



Crossing the Boundaries of Tradition

Forensic Reviews of Pension Plans

Presented by Al Kiel
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Agenda

- > Investment Issues
- > Governance Issues
- > Financial & Valuation Risks
- > Future Trends for Pension Plans
- > Questions

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Investment Fund Governance

Developing policy and structure:

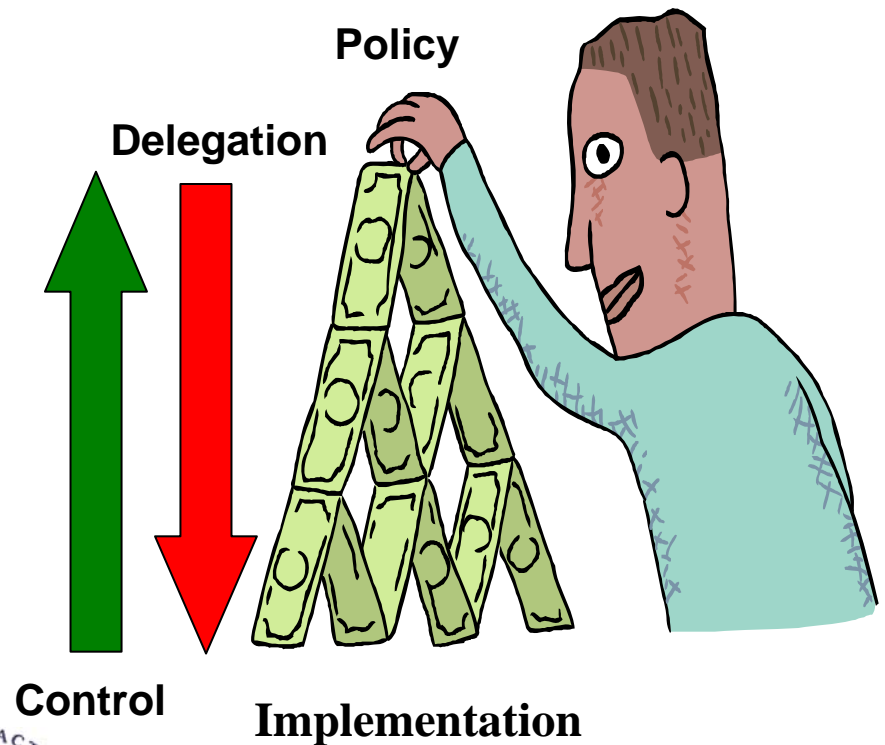
- Determining objectives (i.e. what we are trying to achieve)
- Defining risk

Implementation

- Appropriate delegation
- Linked to policy

Control

- Evaluating effectiveness of policy and implementation





Delegation Issues

- > Defining roles
 - Independence, segregation of duties, etc. (see Control Issues)
 - Setting expectations
- > Hiring agents
 - Appropriate due diligence
 - Determining competence, independence, etc.
 - Hiring an investment advisor is an investment decision
- > Supervision of agents
- > Conflicts of interest
 - Does this extend beyond the Trustees ?

Clear responsibilities = Accountability



Delegation Mini-Cases

1. Trustees rely on misleading reports from a third-party and find out “too late” that there are problems with an investment.
2. Legal counsel to the pension plan starts its own pension management company, which is hired by the plan. The plan is this company’s only client.
3. Legal counsel for a pension plan is responsible for drafting all the documentation for a condominium project and also purchases one of the condominiums.
4. An investment advisor convinces the Trustees to invest in “portfolio insurance” which ends up costing the fund a significant percentage of its overall value.
5. Investment advisor to a pension plan recommends a private equity investment in a company, and receives a commission from the company when the deal is completed.
6. An investment manager receives performance bonuses pursuant to its contract with a pension fund. The manager calculates the investment performance itself, and selects the benchmarks (after the fact). No performance criteria is specified in the contract or in the investment policy statement.

What is the requirement for independent verification?



Control Issues

- > Segregation of duties
 - Pension fund assets held separate from other assets
 - Separation of custody of assets and investment decision-making
 - Separation of investment management and brokerage functions
- > Appropriate authorization
- > Monitoring
 - Performance evaluation
- > Compliance
- > Valuation

Accuracy, completeness and timeliness of information flow is key



Control Mini-Cases

1. At an annual meeting, Trustees are asked to confirm all investment decisions made in the year (but there is a lag in reporting).
2. Investment policy has detailed restrictions on stock and bond investments, but very little restriction on real estate, private equity, etc.
3. Pension contributions commingled in a welfare fund.
4. A \$30 million dollar investment in real estate becomes a \$100 million investment, since the Trustees need to keep authorizing additional funds to keep the properties from defaulting on first mortgages.
5. Pension assets remitted directly to an investment manager or third-party adviser.
6. A pension fund's real estate investments are valued by an independent appraiser to be worth several hundred million dollars. These properties have lost money every year for several years on an operating basis (before depreciation or financing costs). The investments are maintained on the pension fund statements at book value.
7. Quarterly performance evaluation for third-party investment managers. In-house investments are excluded from the performance evaluation reports.

Typical examples of inadequate control



Transactional Issues

- > Does the investment decision make sense?
- > Appropriateness of due diligence
 - What constitutes an appropriate standard of care?
- > Reliance on third parties
- > Conflicts of interest
- > Why alternative investments are much “riskier” than public market investments

What is the industry standard?



Transactional Issues

- > Specific considerations
 - Independence
 - Suitability of investment
 - Size of commitment
 - Fit with the rest of the portfolio
 - Suitability of management
 - Financial viability
 - Adequacy of consideration
 - Reasonableness of pro forma projections
 - Adequacy of documentation
 - Adequacy of security
 - Appropriate termination/exit provisions
 - Priority
 - Potential for dilution

Prudence is procedural

Investment Decision Mini-Cases

1. Investment managers are hired to manage all the stocks and bonds, but real estate is managed directly by the Trustees.
2. A \$10 million private loan in a company becomes a \$40 million investment as the pension fund commits additional funds to cover operating costs. Pro forma company financial statements continue to show profitability in a few years time.
3. A special purpose investment corporation is established by a pension fund. The purpose of this corporation is to invest in certain venture capital deals. A third-party advisor is hired as the managing director of this corporation (with signing authority).
4. A trustee serves on the board of directors of a corporation in which the pension fund invests. The trustee is granted stock options as a member of the board.
5. Company X has a mortgage with the pension fund. A new company Y is established by former members of the Company X Board. The Pension Fund advances funds to Company Y, which buys the property from Company X, and repays the mortgage to the pension fund.
6. 25% of Fund assets invested with same third-party real estate company. In most cases, the pension fund is the sole investor in the properties in which this third-party real estate company invests.

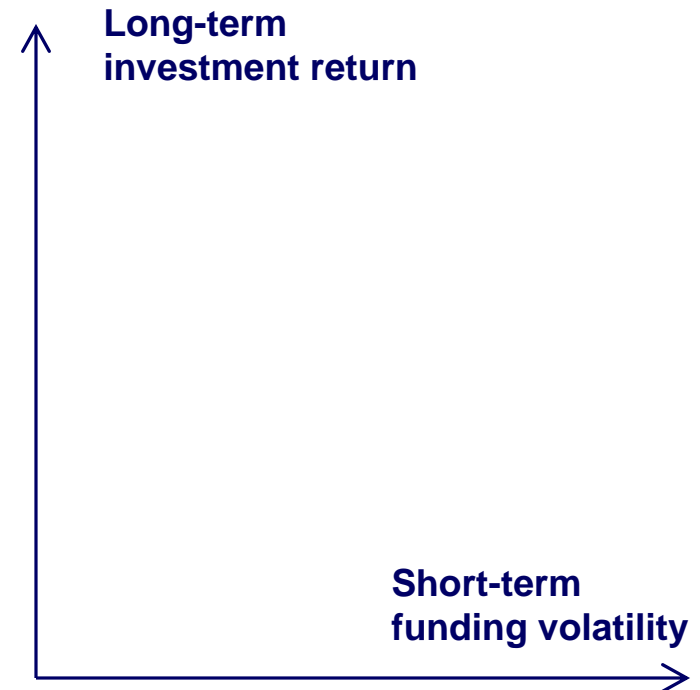
Need to have “a reasonable basis for an investment decision”



Pension Fund Risk...

...must be defined in terms of Fund Objectives:

- > **Objective 0:** Security of benefits
- > **Objective 1:** Maximizing long-term investment return (or minimizing long-term funding costs)
 - Reflecting investment time horizon
- > **Objective 2:** Managing short-term funding volatility
 - Reflecting valuation constraints



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Specific Considerations for Pension Plans

- > Lower risk tolerance
 - More sensitive to short-term funding volatility
 - Cannot afford, in a low rate environment, to invest primarily in bonds
 - Investments that smooth valuation may be attractive
- > Political pressures
 - Lowering benefits unattractive
 - Pressure to defer recognition of “problem investments”
- > Expertise and competence of trustees may be an issue
 - Seeking extraordinary performance
 - The investment industry tends to perpetuate myths to sell products
 - Expertise also required to properly delegate to agents and supervise agents
 - Relying “in good faith” on bad advice?



Governance Issues

- > Duties/responsibilities of trustees on pension boards v. other responsibilities.
 - possible conflicts: flexibility in interpretation of plan
 - issues with union official automatically qualifying as trustee
- > Compensation of trustees.
 - most not formally compensated, but serious issues around perks
 - significant need for guidelines around expenses; transparency
- > Legal implications of being on the board of trustees.
 - significant risks; need to recognize limits of knowledge



Governance Issues

- > Employers - Risk of joint and several liability for deficiencies.
- > Members
 - how are the interests of members and/or pensioners represented?
 - equity issues between generations of members?
- > Board
 - little guidance on how trustees are to be selected.
 - absence of meaningful statutory guidance on powers/duties.
- > Third Party Administrator - Possible conflicts of interest around collection of contributions.

Proper documentation is the key



Governance Mini-Cases

1. One of the duties of the auditor, as set out in the “Summary of Responsibilities”, is to check contribution remittances and the calculation of benefit payments. This does not occur.
2. Three separate parties (the Trustees, the Consultant and the Administrator) in the governance structure are indicated to have responsibility for administration of the plan.
3. The plan documentation gives authority to the Trustees and separately to the third party administrator of the plan to approve payment of expenses.
4. The trust agreement for a plan requires that the trustees meet not less frequently than every three months. There are occasions where this does not occur.
5. Plan documentation does not identify those responsible for member communication. As it is not clear that it is a necessary expense, insufficient communication with members occurs. Distrust and misunderstanding develops.
6. A committee is established separate from the board of trustees but with overlapping duties. This raises issues of accountability and encourages power struggles.

Need for “clear delegation and acceptance of responsibilities”



Financial & Valuation Risks

- > Quality of membership data
- > Collection of data and contributions
- > Non-remittance/late remittance of contributions
- > Crediting of interest on contributions
- > Calculation of members' entitlements
- > Benefit increases
- > Inappropriate expenses paid from the fund



Forensic Mini-Case

- > MEPP involving about 100 employers and about 1000 members
- > Board of trustees (management and union), TPA, and experienced consultants
- > Key findings of the forensic review:
 1. Non-compliance with reporting requirements
 2. Investments not held in the Fund name
 3. Inadequate standard of care exercised with investment of the pension fund
 4. Questionable remuneration of agents
 5. High-ratio mortgages/self-serving real estate investments
 6. Control over employer contributions
 7. Obvious membership data errors
 8. Calculation of benefit entitlements
 9. Crediting of interest
 10. Self-annuitization
 11. Forfeiture of contributions by re-employed pensioners
 12. Unfiled reciprocal agreements
 13. Inappropriate plan expenses
 14. Poor governance structure
 15. Administrative practices contravene plan terms
 16. Contravention of trust agreement
 17. Contravention of the pension statute
 18. Contravention of the Income Tax Act

An isolated incident or a common trend?



Future Trends of Pension Plans

- > Class action lawsuits
- > Resignation of Trustees
- > Appointment of third party Administrator
- > Terminate plan and distribute assets
- > Contingency reserves
- > Increased regulation and supervision



Questions?

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