

FINANCIAL SERVICES COMMISSION

JN Fund Managers Ltd Seminar

Theme: The Impact of Governance and Investment Decisions on the
Solvency of Pension Funds

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How the New Legislation Will Ensure Good Governance and Solvency

This seminar is happening at a very timely moment. As many of you understand the Pensions (Superannuation Funds and Retirement Schemes) Act, 2004 (“the Act”) was passed in September 2004 and was brought into force on March 1 last year. However, there appears to be some confusion about the status of the legislation and what is now happening, partly caused by inaccurate reports in the print media and partly because the situation is in fact somewhat confusing. Let me repeat, then, that the Act was passed in September 2004 and was brought into effect in March 2005.

However, there has since then been an extended delay in fully implementing this phase of the pensions reform because concerns raised in the Senate last year prevented the four attendant Regulations from being approved by that body. Without this approval the regulations cannot come into effect which means that the process of registration and licensing cannot commence.

The time has been well used, however, as the FSC and the Ministry of Finance engaged in a process of further dialogue with the parties who expressed concerns before the Senate Select Committee and with others. This dialogue has led to many improvements to the Regulations and also to some important changes being recommended for the Act itself. I am very pleased to say that after careful scrutiny by the Senate that body has now approved the Regulations as well as the changes that were recommended for the Act. The modified Regulations and the changes to the Act are now before the lower House for its approval.

It is important also to understand that the approval of the Senate has been obtained against the background of a strategy for legislative reform which has been divided into two phases. We can refer to them as the Regulatory Phase, or Phase I, and the Adequacy Phase, or Phase II. In the current phase the objective is to commence the long overdue process of registering and licensing the various participants involved in the provision of pensions services for the benefit of the workers of Jamaica. In Phase II issues relating to the adequacy of pensions will be addressed, which include the issues of portability, vesting and locking in of contributions. The regulatory framework for approved retirement schemes will also be focused on in Phase II. Finally, Phase II will include an opportunity for issues and concerns that were raised in the course of the implementation of Phase I to be addressed in amendments to the Act and the Regulations. It is intended that Phase II legislation will be completed by the end of the fiscal year that will be starting nine days from today.

WHY REGULATE PENSIONS

Needless to say, the new legislation has been controversial. I will not attempt in this presentation to extend the controversy but at least one question should always be asked. Why should pensions be regulated? Pensions represent a significant portion of the wealth of the average employed person. Pensions represent the difference between financial security and comfort, on the one hand, and continuing toil, suffering and even penury, on the other, for such persons when they reach retirement age. Because it is necessary to save over a lifetime in order to have an adequate pension in old age, it is difficult for the average person to commit to this course at an early age. It is also easy for mistrust and uncertainty in relation to the persons or entities who control these savings to translate, for the average person, into a disincentive to maintaining this commitment over the course of a lifetime.

Since March last year, when the Act came into effect, the FSC has received numerous complaints from concerned plan members. The alleged circumstances which have given rise to these complaints reflect a full range of problems which are confronting the pensions industry. Let me share with you some of the things that we have been hearing.

- Members being threatened because they refuse to sign documents with which they were not in agreement or did not understand
- Undue delays in the payment of benefits;
- Failure of the sponsor over a number of years to pay over employer's and employees' contributions;
- Information being withheld from members;

- Surplus amounts attributable to members, both in continuing plans and terminated plans have and still are being refunded to the employer. “Horse-trading” is usually the basis used to ensure allocation to members;
- Plan members have had to resort to litigation to resolve difficulties with trustees. Some of these cases are currently before the court;
- The rules of some pension plans have been changed or interpreted to facilitate a desired benefit payment to a particular person or group of persons;
- Members are made redundant except for a few. Pension plan is then subsequently wound up with the surplus going to the employer and the few remaining members;
- Plan being in deficit and as such only partial payments of benefits can be made;
- Pension funds being used to gain control in another entity;
- Financial losses incurred by schemes in circumstances where there is conflict of interest between the pension funds and the investment manager;
- Actions taken in extreme haste in order to wind up plans so that surpluses can be disposed of without scrutiny by the FSC.

For these reasons, amongst others, there is a recognised imperative for the sector to be regulated. This is not an exercise in theory. We must remember that retired persons have in shorter supply two fundamental resources that those of us engaged in the cut and thrust of energetic debate usually possess in full: time to correct and recover from mistakes and a regular income. The current Act and regulations are designed to achieve the objective of restoring and building up

further a sense of solid confidence on the part of workers in the safety of the financial arrangements for a pension in their old age.

GOOD GOVERNANCE

By their nature superannuation funds and retirement schemes are subject to conflicts of interest between the various stakeholders and the ultimate beneficiaries. As such they require a set of internal statutes and external regulations to ensure that they are managed in the best interest of the beneficiaries.

The concept of "governance" has been gaining currency for some time. What therefore is pension governance and what makes for good governance?

What is Pension Governance?

Pension governance is an effective system which holds pension decision makers accountable for results. A good governance system is flexible and allows for change that reflects past experience as well as emerging trends.

What makes for effective Governance?

Effective pension plan governance has, in my view, three important components:

1. Clear Accountabilities:

Management of pensions business lends itself to cascading decision making whereby decisions of varying impact requiring different levels of knowledge regarding policies, strategies, and day-to-day management can be assigned to different persons. There must be clear and well documented terms of reference

that are acknowledged and adhered to, as without these the danger exists that important policy decisions will not be made or will be made by inappropriate persons, with potentially costly and irremediable consequences.

2. Requisite Knowledge:

To be successful a pension system must have certain requisite core competencies. These must be identified, documented and nurtured so that they are preserved overtime. In addition a balance must be maintained between available pension core competencies and the complexity of investment structures.

3. Information Flow:

Information flow should be engineered based on the impact of major pension-related decisions and such that focus will be given to the primary purpose of the fund or scheme. Accountability can only be exercised with relevant information. This is an area where even limited intervention can yield considerable improvement in pension governance.

Good governance also considers administration, compliance, funding and investments. It also includes the building of constructive relationships between trustees, their service providers, and relevant supervisory bodies in an effort to manage the affairs of the pension plan and achieve its stated objectives.

IMPACT OF NEW LEGISLATION

Funding and Investment

The solvency of a superannuation fund or retirement scheme can be seen as a measure of the financial strength of a pension plan. Solvency represents the

hypothetical funded status of a plan if it were wound up or discontinued. Strategic planning for pension plans must examine how contributions and solvency will vary in different scenarios. Funding levels must be adequate to permit the payment of benefits. The management of the investments of superannuation funds and retirement schemes is no doubt an aspect of governance to which much effort has been devoted with positive results. Despite this however there is still room for improvement. The governance structures of a fund or scheme and external regulation therefore play an important role in investment strategies.

Actuarial Regulations, when drafted, will include a requirement that trustees must have in place a written policy regarding funding. This policy will address among other things how the objectives of the pension plan will be met.

Investment managers must follow prudent investment management principles consistent with their mandate as expressed in the Statement of Investment Policies and Principles which must be established by the trustees for each superannuation fund or retirement scheme.

Reporting

The new legislation provides for significantly improved level of disclosures by pension funds and their managers. This is critical to ensuring that plan members and beneficiaries will have adequate information to allow them to evaluate their financial options and, through their representatives, contribute to improving the efficiency of decision making and resource allocation. Improved disclosure will also permit the FSC to carry out its risk assessments as well as its monitoring of

the quality of financial management and corporate governance provided to the pension funds by trustees and their agents.

The Act and regulations also contain important provisions designed to safeguard the interest of plan members through complaints mechanisms and, amongst other things, recourse to the FSC. The disclosure provisions enshrine in the pensions legislation a right hitherto not available to pension plan members, whilst the complaints mechanism internal to a plan together with right of recourse to the FSC provide effective tools essentially empowering plan members to play important roles in the monitoring of their own plans. Most importantly, the right has been given to members to have member-nominated trustees who may only be removed by the members.

Duties and Roles of Stakeholders

Trustees:

Pursuant to the Act a superannuation fund or retirement scheme must be established under irrevocable trust. Each trust must have a Board of Trustees vested with power to administer the fund or scheme. Trustees are required under the legislation to review the performance of their appointed agents and advisors and thereby to satisfy themselves of the continued suitability of these persons. Trustees are ultimately responsible for ensuring adherence to the terms of the pension arrangement and are more accountable to the plan members and to the Commission.

Administrators:

To mitigate risk and establish sound governance in the area of administration, fund administrators must provide regular, timely, clear, fair, complete and

accurate information and reports to trustees, their advisors and agents.

Administrators must also prepare, update and maintain policies and procedures on security of information (privacy, backup), inquiries, complaints and such other functions necessary for the efficient running of a fund or scheme.

Investment Managers:

Pension fund governance has direct implications for investment strategies of superannuation funds and retirement schemes since this element together with administrative efficiencies determine fund performance. Investment managers must act in accordance with the parameters specified by the fund's trustees in their investment mandate as contained in the Statement of Investment Policies and Principles.

Role of the FSC

Governance problems in a pension plan are often demonstrated, for instance, through inability to pay pension benefits, mismanagement of pension assets, and confusion about responsibilities and expectation. The investment of pension assets also has a significant impact on solvency. Consistent with international best practice, the FSC has chosen to follow a risk-based approach to its pension supervision programme. The risk-based approach that will be utilised will be a useful tool for identifying irregularities such as significant breaches of investment regulations, unusual investment under-performance and serious asset-liability mismatches. In administering the Act and attendant regulations, the intensity with which the FSC scrutinizes registrants and licensees will be based on their risk profiles, as evaluated by the FSC. The Commission will be attentive to any warning signs of poor management and will promote the adoption of procedures designed to ensure stability and engender public

confidence. Effective plan governance and appropriate investment and actuarial policies will also aid in the management of risk inherent in pension arrangements and thus impact their long-term viability.

CONCLUSION

Pensions regulation plays a key role in the governance structure and solvency of pension plans. The benefit and value of pension legislation we believe lie partly in improving the framework for pension administration and investment by holding stakeholders accountable and by facilitating the means for assessing how well the pension plans and their service providers are performing. The greatest benefit, though, lies in the reinforcement that these measures provide to existing norms and standards of good governance and prudent financial management and the means that they provide for exposing to scrutiny by plan members and the FSC those who either cannot or will not meet those norms and standards. The FSC is committed to a process that will best deliver this reinforcement. We believe that structured dialogue with the stakeholders and practitioners will best ensure that this will be achieved. One of the positive outcomes of the controversies generated in this phase of the reform has been the close dialogue with affected parties that has ensued. We look forward to building on this base a continuing discussion amongst and between the stakeholders, the practitioners, the government and the regulator to this end.

Thank you.

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