utilizing the feedback gathered from off-site supervision.

In Jamaica, during on-site examinations, the internal control environment is evaluated to determine the existence, adequacy and effectiveness of internal controls. Documents, including internal and external audit reports, operational policies and procedures and job descriptions, are examined. In Macedonia, MAPAS conducts regular on-site audits on the key areas of internal controls of the governing body, e.g. internal procedures, decision-making process and major control points. A comprehensive on-site inspection is performed annually, while partial on-site inspections may be conducted more frequently if any internal control weaknesses have been identified. In the Netherlands, DNB actively performs supervision over the pension fund's system of internal control, e.g. during on-site visits. The Pension Act requires pension funds to regularly perform a continuity analysis that provides insight into its long-term financial position. DNB reviews these continuity analyses, based on a number of criteria laid down in specific guidelines.

Some supervisory authorities may focus their supervisory oversight of internal controls on the internal control unit of the governing body. In Hungary, the HFSA either supervises the activities of internal controllers during on-site inspection or communicates with them in the course of daily supervision. HFSA may also contract the services of an expert, in certain cases, to carry out inspections. In Poland, during on-site inspections, the supervisory authority studies the documents produced by the internal control unit, including its work plans and internal control reports, to assess whether or not the governing body has complied with relevant law and regulations. Among others, the investment activities of fund managers may be inspected to ensure that no insider trading activities have taken place.

For non-professional governing bodies, one of the best supervisory approaches is to equip them with necessary skills and knowledge of internal controls. In the UK, trustees are required to ensure that they have adequate internal control mechanisms in place, and a code of practice is given by the supervisory authority to trustees with the aim of providing them with practical guidance on how they might establish effective risk management processes and internal controls.

The quality of the internal control systems of pension fund service providers may pose a threat to the funds and thus the interests of plan members and beneficiaries.

As such, supervisory authorities may have to monitor the internal control systems of pension fund service providers which could be performed either by themselves or through the governing bodies. For example, in Thailand, the governing body is required to appoint proper professionals to carry out delegated functions. In this regard, the governing body should carefully select the parties suitable for the tasks to be delegated by conducting due diligence on them, including their internal control systems. The governing body also has to ensure that the service providers should maintain proper internal control system on an on-going basis. To this end, the governing body is required to include in its contract with the service providers certain clauses which would enable the SEC to carry out inspections to the service providers as and when necessary. In Australia, the supervisory authority is developing a programme for on-site review of entities in the two major categories of service providers i.e. the administrators and custodians.

V. Observations of Good Practices

The survey and the case studies in a number of IOPS member jurisdictions have provided useful reference in respect of the supervisory oversight of pension fund governance. Generally speaking, the regulatory approaches adopted by the responding IOPS members are in line with OECD Guidelines for Pension Fund Governance in the areas of competence and expertise, accountability and internal controls of the governing body. Some of the good practices of the responding IOPS members are summarized below.

A. Competence and Expertise

To ensure that the management of the governing body is fit and proper, it is a widely adopted practice that they have to meet certain requirements in respect of honesty, integrity and competence. Supervisory authorities may assess the skills and knowledge of the non-professional governing body through appropriate tests to make sure that it is competent enough to properly perform its duties.

Post-licensing monitoring is just as important as pre-licensing assessment of fitness and propriety. In this regard, supervisory authorities may proactively conduct on-site inspections to the governing body to verify that the members of the governing body continue to meet the “fit and proper” criteria. The governing body may be obliged to notify the supervisory authority of any changes in its membership and be required to make annual declaration that its members are fit and proper to perform their duties.

In respect of expert advice, many jurisdictions require the governing body to select the service provider carefully and be held responsible for the conduct of the relevant expert. Core functions of the governing body may not be allowed to be outsourced to third parties.

To ensure that the governing body complies with the relevant requirements of outsourcing, the supervisory authorities are, in many cases, empowered to inspect any contracts between the governing body and the service providers and request the governing body to rectify any irregularities.

The case studies of Australia and the UK illustrate how different approaches could be employed to address the same pension fund governance issue. To address the issue of “lay trustees”, Australia has stepped up licensing requirements to ensure that trustees meet at least minimum level of expertise and competence. In the UK, efforts have been made to educate the trustees with a view to enhancing their skills and knowledge on an on-going basis. Therefore, there is no single best way to solve the supervisory problems, supervisory authorities may resort to an approach which is considered to be most appropriate for their own circumstances.

B. Accountability

There are many ways to enhance accountability of the governing body. Representation is one of them. To ensure that independent voice can be heard on the board of the governing body, some jurisdictions require that one or more independent directors be appointed to the board.

Employee or member representation on the board is another way to enhance accountability of the governing body in some jurisdictions. It is particularly a common practice for those jurisdictions with closed pension funds to require appointment or election of plan members or employees' representatives to the board of the governing body.

For those jurisdictions with representation requirements, the supervisory authorities generally require the governing body to fulfill these requirements in the licensing process. On-going monitoring is commonly used to check any personnel changes in the board.

Disclosure is an important tool to enhance accountability of the governing body to the plan members and beneficiaries. It is a common practice that the governing body is required to provide the essential information of the pension plan to prospective plan members prior to joining the plan and updated information of the fund and their accrued benefits on a regular basis after joining the plan.

To enable supervisory authorities to be in possession of necessary information for assessment of pension funds, regular reporting of the governing body to supervisory authorities is required in most jurisdictions. The reporting requirements may cover the basic information of the funds, investment and financial situations as well as governance.

The amount of information to be disclosed and the frequency of disclosure to plan members, beneficiaries and supervisory authorities vary across jurisdictions depending on the circumstances in each jurisdiction.

In some cases, ex-ante authorization is required for certain documents of crucial importance before they are disclosed, so as to protect the interests of stakeholders, particularly plan members and beneficiaries.

On-site and off-site inspections are commonly used by supervisory authorities to check whether the governing body has disclosed information accurately and in a timely manner. Some supervisory authorities may have to supervise a large number of funds which makes it impossible to inspect every piece of disclosed information. In this regard, some jurisdictions may conduct sample checks.

Supervisory authorities, in some cases, may gather useful information in respect of the governing body's compliance with disclosure requirements from the relevant parties (e.g. external auditor), for instance, by setting out that compliance with the disclosure requirements is one of the areas on which the external auditor must express an opinion in the auditor's report.

Communication appears to be an effective way to ensure that the governing body understands disclosure requirements. In some jurisdictions, supervisory authorities deploy designated staff to liaise regularly with the governing body on disclosure requirements.

In many jurisdictions, supervisory authorities are empowered to request the governing body and service providers to correct any inaccurate information disclosed to the plan members and beneficiaries and supervisory authorities.

Requiring third parties to perform the whistleblowing role is also one way to enhance accountability of the governing body. The information provided by the whistleblowers could help supervisory authorities identify risk of material nature in a timely manner. Whistleblowing is commonly required of external auditors and actuaries in most jurisdictions. In some cases, custodian, depository or any other parties involved in the pension plan may be required to perform this role.

Compliance with whistleblowing role is normally monitored through on-site and off-site supervision. In some jurisdictions, supervisory authorities compare the auditor's and actuary's report with the findings of the on-site inspections and off-site reviews and take corrective actions against the party which fails to perform the requisite duties.

C. Internal Controls

In most if not all jurisdictions, the governing body is required to have appropriate internal control systems to monitor and manage risks, though different regulatory approaches may be adopted by supervisory authorities.

The governing body, in some cases, is required to ensure that their service providers (particularly those involved in investment management) have set up appropriate internal control systems.

In some jurisdictions, the governing body has to set up a specialised internal control unit to carry out internal control functions.

The internal control structure and mechanism of the governing body is often assessed during the licensing process so as to minimize the risk that pension funds are managed by the governing body with weak control systems.

On-going monitoring by means of off-site reviews and on-site inspections are commonly used by many supervisory authorities to ensure that adequate internal control systems have been put in place by the governing body and are functioning properly. It is also a common practice that if weaknesses have been found in previous occasions, inspections may be conducted more frequently, and in-depth evaluations may also be needed.

In some jurisdictions, if the supervisory authority does not have expertise in particular areas to conduct in-depth analysis of the internal control of the governing body, it may engage the services of independent, external experts. The skills of the external experts may strengthen the capabilities of supervisory authorities.

The supervisory authorities in some jurisdictions may conduct inspections to third party service providers which perform important functions, such as investment management. In certain cases, the governing body is required to perform the role of monitoring of the internal control of its service providers. In this regard, it is quite common for supervisory authorities to ensure that the governing body has performed its duty of monitoring service providers, through off-site reviews and/or on-site inspections.

VI. Trends and Future Developments

The approaches and means used to supervise pension fund governance have to be reviewed from time to time, in line with the trends and developments in this area. Against the background of consolidation of the pension industry, growing importance of risk management and establishment of new DC pension systems, raising the competence of the governing body, enhancing transparency and disclosure, and improving internal controls are regarded as the key governance issues of pension funds in the coming years.

The trend of consolidation in the pension fund industry is expected to continue in some jurisdictions. In Australia, further consolidation within the industry and consequential reduction in the number of superannuation funds regulated by the supervisory authority will continue but probably at a slower pace than over the past few years. Likewise, there will be further consolidation of major service providers such as administrators. With this development, higher skills and expertise of the governing bodies may be required as they have to manage larger assets of funds and increased numbers of plan members. In Bulgaria, consolidation of financial markets, overlapping of activities among investment, insurance, pension companies and banking institutions are gaining momentum. Further integration and expansion of their scope of business is expected in the future. Greater transparency and proper disclosure on conflicts of interests are therefore required.

The competence of the governing body will continue to be a core governance issue in the coming years, and further developments on this front are anticipated. In Australia, there may be a move to greater reliance on independent directors on trustee boards to supplement the skill base of directors elected under equal representation rules. In Jamaica, it is expected that as trustees and agents become increasingly aware of the requirements under the legislation, the level of governance of pension plans will improve. Additionally, a trend is emerging where corporate entities are putting in place compliance officers, which will lead to a strengthening of statutory compliance. In Hungary, efforts are being made to ensure the governing body's on-going compliance with requirements on competence. The governing body is requested to conduct regular assessment of its compliance with fit and proper requirements. It is also a policy option of the supervisory authority to require the assessment of compliance be performed by a compliance officer or an independent internal control unit. In the Netherlands, the expertise and performance of the governing body is currently given the highest priority by DNB.

The second pillar, DC pension system, is anticipated to continue to receive support with new systems being introduced in a number of jurisdictions. In India, the next three to five years are crucial for the development of the DC-based pension system. The abilities of the central recordkeeping agency, pension fund managers, custodians, etc. to comply with the prescribed guidelines will be tested. In the UK, a major market trend in work place pensions will lead to a rapid growth of contract-based schemes operated by insurance companies. In addition, in 2012 the UK government is planning to introduce new legislation that will require auto-enrolment and employer contribution to pension schemes, which is likely to add pressure to enhance governance standards.

To allow supervisory authorities to conduct effective supervision of pension fund service providers and to ensure pension plan members make informed investment decisions, adequate transparency and proper disclosure of pension funds are necessary. Some jurisdictions expect that transparency and disclosure will remain an important focus in the coming future. In Hong Kong, efforts have been made to further enhance the transparency and disclosure of fee information of the MPF funds via clearer, more consistent, documentation and a web based comparative platform. Measures are also underway to require further disclosure in member benefit statements including clearer information concerning fees and charges. In Turkey, the relevant regulations will be revised in line with recent amendments in the private pension law, which would ensure accurate disclosure of pension fund information to the plan participants.

How to build up the ability to assess risk and enhance internal control of pensions funds is an on-going concern of many supervisory authorities, which will likely linger on in the longer term. In Germany, BaFin has initiated legislative amendments to improve the risk management of financial institutions. Each institution has to put in place an adequate organisational framework, which enables it to monitor and control its risk-relevant business activities. Pensionskassen and Pensionsfonds have to comply with the minimum requirements for risk management. There is also new reporting requirements in which the companies have to submit to BaFin a risk report one month after its presentation to the company's management. In Turkey, a new regulation has been drafted which introduces a new framework for the internal governance system of the pension companies, which comprises three separate systems: internal control (overseeing the operational viability of the company), internal auditor (conducting compliance-based auditing), and risk management (overseeing the risks of the company). The responsible officers of these three systems directly report to the board of directors. In addition, the supervisory authority in Turkey is planning to shift to a risk-based supervision approach in the coming few years.

Conducting proper oversight on the governance of pension funds is important for the protection of members' and beneficiaries' interest. Over the years, supervisory authorities in various jurisdictions have developed different strategies and adopted different approaches to ensure that pension funds are properly governed. As the pension fund industry continues to develop, there is a need for supervisory authorities to continue to refine their strategies and approaches to meet with the changing circumstances.

ANNEX A

Selected Case Studies

This Annex presents four case studies in respect of supervisory oversight of pension fund governance. The case studies on Australia and UK are related to the competence of non-professional trustees, while those on Chile and Hong Kong are concerned with conflicts of interests.

Australia

How to Ensure that Non-Professional Trustees are Competent Enough to Perform their Roles and Duties in a Rapidly Changing Environment – Australia's Experience

- Prepared by Australian Prudential Regulatory Authority ('APRA')

Issues/Challenges in Respect of Non-professional Trustee's Competence in Performing their Roles and Duties

The Government initiated a review of the superannuation industry in 2001-2002 with the purpose of examining whether the current regulatory framework provided sufficient safeguards for member benefits. Issues and challenges in a number of areas, including non-professional trustees' competence, were outlined in a paper[20] released by the Treasury in October 2001 and the subject of an extensive consultation process conducted by the Superannuation Working Group (SWG). These could be summarised as follows:

- Diversity of the industry: the diversity of the industry and the wide range of superannuation products with varying degrees of risk transfer meant that the development of prudential policies, aimed at providing safeguards to the then 19 million superannuation fund member accounts regulated by APRA, was inherently complex.
- Equal representation requirements: non-public offer funds are required to have equal numbers of employer and member representatives in the trustee structure (corporate or group of individuals). While such arrangements have advantages, volunteer trustees were not always competent to perform their duties.
- Inadequate legislative framework: recent legislative changes had enhanced APRA's enforcement powers but the focus of the SIS Act was on enforcement action following breaches of the Act. Designed to deal with retirement incomes policy and taxation of superannuation, the SIS Act was inadequate as a framework for risk-based prudential supervision and not sufficiently robust to deal with the challenges posed by smaller funds and their diversity.
    - These concerns stemmed primarily from APRA's experience with some of the smaller corporate funds, where most of its enforcement action

[20] Options for Improving the Safety of Superannuation, available at Options for Improving the Safety of Superannuation - Issues Paper — Australian Government, The Treasury

was concentrated. Typical problems encountered in relation to these funds included non-arm's length transactions and poor investment decisions, resulting in large capital losses. Other problems stemmed from a failure to develop clear investment objectives and implement appropriately matched investment strategies to the fund's member profile; poor asset selection and heavy portfolio concentrations in a narrow range of assets; fraud or serious misrepresentation, sometimes associated with trustees' or directors' use of fund assets for their own benefit; and delays in remitting various contributions.

- APRA considered the existing SIS provisions relating to trustee approval, investment reporting to APRA and general fund governance provisions were inadequate, and the legislative framework insufficiently flexible to cope with market developments.
- While some of those deficiencies could be addressed through powers available to APRA in the SIS Act, the structure of the industry made detection and enforcement difficult. For example, most of the superannuation funds in the highest risk categories were not licensed by APRA and were subject to ASIC's non-enforcement policy regarding non-public offer superannuation funds. Consequently, portfolio selection or other weaknesses could be entrenched before APRA was aware of the problem, given the exceptionally large number of funds relative to APRA's inspection resources, and a poor record by these funds for timely reporting.

Some of the challenges that APRA and predecessor regulators had identified for amateur/volunteer/'non-professional trustees', and which were to be subsequently addressed in the Superannuation Safety reforms that followed from the SWG's work, included:

- Failure to understand the role and duties of a trustee, for example:
  - the trustee entity is the sole responsible entity in charge of the fund's operations;
  - trustees, although they may delegate functions, cannot delegate responsibility and remain responsible for delegated functions; proper control and reporting processes are required for management of outsourced functions;
  - trustees are responsible for institution and maintenance of proper internal controls, including for fraud control and to properly report to members;
  - the requirement to develop and implement an appropriate investment strategy for the fund and ensure proper separation of income and assets from those of the employer-sponsor;
  - the obligation to ensure investment transactions are undertaken on an arms'-length basis.
- Some of the individuals who were trustees may have understood their role in a theoretical sense but faced challenges in carrying out their duties. Examples include:
  - dealing with an employer-sponsor and/or employer representatives on the trustee entity could be intimidating for a member representative who was more used to an employee/employer relationship. This was despite protective mechanisms existing in the legislation;

- dealing with a dominant fellow-trustee. This proved particularly problematic in cases where such a person may also have had an interest in a significant service-provider to the fund;
- lacking sufficient understanding of administrative or investment processes to be able to properly assess service provider performance, fees etc, or to properly supervise key employees.

APRA's predecessor, the Insurance & Superannuation Commission, released a number of publications in the years after the commencement of the SIS legislation in an attempt to boost trustee understanding of role and responsibilities. These included a series of regular trustee newsletters and the following publications:

- The Trustee Guidebook to Superannuation
- A guidebook for small superannuation funds
- The Good Practice Guide
- The Best Practice to the Detection of Superannuation Fraud and the accompanying Superannuation Fund Fraud Control Review Checklist

Nevertheless, poor understanding of obligations and authority and also operational and governance practices were still observed in, generally, the smaller corporate fund sector of the industry.

Solutions/Policy Responses to these Issues/Challenges

The Government responded to the recommendations in the final report[21] of the Superannuation Working Group (SWG) in October 2002[22]. In particular, it agreed to the following:

Universal licensing regime: the SWG recommended that trustees of superannuation entities (other than self managed superannuation funds (SMSFs) or exempt public sector superannuation schemes (EPSSSs)) be licensed by APRA. The Government agreed that a trustee must meet certain conditions in order to obtain a licence to operate a superannuation fund and that the trustee should be required to meet licence conditions on an ongoing basis. These conditions would include requirements for trustees to meet minimum standards of competency, have adequate resources, a risk management plan and adequate risk management systems (including a fraud control plan), systems to manage outsourcing, as well as any other conditions that APRA considers appropriate to operate the proposed business.

To ensure compliance with the new licensing framework, APRA would have appropriate powers, including to issue directions, disqualify trustees, vary conditions and suspend or revoke the licence, subject to appropriate safeguards and review processes.

Risk management framework: The Government also agreed to amend the SIS Act to require all trustees to prepare a risk management strategy (RMS) for itself and a risk management plan (RMP) for each fund under its trusteeship. The RMS would demonstrate arrangements trustees have in place to mitigate relevant risks including risks relating to governance and decision making processes, outsourcing, potential

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21 Options for Improving the Safety of Superannuation - Report of the Superannuation Working Group — Australian Government, The Treasury

22 Government Response to SWG Recommendations — Australian Government, The Treasury

fraud and theft and changes to the relevant law. The RMP for each fund must encompass investment, risks to the fund's financial position, outsourcing, and audit.

Other requirements include the RMP to be signed off by the trustee; changes of a material nature to be advised to the regulator; an annual independent audit of the plan; the RMP of the fund to be available to fund members etc.

Trustees of funds at 1 July 2004 were given a two year transitional period to prepare for and obtain a licence and register their funds. New entrants from 1 July 2004 were required to obtain a licence prior to commencing operations.

To assist licence applicants, APRA issued a set of guidelines covering its expectations as to how trustees would evidence that they met the new requirements. The guidelines covered the new standards on fitness and propriety, outsourcing, adequacy of resources and risk management[23].

Governance and competence of trustees is discussed in the guidance note on fitness and propriety. In respect of the non-professional trustees that were the subject of this project, APRA's guidance makes it clear that, while all individuals in the trustee and responsible person roles must meet the propriety limb of the standard, the fitness limb may be met on a collective basis. That is, individuals are not prevented from being part of a group or board merely because they are not technical experts in superannuation. These situations particularly arise where the legislation requires equal representation of member and employer interests at the trustee level.

The requirements of the standard do not prevent an applicant for an RSE licence, or an RSE licensee, from employing or using in-house and/or external service providers to assist in the performance of its duties and responsibilities. However, in APRA's view, an applicant (group or corporate) for an RSE licence, and a licensee on an ongoing basis, should be able to demonstrate sufficient knowledge regarding the duties and responsibilities of an RSE licensee to make informed decisions in the best interest of beneficiaries based on the advice of technical experts. Experience has indicated that in quite a number of cases 'non-expert' trustees do not feel confident in assessing, querying or directing 'expert' service providers who use technical expertise and jargon which the 'non-expert' (and sometimes 'non-confident') trustees cannot properly assess.

Effectiveness of the Solutions/Policy Responses

A significant outcome of the licensing process was the acceleration of the trend towards industry consolidation that had been observed over the past decade. The number of funds with more than four members was 4,747 at 30 June 1996. At the commencement of the licensing period on 1 July 2004, the number stood at 1,785. At 30 June 2006, the number had fallen to 872[24]. The most notable decline has been in the number of corporate funds, down from 4,100 in 1996 to 1,405 in 2004 and to 555 at 30 June 2006. The number of trustee entities just before licensing started on 1 July 2004 was around 1300. At the end of the transitional period there were around 300 licensed trustees.

The funds that survived have grown, in terms of size, so that average assets under management are now seven times higher than in 2001. The superannuation

[23] These are available at Superannuation Circulars and Guidance Notes

[24] See Table 2 in "Celebrating 10 years of superannuation data collection 1996 – 2006" in APRA Insight

industry, in terms of size, complexity and risk management is increasingly resembling the other industries that APRA supervises, thereby meriting a commensurate prudential and supervision regime.

APRA's supervision focus in the first two years after licensing was completed has been to assess whether what was provided to APRA in written policies during the licensing period reflects actual practice post licensing and whether these policies are responsive to changing market conditions. Earlier experience in the general insurance industry which had to implement enhanced risk management requirements a few years previously suggested that there would sometimes be a gap between the documented approach and the practical implementation, and in a few instances this was exacerbated by a tendency by institutions to take a template approach.

APRA's view after the first two years of supervision post licensing is that there has been considerable improvement in the structure and governance of risk management processes. In terms of overall governance and competence, APRA's view is that funds are now generally managed in a more professional manner than before although some issues remain[25].

Some of the action that APRA has been taking in monitoring governance arrangements post-licensing is to ensure that trustees keep processes up to date, for example in areas relating to induction training and conducting a skills gap analysis. APRA also reminds trustees that, while in many funds material business activities are outsourced to professionals, the expectation of trustees as a group is that they understand where the responsibility lies and that they are sufficiently competent to understand, assess and decide on the advice tendered by service providers.

The benefits from the licensing regime have also flowed through in the area of APRA enforcement. APRA is not an enforcement agency in the sense that ASIC and the ACCC are enforcement agencies. But APRA does take enforcement action from time to time, particularly with regard to fitness and propriety of individuals. Historically this work was mostly in superannuation rather than the other prudentially supervised industries. Further, much of it was in smaller entities where professionalism and skill levels were sometimes in short supply. The consolidation of the industry post licensing and the high degree of professionalism in the industry should lead to less demand in the long term for formal enforcement action.

Current and Future Development

A significant feature of the Australian superannuation industry is the degree of outsourcing of material business activities such as administration, investment management and custody of assets. One view is that this characteristic has, in the past, assisted 'non-professional' trustees to perform their fiduciary duties without needing to be competent in all areas of fund operation. However, it was also open to mismanagement and poor oversight. The standard on outsourcing introduced as part of the licensing reforms requires proper written agreements the terms of which include provision for APRA to obtain information and documents and to conduct on-site visits to the service provider. APRA has developed, and is currently engaged in, a program for review of administrators and is developing a program for review of custodians. In a

[25] This view is supported by a joint survey conducted by the Institute of Chartered Accountants in Australia and Deloitte late in 2007. The survey revealed that superannuation industry experts believe that discipline around governance practices has tightened and that standards have improved since the introduction of the Registrable Superannuation Entity (RSE) licensing regime in mid 2004. The report of the survey is available at: Deloitte, The Institute of Chartered Accountants, Governance, Superannuation, Survey - Deloitte Touche Tohmatsu

separate exercise, APRA has also released for consultation a draft prudential practice guide on dealing with conflicts of interest, which deals with, among other matters, conflicts that may arise with decisions involving outsourcing of services.

Management by trustees of member investment choice is an area of concern to APRA where a wide array of investment options (some extremely narrow and high risk) are made available to members without any requirement for the member to diversify their risk. Trustees in such situations tend to rely on members obtaining financial advice however, taken to the extreme, this practice suggests the trustee is abrogating its responsibility to act in member’s best interest.

United Kingdom

How to Ensure that Non-Professional Trustees are Competent Enough to Perform their Roles and Duties in a Rapidly Changing Environment – UK's Experience

- Prepared by the Pensions Regulator

Executive Summary

The adequate performance by trustees of their roles and duties is, in the UK, a major contributing factor to the good governance of work based pension schemes. The majority of trustees are, however, non-professional ('lay') trustees.

The Pensions Act 2004 requires trustees to have an appropriate level of knowledge and understanding to enable them to perform their role adequately, including sufficient knowledge of the vagaries of their own scheme. The Pensions Regulator is responsible for ensuring that this requirement is met, and developed a framework for trustee knowledge and understanding (the TKU framework).

The regulator's approach to governance acknowledges TKU as a fundamental prerequisite for good governance of schemes. There is clear evidence that trustees who make the effort to learn, and to ensure that they do have the ability to perform their roles and duties adequately, are those that are ensuring that their schemes are well-governed.

Information about the TKU framework and the other work of the regulator can be found on the Pension Regulator's website at www.thepensionsregulator.gov.uk.

A key element of the TKU framework is an e learning programme (the trustee toolkit). Further information about this can be found at www.trusteetoolkit.com. It was also the main focus of the United Kingdom's case study for the IOPS Education and Outreach Private Pension study.

Recent research for the regulator confirmed that the toolkit is extremely effective at educating lay trustees enabling them to change their behaviour in positive ways and increasing confidence in their own abilities.

Issues/Challenges in Respect of Non-Professional Trustee's Competence in Performing Their Roles and Duties

The vast majority of pension schemes in the UK are governed by lay trustees, who come from a variety of backgrounds and bring with them a wide range of experiences. This is the trust model and the voluntary and active participation of unpaid amateurs is a particular feature of British public life. For example, there are groups analogous to lay pension scheme trustees, such as school governors and trustees of charities.

The critical issue for lay trustees is to have sufficient knowledge and understanding to undertake their role. Trustees are responsible for the governance of their schemes and unless they are fully able to understand their role, discharge their duties and use their powers effectively, there is a danger that their scheme will operate inefficiently and that they will not be in a position to protect the benefits of their members.

Although there are large numbers of active and competent lay trustees, nonetheless we know, from various pieces of research, that the challenge for lay trustees to become competent is considerable. There is also anecdotal evidence that trustees responsible for small schemes, particularly, are confused about their role and that some do not understand the basic facts about their scheme, even to the degree of what type of scheme it is.

The challenge for the individual trustee is to identify for themselves gaps in their knowledge and understanding and to have access and sufficient time to undertake the learning that is needed to fill these gaps. In particular, new trustees need to get up to speed quickly, while existing trustees need to maintain levels of competence in a rapidly changing environment.

Even given the burdensome nature of trusteeship, there is strong evidence from research that there is no shortage of people willing to stand as a trustee. However, as in everything, there is a delicate balance to be struck between providing sufficient support and encouragement for trustees to be able to meet the need to be competent, and the imposition of too harsh, complicated or confusing a regime. Both legislators and the regulator are aware of the need to maintain this balance and to sustain the trustee supply line, and so have resisted introducing such measures. Forcing trustees, for example, by making the holding of a particular qualification mandatory, has been avoided.

A very small cadre of professional independent trustees is involved in the running of a small number of schemes. Because of the level of fees involved, they tend to be appointed to larger schemes, and they are invited to serve by employers or lay trustees because of their particular experience. Under certain circumstances the regulator may also appoint an independent trustee to a scheme. Professional independent trustees should be able to demonstrate to the employer sponsor and to their fellow trustees that they are fully compliant with the TKU framework from the date of their appointment.

Solutions/Policy Responses to These Issues/Challenges

The Myners Report on institutional investment placed a high level of importance on the need for trustees to be ‘familiar with issues’ when considering investment decisions. The report, with its number of investment principles, became a voluntary code (Institutional investment in the UK, a review, Paul Myners 2001). The Government intends to monitor progress on this front.

The Morris Review (Morris Review, 2005), a review of the actuarial profession by Sir Derek Morris, suggests that trustees need a better understanding of actuarial matters in order to challenge their advisers.

Building on this work, the Pensions Act 2004 makes explicit the requirement for trustees to know and understand pensions and trust law, scheme funding and investment matters and to be conversant with their own scheme documents. The regulator introduced a framework for trustee knowledge and understanding (the TKU framework).

The framework comprises:

- a code of practice
- Scope guidance
- a syllabus
- an e learning programme, free at the point of access
- support for learning and voluntary qualifications for trustees

The code of practice and scope guidance were produced after widespread consultation with the pensions industry.

The e learning programme – the trustee toolkit – covers the entire scope of knowledge and understanding, and is one way that trustees can fill any gaps in their knowledge. Whilst relevant to trustees of all schemes, those from smaller schemes, which may not have the resources to pay for training, will find it particularly helpful.

The syllabus provides the content for the learning, and the toolkit a method of delivering the learning. Those engaged in training trustees are encouraged to use this material in developing and delivering their own courses to trustees. Since the material has been written by the regulator, it is self-evident that by using these tools trainers will cover the learning points that the regulator (following consultation with the industry) believes trustees should know and understand. Further, the regulator has undertaken a programme of training the trainers in the use of the toolkit as part of a blended learning offering.

When considered as a whole, the framework is designed to foster a change of behaviour among trustees – a culture change leading to a widely accepted belief in the value of learning which should then feed in to better governance of schemes (as shown by the research).

The TKU framework is aligned with the UK Government's skills strategy. The syllabus has been used by the Pensions Management Institute (the UK's professional body for those working in the field of pensions and employee benefits) as a basis for developing its updated qualifications for trustees, the Awards in Pensions Trusteeship. These qualifications have been accredited by the Qualifications and Curriculum Authority (QCA), which means that they can become a relevant component of a lifelong learning regime (in keeping with the UK Government's skills strategy).

It is worth noting that there is no mandatory requirement for trustees to attain any such qualifications. However, having a qualification tied into the National Qualification Framework gives the holder a recognised and portable qualification.

Effectiveness of the Solutions/Policy Response

The regulator's governance survey, undertaken in 2007, considered whether or not the introduction of the TKU framework has changed trustee behaviours. This survey confirmed that there is a clear relationship between the extent of training and those activities that the regulator considers represents good governance, and that higher levels of trustee training is associated with higher levels of governance activity and the understanding of the board.

The governance survey also suggested that schemes are not experiencing significant difficulties in recruiting or retaining trustees, with only a small minority of schemes reporting that they had experienced difficulties in this area. This implies that the introduction of the TKU framework, and other changes under the Pensions Act

2004 has had less of an impact on the recruitment and retention of trustees than some in the pensions industry had thought. However, the regulator will be monitoring this to check for any movement either way.

The toolkit was published module by module as each was completed between January 2006 and May 2007. Changes in knowledge occasioned by deep learning (of which the toolkit is an example) require a period of reflection and of application. Consequently several months after delivering the final module, the regulator commissioned independent qualitative research to consider the effectiveness of the toolkit both as a learning tool, and as an agent for change in the behaviour of trustee boards and the governance of pension schemes.

The research took place between November 2007 and January 2008, focusing on lay trustees who were the audience for the toolkit, by which time over 13,000 lay trustees had signed up to use the toolkit. Importantly, this research was not just about self assessment of the difference the toolkit had made, but independent assessment of trustees' learning by researchers experienced in pensions. It focused mainly on toolkit users, but also included those who did not use the toolkit.

The research results confirmed the anecdotal evidence available to the regulator that the toolkit has proved to be extremely effective in educating trustees and enabling them to change their behaviour in positive ways, and increasing confidence in their own abilities. Most trustees felt that doing the toolkit made them more confident, and all who had used it had enjoyed the experience.

Completing the toolkit highlighted gaps in knowledge and confirmed for many trustees what they did know, and more importantly what they didn't know. In addition some trustees were able to apply what they had learned from the toolkit to their own scheme especially when going through changes, or where there were significant decisions to be made (eg on funding or changing a fund manager).

Trustees of different types of schemes benefited differently from using the toolkit, but all gained significantly in the areas of knowledge that are most important for their own particular type of scheme. Whilst all the issues tested in the research contribute to the governance of schemes, the results indicate that as toolkit use and training generally reach more and more trustees, standards of governance of pension schemes will continue to improve.

Feedback on the toolkit as an e learning resource was overwhelmingly positive with over 85 per cent of comments made being positive, and the rest revealing no serious worries. Users appreciated the interactive nature of the toolkit, its clarity, flexibility and stability, and being able to work at their own pace when convenient. It was recognised as the one place where all the TKU requirements were covered, and being developed by the regulator gave it a high level of credibility.

A report of the research will be published shortly on the regulator's website.

Current and Future Developments

The e-learning programme deals with the principles of being a trustee, so, regardless of the rapidly changing pensions environment, the core learning should not be subject to frequent change. A process is in place, however, to identify any emerging issues that may impact on the existing content and to review the relevant content accordingly.

The TKU scope guidance and code of practice is currently being reviewed. Informal consultation with the industry has produced revised documents on which the regulator will be consulting later on this year.

Three new modules on winding up pension schemes have recently been developed and added to the toolkit. They are not part of the TKU scope but provide 'just in time' learning for trustees involved in winding up their pension schemes.

Some participants in the toolkit research wanted more e learning material, including an expansion of the toolkit website to include other materials and links, and an index to allow the toolkit to be used as a reference source. The regulator is considering how to respond to these and other requests.

Take up of the toolkit amongst lay trustees from smaller schemes (less than 100 members) is relatively low. Trustees from such schemes often have limited access to training budgets, and so the toolkit, being free, is an important resource to them. So the regulator is actively considering ways of targeting this group with the aim of increasing awareness and take up of the toolkit.

Conclusions

In October 2007 the regulator's response to its April 2007 discussion paper on scheme governance confirmed that education is the key focus of the regulator's approach to improving standards of governance. This educational support for trustees is being provided through the voluntary application of good practice guidance published by the regulator, and the regulators e learning programme (the toolkit).

Research shows that the toolkit is acting as an agent for improvement in the behaviours of trustee boards and in the governance of schemes, as lay trustees build a secure knowledge base, grow in confidence and improve their ability to question scheme advisers in a rapidly changing environment.

Given these positive messages the regulator is continuing to encourage lay trustees to use the toolkit, and to focus on those groups with a relatively low take up rate for the toolkit.

Chile

How to Overcome Pension Fund Trustees' Conflicts of Interests – Chile's Experience

- Prepared by the Superintendence of Pension Fund Managers ('SAFP')

Introduction

In 1981, Chile established a new pension system based on mandatory savings in individual accounts. The administration of these individual accounts and management of pension funds was given to private companies especially devoted to this purpose called Pension Fund Administrators (AFP for its acronym in Spanish).

These institutions are corporations, whose sole aim is the management of different Pension Funds and the development of other activities strictly related with the pension area, in addition to providing and managing the services and benefits established in the law.

The Administrators collect the social security contributions, deposit them in each member's personal account and invest the resources, in order to be able to provide the corresponding benefits. They also take out insurance to finance any disability and survivorship pensions arising from their members.

The AFPs are entitled to receive remuneration for their work in the management of the Pension Funds and this is established on the basis of commissions at the members' expense. The commissions are fixed freely by each Administrator, with a standard rate for all its members, who may switch from one Administrator to another whenever they feel it to be desirable.

Issues/Challenges in Respect of Trustees' Conflicts of Interests

Conflicts of interest arise in these setting in at least two areas: commercialization and investment of pension funds. Since AFPs can be part of financial conglomerates, in practice many AFPs are related to banks, insurance companies or other entities. Although AFPs have been established as exclusive business, this ownership relation may turn into practices that are at odds with the purpose of the system. For example if commercialization of the pension savings service is made together with other entities of the same group a risk of tied-in sales arise. If the tied-in sale is done with, for example, a better rate for a consumption credit or a mortgage at the related bank, this poses a problem for the pension system since members are generally more oriented towards current consumption than retirement savings (Indeed, this is what justifies the mandatory characteristic of the system).

In the area of investment of pension funds conflict of interest may exist if decisions are not taken with the sole purpose of obtaining an adequate return with a limited level of risk exposure. This may occur if, for example, an investment decision is made to benefit the position of a related entity such as investing in instruments emitted by a related bank or financial institution.

Solutions/Policy Responses to these Issues/Challenges

It turns out that the exclusive business definition of AFPs is the strongest solution to these potential problems. Regulation forbids the commercialization and offering of products different from the ones that the AFPs are mandated to offer. This implies that on-site supervision can tackle these issues. It also allows investigating accusations in these aspects.

In terms of conflicts of interest on investment decisions, the current regulatory framework [26] establishes a series of regulations concerning the conduct of the Administrators, their shareholders, executives and others, in situations of conflicts of interests between them and the Pension Funds that they manage. The most important provisions on this subject are the following:

- Significantly lower investment limits in instruments issued by companies related with the Administrator, compared with those that are not related.
- The obligation to invest the resources of the reserve fund that belongs to the Administrator in share units of the Pension Fund that it manages, in order to eliminate the conflict of interest in managing two separate investment portfolios, one belonging to the Administrator and the other to the members.
- Rules that prohibit the divulging and use of confidential information referring to the Funds' investment decisions.
- Description of conduct prohibited for Administrators, where this may harm the Pension Funds or incorrectly benefit themselves or third parties.
- Inclusion of provisions designed to standardise the voting of the AFPs in elections of directors to the board of companies where Pension Funds take part as shareholders. The rules encourage Administrators to vote for the most well-qualified and independent directors, in other words, those who are not related with the company's controllers. In this sense, the aim of the elected director should be to maximise the value of the company for all its shareholders, while at the same time constituting a balancing factor on the board.
- Regulation of the elections of directors for the AFPs, so that they may have, as their main aim, the best possible performance of the Fund under management.
- Regulation of transactions with instruments that are eligible for the Pension Funds, carried out by people who, because of their job or position, may have knowledge of the decisions taken by the Pension Funds to purchase, hold or sell securities.
- Establishment of internal control systems in the AFPs, which must be subject to external auditing, in order to ensure compliance with the rules regarding conflicts of interests.
- Obligation for the Administrators to inform the Superintendence of AFPs about any trading of financial instruments in the formal secondary markets between different Funds managed by the same Administrator.
- Obligation for the Administrators to inform the Superintendence of AFPs about trading of financial instruments between the different Funds managed by the same Administrator. This obligation is imposed because, since the multi-funds were set up, the AFPs are allowed to make direct transfers of

[26] Regulations introduced by the 1994 Capital Market Law, which modified Decree Law Nº 3,500 in matters of conflicts of interest.

securities between the different Funds that they manage, equivalent to the transfers of members between Funds in the same Administrator.

Effectiveness of the Solutions/Policy Responses

Violations of conflict of interest regulation tend to be difficult to supervise and detect. The supervision of tied-in sales and other commercial activities is especially difficult given that the regulation allows AFPs to share physical space with other entities, although all their commercial activities have to be carried out by their own personnel. The Superintendence carries out on-site supervision and analysis of commercialization data of products offered by related entities together with transfers of members among AFPs to try to detect these practices. Conflicts of interest in investment are easier to detect due to the strict disclosure regulations. However it is always possible for administrators to perform acts that although are legal, contravene the spirit of the regulation.

Current and Future Development

The pension reform recently approved by Congress and taking effect in October 2008 strengthens the regulation on conflict of interests in these areas. Some measures incorporated by this reform are:

- It is forbidden to invest Pension Fund resources in instruments issued by persons or firms related with the Administrator.
- There must be separation of commercial functions between the AFP and those that may be carried out by members of its Business Group. This includes the prohibition to share physical space and commercial area executives between the AFP and its related companies.
- Sanctions for the use of privileged information are extended to members of the boards of directors of the companies related to the AFP.
- Requisite for at least two members of an AFP board of directors that are independent from the Administrator and its controlling company.
- Requisite for the board of directors to issue an investment policy for each pension fund and a conflict of interests' resolution policy.
- Requisite to constitute an Investment and Conflicts of Interest Resolution Committee at the board of directors, where at least two of its members must correspond to independent directors.

Hong Kong

How to Overcome Pension Fund Trustees' Conflicts of Interests – Hong Kong's Experience

- Prepared by the Mandatory Provident Fund Schemes Authority

Issues/Challenges in Respect of Trustees' Conflicts of Interests

Under the Mandatory Provident Fund ("MPF") System, every MPF scheme must be operated under trust arrangement and managed by a trustee approved by the Mandatory Provident Fund Schemes Authority ("MPFA"). The trustee is the central party responsible for all scheme administration functions. Although it may appoint other service providers to perform certain functions, and must appoint an investment manager, it has the duty to closely monitor the performance of the appointed service providers in order to fulfill its fiduciary duties with respect to the scheme.

Like most jurisdictions, the primary control over conflicts of interests as between the trustee and scheme members is the imposition of fiduciary duties on the trustees. Trustees are required to act in the interest of scheme members and not in their own interest.

Below the general fiduciary duties imposed by the MPF legislation, a number of more issue specific controls on conflicts of interests are contained in the legislation.

The MPF legislation requires controllers of trustees to disclose to the trustees any conflicts of interests and not to participate in any deliberations of the trustees with respect to matters having conflicts of interests. The trustees are required to maintain records of all conflicts of interests for inspection by the MPFA.

To ensure the accountability of the board of directors of the trustees, the MPF legislation stipulates that one of the directors of the trustee must be an independent director with no past or present association (financial or otherwise) with the trustee, its controllers or associates that could affect the impartiality of the directors' independent judgment.

Although investment managers are allowed to use the services of their associated companies in investment transactions, the MPF legislation stipulates no more than one-half of the total value of the total commissions paid for acquisitions and disposals of securities for MPF funds to be paid to associated companies of the investment manager. And MPF funds are prohibited from investing in securities of the trustees, the custodians, investment managers or the guarantors.

The MPF legislation also requires the investment managers to be independent of the trustees and the custodians of the MPF schemes. The criteria for determining independence are set out in the legislation.

Breaches of these requirements could incur financial penalties, constitute criminal offences, or result in suspension or revocation of their approvals as approved trustees.

The legislative theory that trustees are required to act in members interest and ignore their own is of course stressed in an environment where the 19 trustees under the MPF System are all commercial entities. They therefore are constantly faced with the issue of balancing their own commercial interest with those of the scheme members. How should the trustees balance the interests of both parties and where is the right balance? As a regulator, how does the MPFA ensure that the trustees properly carry out their fiduciary duties and have not put their own interest ahead of the interest of scheme members?

On the whole, there are few real conflicts of interests as between the trustees and scheme members. Both have a strong interest in ensuring that all aspects of scheme administration are efficient and effective and that investment outcomes are optimized. As in other jurisdictions, conflicts of interests are most evident where the interest of scheme members and the commercial interest of the trustee (or their related parties) are at variance. Practically this is most evident in relation to:

- setting the levels and structure of fees and charges,
- transactions with the trustee or related parties,
- appointment of service providers (in particular the investment manager), and
- scheme/fund design and structure.

Solutions/Policy Responses to these Issues/Challenges

For each of the areas where conflicts of interests are most evident, solutions have been devised and policies have been developed on an on-going basis to specifically deal with the issues and challenges presented by these areas.

Setting the Levels and Structure of Fees and Charges

The level of fees and charges of MPF funds has been a hotly debated topic over recent times. How ancient concepts of fiduciary duty should apply in the context of modern commercial trading enterprises has not really been tested as a question of law. On the one hand, if trustees are required to act in members' best interests and ignore their own, they should charge no fees or perhaps only so much as will ensure their own survival as trustees. Modern commercial application of principles would however suggest that trustees should be able to charge whatever they wish, provided that scheme members are fully informed and the market operates efficiently.

The approach adopted in Hong Kong is to rely on market forces to determine the levels of fees and charges. The regulatory issue has been to ensure that market forces are allowed to operate as efficiently as possible in setting these prices. This has many elements.

On the “demand” side of market forces the emphasis has been on ensuring that scheme members and other stakeholders have access to clear, comprehensible and usable information about fees and charges. The MPFA developed the Code on Disclosure for MPF Investment Funds (“Disclosure Code”) in 2004 which requires:

- a standardized Fee Table for disclosure of fees and charges;
- a semi-annual Fund Fact Sheet containing summary of key information such as particulars, performance and fund expense ratio of a fund; and
- the use of a standardized On-going Cost Illustration showing the dollar amount of total fees and charges that will apply on each $1,000 invested into a fund.

These tools help enhance transparency and disclosure of fees and charges of MPF schemes/funds and ultimately improve market competition. The MPFA hopes that market forces would put trustees' interest in constant check and thus force them to maintain their fees and charges at a reasonable level.

The disclosure improvements are being supported by a web-based comparative platform so that members can easily compare fees and charges across different funds, schemes and operators.

Legislative changes are being developed to improve the portability of benefits across different schemes. Trustees are also encouraged to streamline their operations and simplify their procedures to facilitate efficient transfers of benefits across schemes.

On the "supply" side of market forces, the focus has been on rationalizing small/inefficient funds, facilitating mergers or restructures of products and legislative refinements that may reduce scheme operating costs.

Transactions with the Trustee or Related Parties

In 2005 a set of Compliance Standards was developed to guide the trustees in establishing a structured framework for monitoring their compliance with fiduciary duties and responsibilities, including how to deal with conflicts of interests. The MPFA performs regular off-site reviews of the statutory returns (including internal control reports, audited financial statements and investment reports) submitted by the trustees to ensure that they have not been in breach of the amount of business allowed to be given to their associated companies. Periodic on-site inspections are also conducted to ensure that all transactions were conducted at arm's length and that there were no investments in securities of related parties.

The MPFA would conduct investigations if it reasonably believes that the requirements have or might have been breached, and investigates any other situation where it believes that the interests of scheme members may be adversely affected. Trustees are required to rectify any identified deficiencies or compensate scheme members if their interests have been affected as a result of breaches of the legislative requirements.

Appointment of Service Providers (in Particular the Investment Manager)

The trustee must enter into an investment management contract with the investment manager and a custodial agreement with the custodian (if a custodian is appointed). Although there is no registration requirement for investment managers and the custodians, the MPF legislation stipulates stringent eligibility criteria for persons assuming these roles, in particular, the independence requirement of an investment manager (essentially an ownership test). The trustees have to ensure that these appointed parties meet the eligibility requirements before appointing them. In practice, whilst investment managers might meet the statutory test of independence, there are some concerns that some may have practical control over the trustee in some respects, particularly where the investment manager is the sponsor or promoter of the scheme.

As an additional safeguard in protecting the interest of scheme members, the MPF legislation requires the auditors to perform a whistleblowing role and specifies the incidents that must be reported to the MPFA. To ensure compliance, the MPFA reviews the statutory returns in particular the audited financial statements to ensure that the auditors have duly performed their duties in this regard.

Scheme/Fund Design and Structure

In the registering/approval process of MPF schemes/funds, the MPFA reviews the applications to ensure that they fulfill the requirements as set out in the legislation and the Code on MPF Investment Funds. In addition to ensuring that the investment managers to be appointed meet the prescribed requirements, the MPFA would also ensure that the schemes/funds are structured and designed with the interest of the scheme members in mind and not purely that of the trustees. For example, it would ensure that the scheme structure is not unnecessarily complex, each fund in the scheme has a different investment policy and objective, and fees and charges of the underlying funds are all clearly set out in the fee table of the offering document of the scheme.

A practical issue again arises in relation to those schemes where scheme/fund design is within the control of a party (the sponsor) who is not the trustee. In those cases the fiduciary duties of trustees might not operate as any control on ensuring that decisions are made in members' best interests.

To ensure due compliance with all MPF requirements, the MPFA monitors the MPF products on an on-going basis through regular reviews of scheme/investment reports and statutory returns and on-site inspections to identify areas for improvement or rectification. Changes to the structure/design of the schemes/funds have to seek prior approval of the MPFA before implementation.

Effectiveness of the Solutions/Policy Responses

On the whole, the MPF Survey 2006/07 undertaken by the MPFA showed that about 70% of the respondents were satisfied with the services provided by the trustees. Only about 3% of the respondents were not satisfied with trustees' services.

Regarding fees and charges, increased transparency of fees and charges since the introduction of the Disclosure Code has led to greater market competition. As a result, in recent months, many of the 19 trustees lowered the level of fees and charges of the MPF funds under their trusteeship.

In respect of the transactions with the trustee or related parties and appointment of service providers, no major weaknesses have been identified by the MPFA so far in its on-going off-site reviews and on-site inspections.

In the last few years, there have been some consolidations of funds and schemes. Mergers and restructurings would not be approved unless it could be demonstrated that the trustees have put the interest of the scheme members ahead of their own in these cases. So far, the consolidations have been well received by scheme members.

Current and Future Developments

A consultation on proposals to improve the content of annual benefit statements issued by trustees to scheme members was conducted during 2006-07. Based on the results of the consultation, the content of the annual benefit statements will be enhanced to help improve the transparency of fees and performance of MPF products.

Another potential development is introducing legislative amendment to enable employees to transfer accrued benefits derived from their own contributions to an MPF scheme of their choice (currently scheme choice rests with the employers). This would enable employees to choose MPF schemes and funds that fulfill their investment objectives and further enhance market competition.

The MPFA has conducted a review on scheme governance arrangements. A questionnaire has been issued to the trustees in an attempt to gauge the effectiveness of current governance arrangements, particularly in relation to appointment of service providers, fund structures and choice of underlying investments. The objective is to better understand how, and the extent to which trustees can control/monitor their service providers, the investment strategy and whether the real decision makers are acting in members' best interests. . The results of the survey would assist the MPFA in considering the appropriate course of action to be taken in further protecting members' interests.

Meanwhile, the MPFA will continue to strengthen members' understanding of investment by stepping up member education in this area. Members will be encouraged to make good use of the disclosure tools to make informed investment choices and better manage their MPF savings. The MPFA anticipates increased involvement of the scheme members in monitoring the performance and services of trustees as a result of increased awareness of the importance of MPF and increased accrued benefits in their MPF accounts.

ANNEX B

OECD 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.

These guidelines are consistent and compatible with the revised Principles of Corporate Governance, which they complement.

- Regulations on pension funds governance need to be guided under the overriding objective that pension funds are set up to serve as a secure source of retirement incomes.

I. 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.

1. 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.

2. Governing Body

Every pension fund should have a governing body[27] 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 a secure 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 such external service providers.

[27] The governing body may also be an administrator.

3. Expert Advice

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

4. 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.

5. 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.

6. 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.

7. 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, it should be legally liable for its actions.

8. 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.

II. 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.

9. 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.

10. 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.

11. 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.

12. 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.

ANNEX C

Questionnaire on Supervisory Oversight of Pension Fund Governance

Objectives

The objectives of the questionnaire are to find out:

- the state of affairs of the supervision of pension fund governance in the Members' countries;
- the issues/ problems that Members' countries are facing regarding the supervision of pension fund governance;
- any possible solutions to these issues/ problems; and
- the future challenges in the supervision of pension fund governance.

The information collected will be used for the preparation of a working paper on pension fund governance. Members should therefore indicate any responses that they would like to be kept confidential.

Note: If the pension funds in your country have more than one legal type/ form and if their governance structure/ mechanisms are different, please provide separate answers to those relevant questions in respect of each legal type/ form.

Respondent Information

Country :

Authority :

Note: Some of these questions may not be applicable to your country. In which case, please reply 'Not Applicable'.

1. What major areas/ issues of pension fund governance have been a focus for your supervisory authority?

		Please check the applicable box(es)
a.	Accountability of the governing body[28]	☐
b.	Representation of relevant parties on the governing body	☐
c.	Competence / Expertise of the governing body	☐
d.	Conflicts of interest with commercial trustees/ fiduciaries	☐
e.	Independence of auditors	☐
f.	Independence of investment managers	☐
g.	Internal controls	☐
h.	Outsourcing (including expert advice)	☐
i.	Redress mechanism	☐
j.	Segregation of duties	☐
k.	Transparency and disclosure of relevant information	☐
l.	Fees and charges	☐
m	Others (please describe)	☐

2. Were there particular incidents that led to these areas being a focus?

3. How does the supervisory authority ensure that the governing body and other pension fund service providers have set up and maintained appropriate internal controls with clear segregation of oversight and operational responsibilities?

4. How does the supervisory authority ensure that the governing body has balanced representation and is accountable to relevant stakeholders?

5. How does the supervisory authority ensure that the governing body is 'fit and proper' and possesses the relevant qualifications /expertise to perform its role?

6. How does the supervisory authority oversee conflicts of interest (particularly relating to commercial fiduciaries / trustees) and ensure that the pension fund service providers (e.g. investment manager, auditors) are independent of the governing body (in jurisdictions where that is required)?

7. If pension fund service providers (e.g. auditors, actuaries) have a 'whistleblowing' role, how does the supervisory authority ensure that it is fulfilled?

[28] The governing body is the group vested with the power to administer the pension fund and which is ultimately responsible for ensuring adherence to the terms of the pension arrangement and the protection of the best interest of plan members and beneficiaries (*OECD 'Guidelines for Pension Fund Governance'*).

8. How, if at all, does the supervisory authority oversee the expert advice that the governing body receives?

9. What were the major developments in pension fund governance in your country in the past 5 years?

10. What are the major problems/challenges of the supervision of pension fund governance encountered by the supervisory authority?

11. What are the solutions to these problems/ challenges, if any?

12. Look ahead, do you anticipate any potential developments in terms of pension fund governance in your country in the next 3-5 years?

Yes	☐	No	☐

If Yes, please briefly outline the potential developments.

ANNEX D

Supplementary Questionnaire on Supervisory Oversight of Pension Fund Governance

1. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that the governing body is “fit and proper” and possesses the relevant qualifications/expertise to perform its role.

2. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that the governing body has sought proper expert advice.

3. Please give examples of statutory requirements in respect of the liability of the governing body in your country.

4. Please give details of the requirements of appointing independent director(s) to the board of the directors of the governing body, which aim to enhance accountability of the governing body.

5. Please identify whether there is any requirement on equal/balanced/member representation in your pension system.

6. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that the governing body meets the requirements of member representation/independent directorship.

7. Please give details of the disclosure requirements relating to governance issues in your country.

8. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that the governing body complies with the disclosure requirements and any supervisory issues that have been identified in this respect (e.g. the adequacy or accuracy of disclosed information).

9. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that relevant parties perform the requisite role of whistleblowing.

10. Please give details of the supervisory oversight performed by your supervisory authority in ensuring that the governing body and service providers have set up and maintained appropriate internal controls.

11. Please provide information on any potential developments in terms of supervision of pension fund governance in your country in the next 3-5 years.

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