20 Questions

Directors Should Ask about their Role in Pension Governance

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The Canadian Institute of Chartered Accountants
How to use this publication

Each “20 Questions” publication is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management – and themselves – tough questions.

The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics. In some cases, Boards will not want to ask the questions directly but they may wish to ask management to prepare briefings that address the points raised by the questions.

The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper if necessary. The comments summarize current thinking on the issues and the practices of leading organizations. They may not be the best answer for every organization.

Thus, although the questions apply to any organization, the answers will vary according to the size, complexity and sophistication of each individual organization.
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The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants commissioned this publication to assist Boards of Directors in discharging their governance responsibilities. Failure to discharge their responsibilities can expose directors to an increasingly significant liability risk. That risk is more apparent today than perhaps ever before in Canadian corporate history.

Pension governance, which has had a narrow focus in the past, is becoming increasingly important. This is not only because recent high-level corporate failures have emphasized the need for sound corporate governance in general and the management of pension plans in particular. It is also because pension funds are significant in Canadian capital markets, to the sponsoring entity, and in the lives of pension plan members. For many nearing retirement, their pension entitlement is a major (if not their largest) personal asset. Without sound pension governance, this asset is at risk.

Generally, pension plans and funds are off-balance sheet items and are not part of the reporting process for the core business of the sponsor. However, there is a growing awareness of their importance to all stakeholders and of their exposure to more and different kinds of risk. This publication addresses developments within the plan and fund and their consequences to the sponsor’s directors, who bear ultimate responsibility for pension governance.

While some pension governance matters are regulated and most pension plans usually comply with the legislation, there are a considerable number of areas where decisions are at the discretion of the plan sponsor and/or legal administrator. These non-legislated areas are the primary focus of this publication. Because of their discretionary nature, they are more likely to represent a significant risk exposure for directors.

The 20 questions are appropriate for Boards in all sectors of the economy and for both registered and unregistered (supplemental executive) retirement arrangements. The questions address governance matters for both defined benefit and defined contribution pension plans. Most organizations sponsor one or the other and some arrangements contain a combination of both plan types. Regardless of the type of pension plan an organization sponsors, the Board of Directors bears ultimate responsibility for all aspects of its operation.

Pension governance in today’s business environment calls for enhanced leadership by Boards of Directors. To exercise that leadership, Boards need to be knowledgeable about the issues and developments in this complex area. This publication is intended to assist them.

The Board thanks Gordon Hall, author, and acknowledges the contribution of the Directors Advisory Group, who advises the CICA. They identified the need for research and guidance in this specialty area and have provided high level coaching suggestions to the author throughout the course of his work.

Frank Barr, FCA
Chair, Risk Management and Governance Board
I. Why is pension governance attracting attention?

Because pensions are significant
While recent corporate failures have focused attention on pension governance, its importance extends well beyond such short-term and isolated, highly-publicized events. Pension governance is of long-term importance to the corporate community and its workforce for the simple but significant reason that pension plans and funds are themselves important to society at large and indeed, to our economy as a whole.

Simply put, a pension fund is significant:
- to the organization that sponsors it,
- to the capital markets in which it can be such a large and vital element, and
- to the employees who are protected by it.

This makes pension governance a material consideration for the corporate body ultimately responsible -- the Board of Directors. Helping the Board discharge its responsibilities in a way that will optimize benefits to pension stakeholders and minimize its risk exposures in doing so is the objective of this publication.

Significance to sponsors
The employer-sponsored pension plan is the single most important tool in effecting an orderly transition of a workforce from an active to a retired status.

For many sponsoring employers, the pension plan obligations and pension fund assets are material financial considerations.

A survey of private sector sponsors of Canada’s 100 largest defined benefit pension plans, based on data at the end of fiscal 2001, found that:
- for 31 sponsors, the fair market value of pension assets was at least 20% of the sponsor’s total corporate assets,
- for several of the 31, the percentage was in the 30-50% range, and
- for two sponsors, the pension assets were essentially equal to the total corporate assets.

The survey found as well, that 58 of these 100 plans had an aggregate pension asset shortfall (off balance sheet) of $11.2 billion at the end of fiscal 2001 and 27 of the 58 reported a pension-related asset on their balance sheets of $2.8 billion.


The funded status (which is a proxy for the security of benefits) has been low historically for some defined benefit plans. In recent years, the funded status for all plans has weakened considerably and many sponsoring employers have been required to make significant cash contributions.

Directors should also be aware of the call on cash flow of other post-retirement benefits (such as health coverage and life insurance) that many pension plan sponsors provide. Most are funded on a "pay-as-you-go" basis. The Ivey researchers found that 84 of the 100 sponsors provided such other post-retirement benefits and that the total liability reported in the sponsors' disclosures for these benefits was $17 billion. Only $1 billion of assets was set aside to secure these obligations.
Significance to capital markets
In terms of total Canadian market capitalization as of December 1999, the total asset base of registered pension and registered retirement savings funds (together with funds accumulated under the Canada and Quebec Pension Plans) amounted to $C 995 billion. This was greater than the market capitalization of the TSE 300 (now TSX) of $C 742 billion and was 93% of Canada’s gross domestic product at that time. There is no reason to believe this asset base is any less significant today.

Significance to employees
In 2000, 5.4 million paid workers in all sectors of the Canadian economy belonged to registered pension plans. This represented 41% of paid workers overall and coverage of 87% for the public sector.


For employees nearing retirement, their pension entitlement is a major (and often their largest) personal asset. The prospect of losing one’s retirement savings as a result of deficiencies in pension governance is not one anybody would wish to contemplate. Fortunately, few such cases exist. To sustain and improve this track record requires enhanced boardroom leadership.

Recent Pension Governance Developments
Several years before recent scandals focused attention on poor corporate governance, good pension governance was a priority matter in Canada resulting, since 1996, in some 20 authoritative papers on the subject by Canadian governments, pension regulators and private sector pension industry associations. Then some corporate failures shone the spotlight on directors’ duties to both a sponsor’s shareholders and its plan members.

Beginning in 2000, unprecedented capital market difficulties significantly reduced the market value of many pension funds and the expectation of future investment returns. Analysts and investors began to focus on the contribution of the pension fund’s (assumed) returns to the income reported by the sponsoring enterprise under current accounting rules. Some sponsors required cash contributions to improve the security of the accrued benefit obligations.

The pensions area is also becoming more litigious. Sponsors have increasingly become the target of lawsuits in matters such as the use of fund surplus, benefit administration, and the payment of expenses from the fund. With the recent enactment of Class Proceedings Acts in Ontario, British Columbia, Quebec and Saskatchewan, large numbers of people have access to the courts in initiating cases that would be too expensive or complex for one person to sue individually. One large Canadian law firm reported recently on its website class actions of double-digit proportions, many of them pension-related. On another front, sponsors are increasingly called upon, by the nature of their fiduciary duties, to be the instigators of lawsuits where outside suppliers have not met their obligations to the fund or its members.
Also, except for the legislated requirement for annual member statements, communication programs to stakeholders are relatively undeveloped. In the current environment, communication programs to plan members, communications from management to boards, communications to investee firms and to a plan sponsor’s investors are not only warranted but essential. Ensuring timely and transparent communications to all stakeholders is an important element of good pension governance.

A final development is concern about the security of Supplemental Executive Retirement Plans, which now include employees in middle management as well as executive positions. As cash funding of the obligations exists for only a modest percentage of SERPs, the security of the benefit promises for most is the sponsor's future cash flows and its ability to sustain the escalating claims on them.

The Board’s Role and Responsibilities

Ultimate responsibility

While the performance of many functions may be delegated to management and Board committees, the Board itself bears ultimate responsibility for all aspects of an organization’s pension plan and fund.

For virtually all private sector enterprises and for many not-for-profit entities, the Board of the sponsor has a dual duty: (1) it is responsible to the shareholders of the private sector sponsor or to the major stakeholders of the not-for-profit and public sector sponsors; and (2) it has fiduciary responsibilities as legal administrator of the plan and fund (as defined by various Pension Benefits Acts) to plan beneficiaries.

In the public sector, and for multi-employer union-sponsored plans and funds, a Board of Trustees, separate from the sponsor, commonly has ultimate responsibility for many functions. These generally include all matters except for the decision to sponsor the plan and the decisions regarding the plan type and the generosity of the benefit. In other words, the responsibilities of the Board of Trustees are closely aligned with the requirements of the legal administrator as set out in the Pension Benefits Acts of the various jurisdictions.

No matter which sector and which governance structure, the relevant governing entity is responsible to shareholders and stakeholders to ensure that the organization's pension plan is meeting the sponsor's objectives and is discharging its responsibilities to plan members.

Pension benefits are an important aspect of an organization's ability to attract and retain employees. It is incumbent upon directors to ensure that members are informed about the rationale behind the plan design and the division of responsibilities in saving for retirement, and that promised pension benefits are appropriately secured.

*Quebec provincial legislation stipulates that a Pension Committee, which includes plan member representation, is the legal administrator with ultimate responsibility for selected elements of the governance of the employer-sponsored pension plan. In most cases, in the private sector, the handling of these responsibilities has been delegated back to the employer.
Conflicts of interest

The goals of the stakeholders (the sponsors and the plan members) are not always aligned. As well, certain investment information generally available to the relevant Board committee only if requested, may reveal conflicts of interest related to the work of external providers. Accordingly, good pension governance involves not only addressing conflicts of interest but also anticipating their existence.

The dual role that most employers in the private sector fill, as sponsor on the one hand and legal administrator on the other, is the source of potentially significant conflicts of interest that must be managed carefully. Other conflicts are manifest in such questions as:

- Is a specific decision in the best interests of the sponsor or the beneficiaries?
- If there is dual duty, which constituency should have precedence and why?
- Should plan members be permitted on the oversight Board and to make decisions in their own self interest?
- Are directors of outside providers also directors of organizations in which the pension fund might invest?
- Should the plan fund invest in the shares of the sponsor?
- Are there audit procedures to confirm that charges levied by investment managers and traders are appropriate for the institutional market in general, as well as for the specific fund?
- What use should be made of excess assets in the pension fund?
- What is the trade-off between cost reduction and quality of service?

Some conflicts of interest can be eliminated and others can be mitigated or managed. Boards should satisfy themselves that all conflicts are identified, disclosed and appropriately addressed, and that there is suitable documentation they have been handled objectively.

Two major valuations

The Board’s oversight responsibilities are complicated by the fact that a registered defined benefit pension plan is subject to two major valuations:

- The funding valuation required by the Pension Benefits Acts. This valuation, primarily directed to the ability of the fund to secure the promised benefits, involves a solvency valuation (a proxy for a business termination valuation) and a going concern valuation. Together, they set the minimum contribution that must be made and the maximum contribution that can be made to the pension fund at a point in time.
- The accounting valuation prescribed by the Canadian Institute of Chartered Accountants (and the Financial Accounting Standards Board in the U.S.). This valuation requires “management’s best estimates” for each of the demographic and financial assumptions including the discount rate for future benefit cash flows and the expected return on invested assets. These assumptions impact on the sponsor’s financial statements.

A Board needs to monitor the funding valuation to balance its responsibility to plan members, with its responsibility to stakeholders/shareholders. It also needs to monitor the accounting valuation, to discharge its responsibility to stakeholders/shareholders regarding the integrity of the sponsor’s financial statements.

Risk exposures

Most organizations sponsor either a defined benefit or a defined contribution plan. Some pension arrangements combine both plan types.

Sponsors bear the funding and investment risks for defined benefit pension plans. They must track the funded status and asset performance. Specifically, the need for additional contribution outlays may significantly affect the financial results of the sponsoring
organization. Also, the tracking entails monitoring capital markets in Canada and in major markets abroad, as most plans invest close to the book value limit in foreign investments.

With defined contribution pension plans, the members bear the investment risk. For that reason, conventional wisdom holds that defined contribution plans carry little (if any) investment liability and risk exposure for directors. This conventional wisdom is wrong. Directors bear responsibility because the sponsor is involved in the selection of investment managers, in the asset classes that are offered, and in confirming that the book value limit in foreign investments is not exceeded. Member education and monitoring of investment performance and choices are matters that warrant the Board’s ongoing attention. (Also, there are no statutory "safe harbours" in Canada as exist in US statutes.) Directors bear risks of litigation due to failure to educate members, or selection and retention of poor investments or managers.

Ultimately directors are at risk, regardless of which type of plan their organization sponsors.

Penalties
There are negative consequences for stakeholders associated with failing to deliver on plan promises, statutory requirements and fiduciary obligations. As an example, the penalty set out in the Income Tax Act for failure to comply with the foreign property limit is very punitive.

Oversight by committees
A Board's discharge of its oversight responsibility has frequently been by a combination of Board committees — a pension committee, the audit committee, an investment committee and/or a human resources/compensation committee — with no one Board committee being responsible for ensuring an integrated result and for comprehensive reporting to the full Board.

Finite Resources and Board Leadership
Some directors may conclude that this 20 Questions publication represents an exhaustive checklist that management and professional advisors should be asked to implement over a fairly short period of time. This conclusion is not warranted.

As sponsors do not have infinite resources to direct to pension governance enhancements, it is important that Boards identify the priority elements and work with management and external suppliers to address those that are of greatest importance.

Enhanced pension accountability will evolve over time:

- as sponsors refine their corporate governance practices; and
- in response to changing community standards for pension governance in Canada’s private pension system.

To succeed in their leadership role, Board members will need to have or acquire specialist competencies, particularly those that enable them to:

- determine the level of quality with which functions are being handled on their behalf;
- understand the inter-relatedness of the pension governance elements;
- challenge conventional wisdom;
- ask discerning first (as well as second and third) round questions of management and professional advisors; and
- ensure that the finite resources available are being deployed effectively and in the right direction.

By implementing the pension governance enhancements that result from addressing the following questions, the Board will go a long way in exercising its leadership role to the benefit of the sponsoring organization, the pension plan members and beneficiaries and other stakeholders.
II. 20 Questions and commentary

The Board of an organization sponsoring a pension plan and fund is responsible for ensuring that both are running effectively and in the right direction and, as a part of that responsibility, confirming that all its obligations are properly discharged including:

- statutory obligations, to legislative and pension authorities in the relevant jurisdictions;
- contractual obligations, set out in the formal pension plan and fund documentation; and
- fiduciary obligations, which arise as a consequence of being entrusted with the property of others and which are largely determined on a case-by-case basis. These obligations may not be governed by a statute or by the official rules of a plan and fund.

As stated in the Preface, this publication’s primary focus is on areas of pension governance that are not legislated because these areas, discretionary in nature, are more likely to represent a significant risk exposure to directors. Accordingly, except for the matters raised in Questions 19 and 20, it is assumed that sponsors meet their statutory and contractual responsibilities. Most of the 20 questions therefore, address the areas in which considerable discretion must be exercised, whether by management in running the plan and fund, or by the Board in confirming the discharge of its obligations.

The 20 questions are grouped into nine subject areas, followed by commentary on the relevance of the questions to good pension governance, trends and best practices.

With each question, a Board is encouraged to ask itself where its duty is owed (i.e., to sponsor, beneficiaries, or regulators) and whether the question should be directed at the Board itself, management, an external third party, or a combination of some or all of these.

(i) Roles and Responsibilities

Questions

1. Is there a written policy on who recommends, decides, manages and monitors all activities involved in governing and managing the pension plan and fund? Is there a process that allows the Board to confirm that all delegated functions are being appropriately handled?

2. Has there been a formal evaluation of the appropriateness of the governance structure, the delegation model, and the competencies of directors in the past two years? If yes, is there an action plan to correct any identified deficiencies? Are there conflicts of interest related to governance structure and if so, are they being appropriately addressed?

3. Does the Board have a process to keep itself informed about relevant developments that could have a significant impact on the plan’s design, affordability, administration and financial management?

Commentary

Assuming or delegating responsibilities

One of the most difficult tasks in structuring the governance of a pension plan and fund is to determine and assign responsibilities for the performance of specific functions. The Appendix identifies the ten elements of good pension governance that senior executives and managers of sponsors focus on day-to-day in the running of their plans and funds.
The Board's first task is to ensure that responsibility for the performance of each of these elements has been assumed by the Board or by management, or has been delegated to an outside provider.

Another Board task is to ensure that responsibility for the oversight of functions external to the plan and fund, such as the financial reporting of their impact on the sponsor, is also assumed by the Board and/or management.

The specific governance structure is a Board decision.

No matter what the governance structure, the Board should review and confirm principal matters such as the following:

- The sponsor has reviewed and established sound delegation of functions for all elements. This process should be documented and there should be monitoring, report-back and evaluation procedures.
- There are policies to guide management and Board handling of functions including the retention and the expectations of professional advisors (e.g., the actuary, the investment managers, the investment consultant). These policies specify goal-setting, monitoring and evaluation.
- The directors have the knowledge and experience to appropriately discharge their financial, legal and social responsibilities to the parties to whom they are owed.

Sponsors of smaller funds may feel they cannot afford an internal dedicated management function. In these circumstances, some management responsibilities may be pushed up to the Board and others may be pushed out to external specialists. It is important to keep the management and director roles separate and distinct.

Many pension plans have gaps in the information loop, in reporting back to the Board by those to whom responsibilities have been delegated. In the interests of risk management and performance improvement, plan sponsors should implement a rigorous report-back system. In a time of increasing litigation, there is value in being able to demonstrate that duties have been considered, delegated, undertaken and monitored. This need not involve onerous reports. For many tasks, a checklist will convey the necessary information in a format where changes or gaps in performance can be highlighted and tracked over time.

**Reviewing structure-related conflicts of interest**

The inherent conflicts of interest are potentially very significant, especially where the employer is both the sponsor and the legal administrator. In some recent cases, officers of the plan sponsor revised the sponsor's financial statements but failed as a trustee of the employer-sponsored pension plan—and as one that invested in shares of the sponsoring employer—to take action to protect the interests of plan members and beneficiaries. In extreme cases, this has caused severe reductions in employees’ retirement security. Boards are encouraged to review these conflicts of interest regularly, even if the governance structure conforms to regulation and is defensible on strictly legal grounds.
Staying current
In addition to acquiring the knowledge and experience to appropriately discharge its responsibilities, the Board needs to stay current on developments that have a significant impact on the elements of good governance. These developments could include:

- governance proposals;
- changes in the overall financial health of the pension plan and fund;
- legislative developments (e.g., new definitions of eligible partners, privacy legislation);
- financial reporting for the sponsor;
- new forms of investment;
- trends in litigation (e.g., on surplus); and
- proposals to outsource benefit administration.

(ii) Plan Design and the "Pension Deal"

Questions

4. Is the plan design appropriate for the sponsor, for its sector of the economy and for the current and contemplated workforce? Are decisions regarding plan design accompanied by decisions as to how the promises will be secured?

5. If the plan is a defined contribution plan, are the members receiving the appropriate investment education?

6. Is an enhanced communication program warranted to inform members of the rationale behind the plan design and to delineate the division between the sponsor’s and the members’ responsibilities in saving for retirement?

Commentary

Except where they have contractually agreed to do so, there is no legal or statutory duty for employers to establish and maintain pension plans. However, pensions are an important element of remuneration in most sectors of the economy. The Board has the final say on key design decisions such as whether the plan is to be a defined benefit or defined contribution plan and on the level of benefit it will provide to members. Directors should ask whether and how management uses the company pension plan to attract and retain the most appropriate workforce.

Directors should also ask management whether it has confirmed plan members’ understanding of their employer’s pension arrangements and of how these arrangements are assisting members in meeting their retirement security goals.

There are financial, legal, administration, and communication risk exposures for both defined benefit and defined contribution plan types, with consequences for the plan sponsor, the plan members, directors and officers, and professional advisors. The precise nature of the risk exposures varies by plan type. For example, defined contribution plans can be subject to pension benefits, securities, and insurance legislation, depending on the type of plan and the type of investment options offered. Sponsors of these plans should give careful consideration to:

- the provision of investment advice;
- any failure to inform or educate;
- the provision of erroneous information;
- the choice of investment options and levels of diversification;
- the choice of service providers; and
- conflicts of interest.

For the employer-sponsored pension arrangement, the Board’s focus should not be narrowly on design but rather on the "pension deal" (i.e., what is the nature of the pension promise, what are the underlying risks and who is to bear them?).
The Board should ensure clarity regarding the target benefit level, who bears the risk for the delivery of the retirement income, and the form of the security. In articulating this broader accountability context for the company-sponsored arrangement, it should keep in mind major eventualities such as business terminations and low and high inflation environments and prolonged bull and bear markets.

Within current governance practices, an enhanced communication program would include a formal, written communication policy.

“Communication was ranked as the number one priority for improvement, consistent with the finding that few plan sponsors have a formal written communication policy.”


(iii) Funding and Financial Reporting

Questions

7. Will the current funding policy:
   • Put at risk the fund’s ability to secure the obligations?
   • Lead to over-funding of the benefits and result in stranded pension assets?
   • Lead to a material call on the sponsor’s future cash flow because the fund is not generating, or likely to generate, the rate of return assumed in the actuarial valuation? If so, what are the projected contribution needs?
   • Lead investors to question the contribution of pension fund returns to the sponsor’s reported financial results?

8. If the pension promise is the result of collective bargaining, is the Board satisfied that the fund, together with the future contribution cash flow, will be sufficient to meet the negotiated benefit obligations?

9. What is the process for developing "management’s best estimate" assumptions for financial reporting purposes including the return expected on pension fund assets? Are investors fully informed about the impact of these assumptions on the sponsor’s financial statement results?

Commentary

Funding

Only a few defined benefit plans have a formal written funding policy that:

• specifies the desired relationship between the fair market value of the assets and the liabilities at given points in time;
• contemplates going concern and business termination eventualities, high and low inflation environments and prolonged bull and bear markets;
• recognizes that the greater the asset shortfall and/or the greater the mismatch of assets and liabilities, the riskier the total environment becomes for all stakeholders; and
• provides guidance to management of the plan sponsor to determine whether the contribution to the fund should be the minimum required, the maximum permitted, or some other amount in between.

As well, given that (1) funding valuations of registered pension plans are required by statute only once every three years, and (2) valuation smoothing of the fair market values of assets is spread over periods up to three or five years, early detection of the impact of either a high inflation environment or depressed capital markets on benefit security and on the sponsor’s future contribution requirements can easily be missed.
A sound funding policy is an essential foundation for benefit security and for investment discussions. It is also an important safeguard against over-funding and being left with stranded pension assets. Competent Board members will quickly grasp the essence of trade-offs between benefit security and necessary funding for defined benefit plans.

Normally one would anticipate considerable consistency between the key elements of an organization’s funding policy and the key elements of its Mission and Values statements. For example, an organization that assigns a high priority to human capital matters would normally ensure that obligations under its pension arrangements are appropriately funded. Minimum required funding of registered retirement arrangements and not funding Supplementary Executive Retirement Plans (see category (iv), below) may be considered appropriate in organizations that focus on the sponsor’s growth and fully communicate the risks to plan members.

A Board should encourage the early formulation and communication of a formal written funding policy. Each year, after the policy is adopted, the sponsor should voluntarily disclose to stakeholders whether the contributions to be made are the minimum required under the policy, or include additional discretionary funding.

“While fluctuations in the present value of assets versus liabilities (funding ratios) represent high financial risk for all plan sponsors, most plan sponsors fail to recognize this risk because it is seriously attenuated by actuarial and accounting smoothing of financial statements.”


Financial reporting for the sponsor

Because of financial market reverses in recent years, many (investment analysts, Boards, etc.) have called into question (1) the impact of management’s best estimate assumptions and (2) the expected return on pension fund assets on the sponsor’s income statement and balance sheet.

This scrutiny has stimulated action and discussion on a number of fronts:

- Credit rating agencies have started to assess the health of pension plans and funds as part of their reviews of sponsors.
- Questions are being asked about refinements to the costing method, and the framework for assumptions-setting and amortization of gains and losses prescribed for accounting valuations.
- The appropriateness of the "mark-to-market" world of financial disclosure is being questioned.
- There are advocates for greater involvement by independent auditors in confirming that the determination of specific aspects of charges to income statements is in order and that obligations have not been significantly misstated. These aspects may include: data integrity, the enrolment of eligible full- and part-time employees, and confirmation that pensioners paid by direct bank deposit are still alive.

“...rating agencies...have downgraded their ratings of several European companies...because of their pension shortfalls. The lower credit ratings mean that companies will have to pay more to borrow in bond markets.”

"Management's best estimate assumptions" (as required by Section 3461 of the CICA Handbook, for use in determining the sponsor's income statement charges and for disclosures) warrant careful oversight by the Board. Key assumptions for directors to focus on include:

- the spread between the interest discount rate used to determine the present value of accrued benefits and the salary increase assumption used in estimating the amount of the accrued benefits; and
- the expected return on invested assets.

"Management's best estimate assumptions" is a somewhat misleading label, missing the point that these assumptions by management should also be reviewed by the Board. As these assumptions become more aggressive, the computed annual pension expense reduces. Incremental liberalizations in assumptions lead to significant reductions in pension expense. Losses arising from overly optimistic assumptions are pushed out to be borne by future generations of shareholders.

The relevant Board committee should confirm that management has appropriate processes for updating and refining these estimates and has guidelines for sign-off. This committee should also ensure that the key assumptions noted above, including any changes for the most recent financial reporting period, are disclosed to the sponsor's investors.

Pension financial reporting is being reconsidered by the Canadian Institute of Chartered Accountants and by the International Accounting Standards Board, with interest being expressed in the elimination of amortization of actuarial gains and losses, reporting pension fund investment gains and losses separately on the income statement, and in treating pension service costs as expenses. The Board should be cognizant of these developments and their potential impact on the pension plan sponsor.

“...the full and immediate recognition of all gains and losses in the financing cost,... appears to be a popular view among financial economists...A (pension) plan deficit is unlike other debts because it does not entail contractual interest and capital payments; a plan surplus is not an asset immediately for use in the business. It is reasonable for financial statements to reflect those economic realities in spreading the recognition of gains and losses over future periods.”


**Monitoring the financial health of a defined benefit pension plan**

To track the combined effect on defined benefit pension plans of volatile asset values and growing liabilities, some sponsors examine the ratio of asset values to liabilities over time with the help of consulting actuaries and financial economists. This analysis is undertaken voluntarily for information purposes and is not a requirement of any statute or professional body.

Simulations of the financial health of a specific plan in this new era of "mark to market" financial management are used by sponsors of defined benefit plans to:

- obtain a fairly frequent reading on the combined effect of both asset and liability volatility;
• stay very close to deterioration in funding ratios and surpluses; and
• anticipate the need for higher sponsor contributions, drags on corporate earnings and potential deterioration in credit ratings for plan sponsors.

Mercer Human Resource Consulting introduced such a simulation to Canada, the Mercer Pension Health Index, which provides a monthly measure of the ratio of assets to liabilities for a model plan.

(iv) Supplementary Executive Retirement Plans (SERPs)

Question

10. If the organization provides a SERP, are the benefits funded or otherwise secured? If not, have the plan members (i.e., the managers and executives) been formally advised that their additional company-sponsored retirement income is at risk?

Commentary

Because of the limits set out in the Income Tax Act on the amount of annual pension that can be provided via a registered pension plan, many employees in Canada with pensionable earnings greater than about $C100,000 are covered by a SERP. These include middle managers as well as executives. Many of these people are unaware of the risks to benefit security that accompany pay-as-you-go funding. Forfeiture of the SERP entitlement can occur as a result of a sponsor’s future financial difficulties or the loss of the entitlement in the event of a spin-off of a business division.

For defined benefit SERPs, the amount of the pension entitlement should be reasonable in a total compensation context as well as relative to attraction and retention objectives of the sponsor. The amount of the defined benefit payment should also be capable of ready determination based on earnings, years of service and vesting criteria.

Also, pension entitlements for all SERPs should be predictable in terms of the likelihood of payout. However, only slightly in excess of 20% of all SERPs are cash funded in whole or in part and a small additional percentage of all SERPs have security provided by Letters of Credit. The liabilities related to SERP entitlements are growing rapidly.

There are precedents (e.g., Confederation Life) where members of SERPs have been severely impacted. As a result of wide media coverage of such failures, there is now a general awareness of the risk exposure. Consequently, for future defaults of this nature, the risk of a class action against directors is fairly high.

(v) Business Transactions and Pension Obligations

Question

11. Are business transactions—such as acquisitions, mergers, divestitures and restructurings—being assessed with respect to the impact on pension obligations and their funding, keeping in mind duties to plan members, both continuing and divested, as well as to shareholders?

Commentary

Corporate strategies frequently lead to acquisitions, mergers, divestitures and restructurings. These corporate transactions can lead, in turn, to plan amendments, plan mergers, conversion of one plan type to another, transfer of pension liabilities and assets in the event of purchase and sale, plan splits as well as partial and full plan wind-ups.
Each of these events warrants close attention to (1) the requirements in pension statutes, (2) the consequences for each group of stakeholders; and (3) common law precedents.

In the case of transfer on purchase and sale for example, having a well-researched plan for determining and dealing with the pension obligations for employees affected by such a business transaction is critical to arriving at an informed strategy, avoiding nasty surprises, and achieving value-added results for all stakeholders. There are a number of steps for risk mitigation:

- due diligence to establish the magnitude of the unfunded pension liability relative to the asking price for the operating division;
- a current funding valuation for the pension plan, rather than one that might have been undertaken three years earlier; and
- due diligence on the purchaser who proposes assuming significant unfunded pension liabilities (with respect to divested employees) with an offset in the purchase price for the operation. If the purchaser subsequently declares bankruptcy, the vendor could end up with a “moral liability” and a public relations problem even though there may be no legal liability.

(vi) Cost Effectiveness in Spending

Question

12. Is there an accounting of the total annual administrative expenses, including administration and fees paid to third parties associated with sponsoring the pension plan? Does it include an assessment of the cost-effectiveness of current benefit administration procedures (e.g., in-house vs. outsourcing) and the fees to outside parties?

13. If the plan is a defined contribution plan, are the fees paid by plan members competitive?

Commentary

Relatively few sponsors in the private pension system prepare an annual report on all of the administrative expenses associated with running their plans and funds. These expenses include fees to third parties, such as for actuarial, investment management, investment consulting, custodial, trustee, legal, audit, consulting and outsourcing services. The stimulus for serious discussion on cost effectiveness is frequently a costly systems replacement. With incomplete expense information, a sponsor will not likely be inclined to evaluate returns on outlays (as defined by the sponsoring organization and in a value-for-money sense).

If outsourcing of pension administration is considered, due diligence should be undertaken regarding a potential supplier’s ability to handle the outsourced functions over a prolonged period. This would include implementing a proven disaster recovery plan.

With regard to the competitiveness of fees, in the case of defined contribution pension plans the fee level charged to plan members will have a significant impact on the accumulation in an individual’s account over time.
(vii) Investment of the Pension Fund

Question

14. Does the plan sponsor review the Statement of Investment Policies and Procedures (SIP&P) annually to ascertain that it is current? Are the investment policies that guide handling updated annually to align with the sponsor’s beliefs regarding long term asset mix and the investment manager structure? Are the merits of new types of investments investigated?

15. With respect to monitoring the investment performance of the fund:
   • How often is performance monitored?
   • How does the sponsor measure and compare performance (e.g., use of quantitative and qualitative measures)?
   • Is the performance adequate to meet obligations?
   • What are the criteria for changing investment managers?

16. Does the organization have formal written policies with respect to:
   • Proxy voting?
   • Use of derivatives?
   • Currency hedging?
   • Soft dollars (i.e., rebates on brokerage commissions used to purchase research, software, etc.)
   • Maximum single stock exposure?
   • Ownership of equity of the sponsor?

Commentary

Sponsors generally have a disciplined approach for establishing and monitoring the investments in the fund. Most large pension funds review their Statements of Investment Policies and Procedures annually and ask their external managers to certify compliance with the investment style and goals specified. Sponsors generally use external managers, review all aspects of performance (quantitative and qualitative) quarterly, assess that performance against pre-set benchmarks and expectations, and evaluate the merits of new types of investment. They have developed policies on matters such as market concentration in the form of maximum exposure to a single stock and the use of derivatives.

As one would have expected, some large public sector funds have behaved increasingly as institutional investors. In doing so, they have challenged the management and Board performances of publicly listed enterprises in which they have invested. In the past, most private sector sponsors perceived that they had more to lose in stakeholder relations than to gain in investment returns by engaging in shareholder activism. Establishment of the Canadian Coalition for Good Governance is evidence that a significant number of pension funds and investment managers are working behind the scenes with the management and Boards of investee enterprises to promote corporate governance reform and, as needed, to push back on inappropriate proxy proposals.
Boards of pension funds who are not already actively involved in corporate governance reform should ask questions about the fund’s role in future reform initiatives. For example, specific initiatives that management and Boards could investigate (none of them strictly required by statute) include:

- a definition of what constitutes conflicts of interest for all parties involved in the investment process (e.g., the investment analysts and investment managers) and a check that appropriate policies to guide their handling are in place;
- a policy as to whether the fund can invest in shares of the sponsoring entity or whether this represents an inappropriate conflict of interest;
- a periodic after-the-fact reporting by the investment managers of the major proxy voting matters for the period, how sensitive proxy proposals have been handled and what refinements (if any) to the SIP&P should be considered; and
- criteria in proxy proposals to be satisfied in the future before the pension fund’s support will be forthcoming.

“Investment banks have been unable to resolve conflicts of interest between their different businesses. Consumers are cross and regulators have their knives out.”


(viii) Risk Assessment and Management

Question

18. Has there been an evaluation of exposures to risk in the operation of the pension plan and fund, including the balance sheet and income statement risks for the plan sponsor? If yes, what deficiencies were identified and what steps have been taken to mitigate and manage risk exposures?

Commentary

The risk assessment and management process could include:

- identifying the risk exposures for the plan and fund (e.g. financial, legal, administration, communication) as well as the pension-related risk exposures for the plan sponsor, for directors and officers and for professional advisors and service providers;
- creating a risk map for each risk exposure that sets out an assessment of the magnitude of impact, the likelihood of the occurrence of each risk, the risk owner, and how each risk exposure is managed/mitigated; and
- deciding which Board committee oversees each risk.

For example, the Board may want to initiate an early review of all pension-related legal causes of action in view of:

- the number of pension-related enquiries, notices from the pension standards regulators and tribunal hearings;
- the significant increase in the number and magnitude of pension-related litigation, including class action suits; and
- claims for breach of fiduciary duties not generally being subject to a statute of limitations.
The risk assessment and management process can be helpful to management in not only planning the most appropriate response to potentially negative outcomes, but also in identifying and evaluating opportunities to improve performance.

The process can also be helpful to a Board in evaluating a pension strategy brought forward by management, in bringing all key elements of pension governance together for evaluation and priority setting and in confirming that all risk exposures have been captured and appropriately addressed.

The process can also be helpful to both management and the Board in:

- confirming the risk exposures to be borne by the plan and fund, by the sponsor and by officers and directors;
- assessing the appropriate form and amount of insurance protection to be secured under director and officer liability and fiduciary (trustee) liability insurance policies;
- assessing the form of indemnities available from the company to directors and officers;
- reviewing the contractual arrangements with professional advisors and service advisors and determining whether appropriate indemnities are available and should be obtained; and
- assessing the errors and omission insurance coverage that professional advisors and service providers should be required to maintain throughout the terms of their appointments.

(ix) Management Representations Regarding Compliance with Statutory Requirements and Formal Policies

Question

19. Should the Board ask management for a representation, perhaps annually, that all of the functions management has been asked to perform have been handled pursuant to statutory requirements and formal policies?

20. As a basis for discussing and prioritizing accountability enhancements, should the Board go further and request a "gap analysis" that benchmarks the current governance practices for the plan and fund to:

- minimum statutory requirements; and
- the community standards for good pension accountability for plans and funds in the peer group?

Commentary

Consistent with a Board’s responsibility to ensure that a plan and fund are being run effectively and in the right direction, it should seek assurance of ongoing statutory and contractual compliance and of compliance with formal policies that guide the handling of functions where the performance has been delegated to other parties.

Boards should seek periodic representations from management and external suppliers that all functions they have been asked to perform and that are required by statute, contract and formal policies, have been successfully handled. Boards should also ask management to identify areas where new policies and standards could eliminate exposures to penalties, ensure consistency of handling, streamline handling and achieve cost reductions.

While it is perhaps inevitable that some Boards will be satisfied with minimum compliance, all Boards are encouraged to reach for a considerably higher standard of governance if doing so will benefit the stakeholders and shareholders of the sponsor and the plan beneficiaries.
While most pension plans and funds in Canada’s private pension system have been capably managed and most have delivered on their promises, the time has come for directors to assume a more proactive leadership role in the boardroom than they have in the past.

**Statutory Refinements - a place to start**

Selected refinements to statutes can contribute to enhanced pensions and pension governance; government policy makers should give them serious consideration. These include: (1) a requirement that funding policies become formalized in a written document together with a requirement that the policy and contributions made pursuant to that policy are shared with relevant stakeholders, (2) clarifications (in statutes) regarding the disposition of excess pension assets for partial plan windups and (3) promulgation of the qualifications for directors who serve on pension committees and are considered to be pensions and pension-governance literate.

However, as good pension governance requires a leadership state of mind and not mere compliance with a set of rules, further strengthening of statutes beyond adding a few such refinements is not the preferred way to achieve improved performance within Canada’s private pension system.

**Boardroom Leadership - the means to the end**

Unless Boards provide the leadership and introduce governance enhancements that are most relevant for their circumstances, more extensive statutes will be the likely outcome. That probability is high in an environment where resources are being shifted towards regulation and related oversight.

To date, Boards have most often concerned themselves with a limited number of high-level decisions: adoption of the plan, major benefit liberalizations, investment matters and in some instances, the sponsors’ funding obligations.

For the future, a Board should consider whether its scrutiny of pension governance matters should be significantly broadened and deepened. This is not to suggest that the Board assume the role of management but that Board and management work collaboratively in undertaking this scrutiny. This undertaking involves knowing what the top-line questions are and knowing when, how and whom to ask for more details. Also, in the multi-faceted and rapidly evolving pension governance area, awareness of new developments will be critical to this enhanced form of Boardroom oversight.

Boardroom leadership on pension governance can take several forms including:

- Ensuring that Board members have the pensions and pension governance knowledge and experience base to appropriately discharge their financial, legal and broader governance responsibilities;
In the future, more detailed governance rules and regulations for pension plans and funds may be expected. One question for stakeholders is two-tier regulation: Should large sponsors and funds be held to higher and more detailed governance standards than smaller enterprises? Those who favour principles-based regulation would have the same principles extend to all sized enterprises. In that event, the Board's essential decision is how to apply the principles to their particular organization.

Committee Oversight

As noted, some Boards have a pension committee that provides oversight of all pension governance matters, while others discharge their oversight responsibilities through a joint effort of several Board committees, including the audit committee.

Because of the audit committee’s oversight of financial reporting and internal control matters for the sponsor, there is a case to be made for it to assume a significant part of a Board’s oversight responsibility for pensions.

- Advocating policies and standards to guide the handling of functions by management, the Board and outside suppliers. Policy architectures are being introduced to corporate governance deliberations and can be adapted to pension governance;

- Keeping a watch on major pension reform proposals and on current and emerging governance practices. The following matters, for example, could be standing agenda items for periodic updates;
  - class action suits and case law;
  - retiree activism;
  - ownership of excess pension assets;
  - privacy legislation;
  - public comment and advocacy positions regarding refinements to pension statutes and regarding the role and the effectiveness of both pension standards and financial market regulators;

- Incorporating into the formal policies for a plan and fund, the codes of conduct of the professionals who render services;

- Advocating, and assigning a high priority to implementing, quality voluntary communication from sponsors to plan members, to investee firms and to the sponsor’s investors; and

- Having the Board undertake a process of evaluation and self-assessment by annually asking itself: "How are we doing?"
Recent corporate governance developments for publicly listed enterprises include specific changes for audit committees, such as:

- requiring audit committee members to be independent;
- having audit committees oversee the work of the external auditor and the internal audit function;
- empowering audit committees to retain their own advisors; and
- providing guidance regarding the qualifications of specialists who serve on audit committees.

Boards should ask themselves whether and which of these same changes should be adopted for their pension committees.

“It is a new age – one where management is much more capital constrained, one where shareholders are going to have to be intensely aware of the prior claims on the cash flows and assets of their companies.”

(a) Overview of the Ten Elements

There are ten elements of good pension governance internal to plans and funds that senior executives and managers of sponsors focus on day-to-day in running them:

1. **Functions and Ultimate Responsibilities.** Sponsors need a clear and documented delineation as to who does what—who analyzes, recommends, approves, implements, monitors, reports and evaluates.

2. **Plan Design.** Because the pure benefit cost is a chief factor of design review, and because cost effectiveness in spending is an element of good governance, plan design is therefore an element of good pension governance.

3. **Funding Policy.** For defined benefit plans, the funding policy sets out the desired ongoing relationship between the fair market value of fund assets and the liabilities accrued for service to-date. This policy is an important guide for other major areas of decision-making: benefit security for plan members, stranded assets and the investment policy for the pension fund.

4. **Investment Policy and Structure.** This element covers: the long-term asset mix set out in the Statement of Investment Policies and Procedures; return expectations; policy asset mix; investment manager structure; permitted and prohibited investments; quality standards; maximum quantity restrictions; delegation of functions; performance measurement and monitoring; policies to guide the voting of proxies; and the handling of conflicts of interest.

5. **Legal compliance.** This covers statutory requirements as well as trust and fiduciary law and common practices beyond minimum requirements.

6. **Administration.** This includes written policies and procedures; standards for core tasks such as calculations, year-end data collection and reconciliation and data certification; and annual administration reports.

7. **Fund Transactions.** This includes accounting for, and reconciliations of, all transactions including those reported by the custodian and the investment managers.

8. **Expenses Paid From The Fund.** This element deals with the external and internal fees that can properly be paid from the pension fund.

9. **Cost-Effectiveness in Spending.** The focus of this element is on whether/how sponsors track costs (all types, whether pure benefit or administrative costs) and on the evaluation of returns on expense outlays.

10. **Communication.** This covers communication strategies (for all stakeholders including plan members, investors, providers, regulators etc.), annual reports and the education and awareness of plan members.

These ten governance elements apply to most sectors of the economy and to each plan type, (i.e. defined benefit and defined contribution). Exceptions are funding policies, which apply only to defined benefit plans, and assurances that plan members are receiving sufficient investment education and choices, which apply only to defined contribution plans.
(b) The Roles of the Sponsor and the Legal Administrator
Involving Fiduciary Duties to Plan Members

The Pension Benefits Acts focus on the role and responsibilities of the "legal administrator". Sample extracts from the Ontario Pension Benefits Act:

- Section 19(1) - "The administrator…shall ensure that …are administered in accordance with this Act and the regulations"
- Section 19(3) - "The administrator…shall ensure that…are administered in accordance with ….the filed documents…"
- Section 22(1) - "The administrator…shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person"
- Section 22(2) - "The administrator…shall use…all relevant knowledge and skill…the administrator possesses, or ought to possess by reason of profession"
- Section 22(4) - "The administrator…shall not knowingly permit the administrator's interest to conflict with…its duties/powers in respect of the fund"
- Section 22(9) - "Administrator not to benefit, except pension benefits, ancillary benefits and charging fees and expenses related to the administration of the plan…"
- Section 22 (5) – "Where it is reasonable and prudent…may employ one or more agents…in the administration of the pension plan and in the administration and investment of the pension fund"
- Section 22(7) – "…who employs an agent shall personally select the agent and be satisfied of the agent’s suitability…and…shall carry out such supervision…as is prudent and reasonable."

The role of the "sponsor" is provided for in these Acts; however it is not spelled out as clearly as the role of the "legal administrator". The sponsor is the party with a vested interest in setting up a plan and fund. In the private sector (in those circumstances where the sponsor is a single employer), the employer has routinely acted as both the sponsor and the legal administrator.

(c) Charts Depicting Whether Ultimate Responsibility is to the Sponsor or to Plan Members

The following four charts provide a graphical depiction of:

- the elements of pension governance common to most plan types, funds and governance structures;
- the elements that involve:
  - responsibilities to the plan sponsor (and its shareholders if it is a private sector enterprise); and
  - fiduciary responsibilities to the plan members;
- the elements where a sponsor wears two hats (i.e., it is both the sponsor and the legal administrator); and
- the elements where some matters may involve fiduciary responsibilities to plan members.

Chart IV contains a reminder that a plan sponsor may want to exceed minimum standards, including all requirements set out in statutes, either because of the sponsor’s corporate governance practices or the community standards for good pension governance.
The elements are clustered in the inter-locking circles according to whether responsibility is to shareholders/stakeholders of the sponsor (left side) or to the plan members (right side). Refinements have been made to the formal names assigned to the ten elements in those instances where one portion of the responsibility may be to specific shareholders / stakeholders and another portion is to plan members (e.g. cost-effectiveness in spending).

The ultimate responsibility for these elements rests with the entity that sponsors the arrangement.

None of these elements involve fiduciary responsibilities to plan members.

Considerable management and Board discretion is possible with these elements, as any statutory requirements are not extensive.

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Most elements involve requirements defined by statutes and by trust and fiduciary law and pertain to the role of the legal administrator.

All of these elements of pension governance involve fiduciary responsibilities, and the primary accountability for these elements is to the plan beneficiaries.

Whenever an employer acts as both sponsor and legal administrator it is wearing two hats as it has ultimate responsibility as sponsor (for the elements highlighted in Chart II) as well as ultimate responsibility for these elements as legal administrator.

Some parts of these elements may involve fiduciary responsibilities to plan members.

Considerable management and Board discretion is possible with these elements, as any statutory requirements are not extensive.

The sponsor may want to exceed minimum standards because of corporate governance considerations, and community standards for good pension governance.
Where to find more information

Statutes and Accounting Requirements


Pension References


14. Hall, Gordon M. "The Hottest Place In Hell" Business Quarterly (Summer 1994), Western Business School (now the Richard Ivey School of Business), The University of Western Ontario.


**Other Publications on Corporate Governance**


**Canadian Institute of Chartered Accountants Publications, The 20 Questions Series:**

- 20 Questions Directors Should Ask about Executive Compensation
- 20 Questions Directors Should Ask about IT
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- 20 Questions Directors Should Ask about Strategy
About the author
Gordon M. Hall, FSA, FCIA, MAAA

Gordon Hall is a professional director and advisor to Boards on corporate and pension governance matters.

Gordon retired recently after forty years of practice as a consulting actuary, the last thirty with William M. Mercer Limited (now Mercer Human Resource Consulting). At Mercer, he consulted to sponsors of many of the largest pension funds in Canada’s private pension system. He also held a number of senior executive positions at Mercer in Canada and was Chair of the global firm’s International Business Development Group when the firm was focusing on global expansion. He was a Worldwide Partner of the global firm (William M. Mercer Companies Inc.) from 1984 until his retirement.

In 1994, he became editor of *The Mercer Bulletin, The Mercer Pension Manual* and the *Mercer Handbook of Canadian Pension & Benefit Plans*. In 2001, he led the Mercer team that designed and undertook the ground-breaking analysis of the governance practices of the largest pension plans and funds in Canada’s private pension system. The report was published in February 2002.

His experience as a professional director includes:

• the Board of Directors of William M. Mercer Limited where he served seventeen years, ten of them as Vice Chairman;

• the Board of Trustees of Queen’s University where he chairs the Audit Committee and serves on the Finance and the Pension Committees;

• the Board of Directors of the Institute of Corporate Directors where he chairs the Governance Committee and serves on the Communication and Fellowship Awards Committees; and

• the Board of Trustees of the billion dollar Pension Fund for Ordained Ministers and Staff of the United Church of Canada, where he is a trustee.

Gordon has undertaken considerable research and public comment on corporate and pension governance, public policy and human capital matters. In the last eight years, more than a dozen of his papers, texts and articles have been published.

Gordon is a Fellow of the Society of Actuaries and a Fellow of the Canadian Institute of Actuaries. He is also a member of the American Academy of Actuaries, and the International Association of Consulting Actuaries.
20 Questions
Directors Should Ask about their Role in Pension Governance

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