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Pension Protection Fund

Future of the Risk-Based Levy - Reflecting good governance practices and risk management

MERCER



MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

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Tower Place, London EC3R 5BU

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1. Background and Introduction

Mercer has been appointed to assess the feasibility of reflecting through a discount, good governance practices in the Risk-Based Levy. This report sets out our findings, together with the options considered which, subject to the approval of the Board of the PPF, will form part of the next round of consultation concerning the future development of the RBL.

PPF interest in scheme governance

In November 2008 the Board of the Pension Protection Fund (PPF) published a “*Consultation on the Future Development of the Pension protection Levy*” which focused on “Unexpected risk”, attempting to take a longer-term view of insolvency risk, and “Investment risk”.

Following the consultation exercise, the PPF established a Steering Group to consider further the issues that arose from responses to the November 2008 consultation. In looking at these issues in relation to the technical elements of the levy, the Steering Group also recognised that scheme governance has a significant role to play in the management of key pension scheme risks. It therefore suggested that the PPF considers the practicality of extending risk characteristics to include scheme governance and risk management. The premise is that well governed schemes will present a lesser risk to the PPF. This together with their other findings is set out in their paper “*Future Development of the Pension Protection Levy: Feedback from the Steering Group*” published in March 2010.

The Steering Group considers that the key priorities in setting the levy are for

- fairness;
- transparency;
- predictability; and
- positive behavioural impacts.

In considering the impact of good governance practices, the Steering Group has indicated that, if implementation is practical, the benefit to trustees and sponsors should be a “modest” discount to the levy.

Our approach to this exercise

Our work in carrying out this exercise has included the following activity:

- A workshop with representatives from the PPF, the Pensions Regulator and the NAPF to draw out issues, to test appetite for implementation and to identify likely challenges;
- Desk-based research to establish whether, and how, other organisations including the FSA and other regulators have successfully managed to reflect the existence of good governance practices in levies or ratings as appropriate;
- Speaking directly with PPF Relationship Managers for anecdotal evidence of trends in governance practices of trustees and schemes entering the assessment period;
- Meeting with the consultants appointed to carry out feasibility and research into the fairness of the levy and reflecting investment risk in the levy in order to understand these work streams better in the context of our own work;
- Speaking with independent trustees for their insight on the current state of pension scheme governance; and
- Applying our own consulting expertise in governance, covenant assessment and funding in drawing our own conclusions about the feasibility of including governance risk as an element in the risk-based levy.

2. Pension Fund Governance

The development of pension scheme governance

The significant and rapid shift in the regulatory regime in recent years means that it is not surprising that the quality of pension scheme governance at the current time is, in practice, variable.

Historically, limited attention was paid by sponsors to pension schemes. Pension schemes tended to be small relative to the size of the sponsoring organisation. There was little regulatory oversight other than the limitation of the tax allowances through ceilings on benefits and funding. In the last 25 years, however, the landscape has shifted significantly, starting with the steady increase in benefit guarantees, followed by greater scrutiny through corporate accounting regimes, through to the regime with which we are now familiar with a heavy emphasis on improving funding and managing risk. For many companies, the pension fund can be equivalent in size to a significant operating unit, with a concomitant impact on corporate financial and reputational fortunes and prospects.

Expectations of trustees in response to these shifts in regime, however, have only really been ramped up in the last decade following the publication of the Myners Principles in 2001 and the Pensions Act 2004, in particular in relation to the change in the nature of funding decisions and the powers bestowed on trustees. The expectations of trustees are barely recognisable from those applying before the mid 1990s, and yet there is the expectation that they can be delivered by the same model of trusteeship that has existed for decades; that of the lay trustee.

The Pensions Act 2004 introduced a step change in expectations which were not articulated clearly; the Pensions Regulator (TPR) has focussed on improving pension scheme governance but initiatives to date have focussed on improving component parts of the governance process (eg internal controls, conflicts of interest etc) without necessarily clearly articulating or providing examples of an overall good governance architecture or setting out how to scale this to fit particular circumstances.

Therefore, it is left to practitioners to interpret and articulate what good governance in the round looks like and so it is not surprising that the quality of pension scheme governance is, in practice, variable. We observe that many trustee boards could increase the time, resource and skill applied to the appropriate governance of their schemes including the management of the key relationships on which their success relies.

Mercer insight into good governance practices

“There is a recognition that the quality of corporate governance ultimately depends on behaviour not process with the result that there is a limit to the extent to which any regulatory framework can deliver good governance.”

FRC review of the Combined Code of Corporate Governance, 2009

Mercer’s approach to good pension scheme governance is aligned with the key principles of corporate governance. The majority of trustee business is carried out in board meetings and so the board needs to be effective. Trustee boards face many challenges in becoming so, not least because of the way in which pension scheme trusteeship has evolved and the often inherent insufficiency of time, resource and skills.

We have seen only too clearly in recent years the results of a failure or absence of corporate governance and there are many lessons that pension scheme trustees can learn from the financial crisis. However, an over-riding theme of the many reports into the causes of the financial crisis was the lack of appropriate board behaviour leading the FRC to conclude the statement highlighted above.

This observation is equally pertinent to trustee boards which are charged with making significant decisions that will impact directly on the lives and fortunes of the members in whose interest they are acting. The existence of governance tools, such as risk registers or conflict policies is not a sufficient condition for effective decision-making and supervisory oversight of delegated activity.

It has been shown through research and surveys that better governed corporate organisations¹ and better governed pension funds² can deliver better returns, and in the case of corporate organisations, lower volatility in share price. Good governance, therefore, does contribute towards improved outcomes.

However, good governance involves the effective relationship management between two unequal parties; the sponsor and the trustees. Whilst the trustees have the fiduciary duty, it is the sponsor who has the money and much of the power. Therefore good governance is not a trustee only activity and we know that there is considerable variability in the control over defined benefit risk by corporate scheme sponsors as well as in the management of their relationship with scheme trustees. Governance, particularly with respect to PPF risk, is a joint responsibility which should not be overlooked.

The pension fund research cited above was carried out in North America and covered some of the largest pension funds in that area. Whilst there has been considerable qualitative research in the UK there has yet to be any extensive scientific, quantitative research carried out. However, we set out below some illustrations of governance practices and their links to value creation or value protection.

¹ ABI Research Paper 7: Governance and performance in corporate Britain, February 2008

² “Pension Fund Excellence” Ambachtsheer et al. Wiley, first published 1998

Illustrative examples

- Appropriate board structure combined with clearly articulated policies and processes, delegation and reporting protocols will allow opportunities to be pursued or preventative action to be taken in a timely manner (maximising up-side opportunities and minimising down-side risk). Example: dynamic implementation of investment strategy using an effective investment committee or fiduciary manager.

It was the absence of such structures that led to the failure by trustee boards to respond nimbly to the investment opportunities that arose during 2008-09. We have seen greater awareness and sensitivity to investment governance constraints and opportunities as a result of this hindsight.

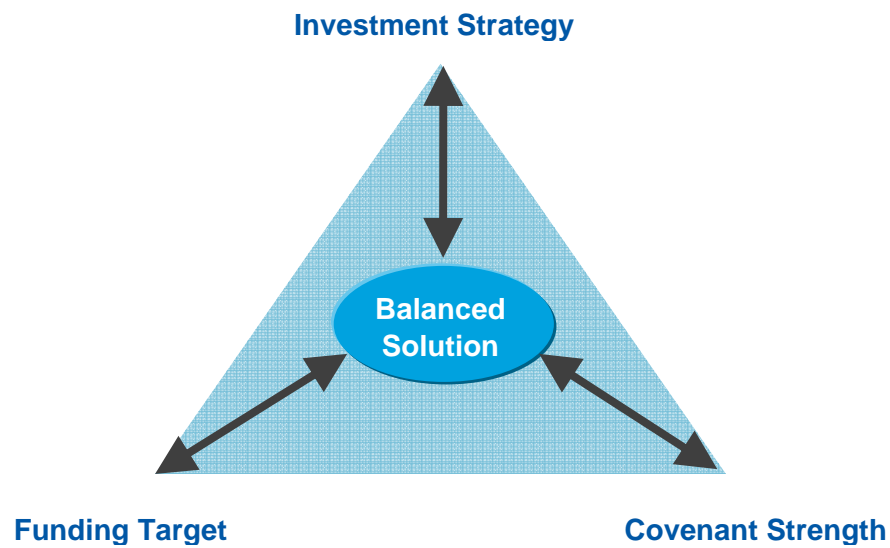
- Scenario planning by trustees (working out their response to a series of “what if?” type questions) allows trustees to be on the front foot in case such scenarios arise. Example: planning a response in case of corporate activity encompassing preparation of advisory team and negotiating positions.
- Active risk management provides a focus for trustees’ time and energy in managing their priorities allowing them to protect value but also to identify opportunities to create value.
- An appropriate level of oversight of many aspects of pension scheme management will facilitate early and cost-effective interventions should things go wrong (protection against down-side risk). Example: administration controls and service level monitoring.
- Appropriate knowledge, skills and behaviours enhance the decision-making process, improving the speed of decision-making and implementation, and the likelihood of a successful decision (maximising up-side opportunities).

Managing key risks

An active strategic risk management programme will provide trustees with a framework and focus for effective and timely decision-making. However, whilst the principles of an effective governance and risk management framework are applicable to all trustee boards, the practical application of the framework will differ according to circumstance and resource.

For the PPF, an improved outcome is a reduction in the risk of a call on the PPF. The factors that impact this risk the most are employer covenant (insolvency risk), current funding level (the funding risk) and likely funding level as impacted by investment risk and funding strategy.

An effective trustee board manages these three elements in concert, developing funding and investment strategies that reflect the risk inherent in the sponsor’s covenant, (recognising their own and the sponsor’s appetite for risk) and establishing appropriate governance practices to implement and monitor such strategies.



In managing these key financial risks, however, trustees should not lose sight of the many other risks inherent in a pension scheme such as operational and governance risks. An active strategic risk management programme will provide trustees with a framework and focus for effective and timely decision-making.

Whilst the principles of an effective governance framework are applicable to all trustee boards, the practical application of the framework will differ according to circumstance, preference and available resource. This combined with the acknowledgement that effective governance is as much about behaviours as it is about process presents a challenge in establishing an objective benchmark against which to measure performance universally.

These points need to be borne in mind as we consider the feasibility of recognising, and the extent to which credit might be given for, good governance practices in the RBL.

3. Others' Perspectives on Governance

In the majority of “similar” situations the level of and standards of governance are not taken into account in determining costs – i.e. there is no financial incentive for good governance.

Where it exists a quantitative or “checklist based” assessment of governance processes tends to be associated with limited reward.

The FSA provides an alternative model, including a qualitative assessment of governance processes where “good” governance can lead directly to a reduction in costs. However, the system requires significant monitoring resources and investment in ongoing relationships with each organisation that is monitored.

Our background research is summarised in Appendix A. In carrying out this research our aim was to establish whether, and how, other organisations had successfully managed to reflect the existence of good governance practices in levies or ratings as appropriate.

In doing so we looked globally for arrangements similar to the PPF (eg the Pension Benefit Guarantee Corporation, or PBGC, in the USA), to the corporate world, to regulated industries, and to pension fund benchmarks (eg the NAPF Pensions Quality Mark for defined contribution schemes).

The one example of an organisation that takes appropriate action based on, amongst many other elements, the degree of corporate governance and oversight exercised is the FSA's ARROW framework and Pillar 2 assessment. Details are set out in Appendix A but in summary, the assessed quality of oversight and governance will have a direct impact on the level of capital required to be held by an organisation.

The FSA is a well resourced organisation and actively manages relationships with regulated firms. These relationships together with detailed disclosure requirements inform the FSA's view on the risks being taken by the firm. Firms regulated by the FSA are likely to number in their hundreds rather than in thousands.

At the opposite end of the spectrum is the (voluntary) NAPF Quality Mark for defined contribution schemes. The administration of the Mark is funded through a modest application and ongoing servicing fee for those schemes which apply for, and successfully achieve, the Mark. The Mark requires schemes to demonstrate good governance although disclosure is very limited.

The USA's Pension Benefit Guarantee Corporation (PBGC) is the only organisation comparable in function and scope to the PPF. This is financed by premiums which are set by US Congress and imposed on defined benefit plan sponsors. It takes no account of governance in establishing the premiums.

The Netherlands does not have a PPF type arrangement but has two supervisory institutions which are concerned with financial stability and communications.

An example of a country that has chosen to tackle the quality of trusteeship directly is Australia. Australia is notable for its strict certification requirements on trustees, both individually and collectively as a board, to declare themselves fit to govern through compliance with a “Fitness and Propriety” Operating Standard.

Whilst the UK’s Trustee Knowledge and Understanding requirements are a step in this direction, trustee certification, for example achieving an Award for Pension Trusteeship through the Pensions Management Institute, is entirely voluntary. To move to an Australian type system of formal certification would require legislation and regulation.

4. How good governance might reduce risk to the PPF

Whilst trustees can do little about employer insolvency risk, they can manage their funding and investment risks accordingly and so it is the management of these risks in particular that we need to focus on when considering the impact of governance practices.

The likelihood of a scheme defaulting into the PPF depends on the insolvency risk of the employer. It also depends on the funding level of the scheme. It is the funding level of the scheme that represents the impact of the risk to the PPF.

The PPF manages its underfunding risk through its own investment strategy and through the collection of levies from all eligible pension schemes. At the moment, a scheme's levy is tied to the sponsor's short term risk profile and only loosely based on the scheme's risk profile. However, the need to raise a fixed amount of levy each year means that the level of levy charged to a particular scheme may change year on year even though the risk profile of the sponsor and scheme remains unchanged.

The PPF is currently reviewing the structure of the levy formula so that it better reflects the level of risk posed by each individual scheme in terms of the likelihood that an insolvency event might occur and the magnitude of any funding deficit on a prescribed basis. Levies are likely to continue to be capped on the grounds of affordability.

Trustees and sponsors therefore can, in theory, manage their levy liability by managing the risk of insolvency, the scheme's funding level and other forms of contingent financial support for the scheme.

Trustees can do little on their own, if anything, about the employer insolvency risk. They can, however, manage funding and investment risks, particularly in the context of sponsor covenant. It is therefore the management of these elements of the risk to PPF that we need to focus on when looking at the impact of good governance practices.

Key risk factors identified at our workshop

Many elements contribute to an overall risk of underfunding. The Steering Group had identified what it considered to be example risk factors.

Using the workshop, through a process of discussion and debate, we developed and refined these risk factors and identified corresponding influences on the risks. The output is set out in the table below.

Key risk factor	Influences on risk
Sponsor insolvency	Trustees have little or no control over the risk of employer insolvency although their assessment and monitoring of covenant will contribute towards their management of funding and investment risks.
Underfunding	Long-term funding strategy Deficit recovery Covenant Contingent assets
Investment	Advice, knowledge and understanding, risk assessment, monitoring, decision-making A separate work stream is looking at investment risk
Trustee competence	Responsiveness to events Conflicts (their own and those of their advisers) Relationship with the sponsor Knowledge and understanding
Record keeping leading to misstatement of liabilities and additional administration costs during the assessment period.	Existence of internal controls in the management of operational risk.

Mitigating actions

The governance activity in which we are interested for the purposes of managing risk to the PPF is that which seeks to manage the risk factors identified above.

We went on to work with participants of the workshop to identify trustee actions which mitigated the risk factors, taking into account those actions already identified by the Steering Group and bringing to bear our own experience of consulting with clients on these issues. Our objective at this stage was to identify the appropriate governance activity without considering whether or not the activity could be measured for the purposes of levy assessment. The output is set out in Appendix B.

Determining measurability of mitigating actions

In order to assess and offer reward for appropriate governance activity for the purposes of calculating a levy discount, mitigating actions need to be capable of being measured and the measure needs to provide a good indication of the active management of relevant risks.

The existence of governance tools alone is not a sufficient condition for good governance and risk management. Likewise, broad statements about trustee activity may not tell us enough to judge whether or not a particular risk is being managed actively.

Whilst the workshop participants identified many risk mitigating actions and activity, it was evident through discussion and debate that in many cases it was difficult to assess the quality and impact of these actions without further scrutiny or disclosure.

Illustrative example

Consider the following question:

“Which of the following issues has your trustee board considered in the past twelve months?”

Longevity risk

Dynamic investment strategies

De-risking

The trustees’ response to the Regulator’s guidance on record keeping

Whilst the list of issues can be designed to reflect what we might consider a well informed and organised trustee board to have looked at, putting a tick against a statement tells us nothing of the trustee board’s behaviours including:

- the quality of discussion and debate;
- whether conflicts of interest were effectively managed in the debate;
- the extent to which advice was taken (over-reliance or under-reliance);
- the degree to which decisions were taken in the context of a broader risk management framework;
- whether any decisions were reached.

All of which would demonstrate effective governance but which, in most cases, are difficult to articulate or assess without a significant amount of disclosure or direct observation.

Further commentary is provided in Appendix B.

5. Possible approaches to recognising good governance practices in the RBL

Following the workshop and taking into account the nature of the discussions, we considered and developed a number of options for recognising good governance practices in the RBL. These are summarised in this section.

Option	Key features
Simple checklist of governance activities and tools	<ul style="list-style-type: none"> ▪ Data simple to submit via Exchange ▪ Modest discount available for high level of correlation with benchmark ▪ Likely to be accessible by many pension schemes
Detailed disclosure and certification on a voluntary basis	<ul style="list-style-type: none"> ▪ Detailed disclosure to include the trustees' risk management programme, trustee selection procedures, relationship management, conflicts of interest management, how the board assesses its own performance. (This list is not exhaustive.) ▪ Certification by pensions professionals or pension scheme auditors ▪ Likely to be accessed by the larger, well resourced schemes
Develop the existing framework further first	<ul style="list-style-type: none"> ▪ Allow the regulatory regime to develop further before incentivising particular behaviours in due course.

We now consider these in turn, looking at the advantages and disadvantages of each and possible ways to address some of the disadvantages.

A simple checklist of governance activities and tools

Overview

A checklist would allow data and information to be submitted relatively easily through Exchange. To achieve reasonably comprehensive coverage of governance practices, the checklist should cover the following three areas:

- **governance tools;**
- **governance processes; and**
- **trustee board structure.**

To keep the assessment objective the questions in the checklist would need to be factual, avoiding reliance on opinion.

Consideration should be given to the verification of responses perhaps on a random fixed percentage or number of returns each year. Care and consultation with TPR would be needed in areas where there is potential overlap with areas that are essentially a requirement of regulations and Codes of Practice.

The level of discount should be modest for a reasonably high correlation with the desired benchmark.

Example

At its most basic the checklist would ask for confirmation of the existence of appropriate governance tools and practices. The following are examples and are not exhaustive.

Governance tools

Do the trustees have:

- a risk register
- a business plan
- a conflicts of interest policy

Governance practices

Do the trustees:

- monitor data quality
- carry out a covenant review of the sponsor
- carry out a self evaluation exercise
- carry out performance monitoring of advisers and providers
- actively manage relationships with sponsor, advisers and members?

Trustee board structure

Does the trustee board

- include an independent trustee
- use committees?

How does the trustee board identify and select member nominated trustees?

We would envisage providing relevant options as answers to some of these questions.

Further consideration would need to be given to making use of funding information, for example, strength of funding basis and length of recovery period. The danger in assessing these metrics is inadvertently creating another funding standard. Nonetheless, they may provide an indication of the level and quality of governance applied by trustees in their funding negotiations.

Requirements

- Establishment and ongoing review and update of an appropriate checklist
- Establishing an objective benchmark for compliance purposes and an associated transparent rating procedure
- Detailed decisions would need to be made as to the best practice frequency of update
- Translation of ratings into levy discount including whether there should be a sliding scale
- Audit / verification procedure

Advantages

- Ease of data and information collection
- Subject to establishing an appropriate benchmark and rating process, the levy discount should be transparent
- May encourage some trustee boards to implement one or two more governance activities
- The ease of data submission and therefore relatively low associated cost means that there would be few, if any, barriers to participation

Disadvantages

- Many of the items that would be covered by a checklist, whilst representing good governance practices, will be required by regulation or strongly recommended through Codes of Practice (risk register, conflicts of interest policy, covenant assessment) and therefore ought not necessarily to be rewarded through a discounted levy
- Statements may be misinterpreted or compliance with the checklist overstated given the financial incentive, although the latter point may be addressed through random verification
- Likely to be seen by many as additional bureaucracy and form filling, given that the list would need to be quite detailed
- Basic checklist compliance is unlikely to provide sufficient evidence to confirm that the overall risk to PPF is lessened because of governance practices. Therefore, it may not be desirable for risk-based levy amounts to decrease overall which means that any discounts given will have to be recouped elsewhere.

Addressing the disadvantages

Mercer's view is that the biggest disadvantage of this approach is that whilst it tells us what tools trustees have and the processes that they might go through, a checklist approach provides little or no information about how such tools are used or the quality of such processes.

Governance tools - example

Many trustee boards will agree that they have a risk register. However, our experience tells us that in some cases, risk registers are looked at annually or even less frequently with little or no reference to them in the meantime. An effective risk management framework will provide a point of reference for all decision-making and will be continuously updated in response to changing circumstances; trustees are therefore more proactive than reactive in their management of risk.

Governance processes - example

Trustee board self-assessment is considered good practice and indeed, if done well, can lead to significant improvement in board effectiveness. However, in our experience, the quality and therefore effectiveness of such exercises is variable. Self-assessment appears to be more effective when a board makes use of external facilitation. This external objectivity provides often necessary challenge to what might have become accepted behaviours.

Trustee board structure – examples

The presence of an independent trustee is generally perceived as strengthening governance. However, in our experience this is not always the case. Being clear about the role and purpose of an independent trustee is essential in finding the right person for the board. Not all independent trustees are professional trustees and some may still be perceived as having conflicts of interest; often former senior executives are retained as independent trustees immediately after retirement. Whilst this undoubtedly has many advantages, it does not deliver in all cases the level of independence that might be expected. The trustee board needs to ensure that any perception of a conflict is managed.

The use of committees is generally seen as a positive step towards expediting trustee business but they need to have clearly articulated terms of reference and very clear reporting protocols in order that the board remains sufficiently well informed.

These challenges may be partially addressed by expanding the checklist questions, although as discussed above, such questions need to remain objective and fact based and capable of being evidenced. We set out some examples below.

Do the trustees have a risk register?

If so;

- How frequently are the scheme's key risks reviewed?
- How often is the risk register as a whole reviewed?
- Are the risk register and key risks referred to during trustee and committee meetings?
- Is the risk register reviewed in response to a change in scheme or sponsor circumstance?
- Does the risk register include a means by which compliance with Codes of Practice can be monitored?

Does the trustee board keep member records under review?

If so;

- Does it reconcile population records, member details; GMP data with NISPI; and, pensioner existence checks?
- Does it apply TPR record-keeping tests?

Does the trustee board carry out a self-evaluation exercise?

If so;

- How frequently is such an exercise carried out?
- Does the trustee board use external facilitation to carry out this exercise?
- Has the trustee board implemented recommended changes from the most recent review?

Does the trustee board have an independent trustee?

If so;

- What type of independent trustee?
- Is there a clear role description?
- Does the trustee board review the performance of the independent trustee?

We would envisage providing relevant options as answers to some of these additional questions.

Conclusion

A basic checklist confirming the existence of certain tools and processes is at best a blunt measure of risk reduction. Additional questions, as indicated above, may provide a better, but by no means perfect, insight to the quality of governance, but will add significantly to the cost of data collection and maintenance.

Detailed disclosure and certification on a voluntary basis

Overview

Detailed disclosure addresses the shortcomings of a checklist approach. Such disclosure would allow trustees to explain their use and application of governance tools and processes in such a way as to allow a better assessment of the quality of these activities.

We envisage that detailed disclosure would need to cover:

- **the trustees' risk management programme;**
- **other agreed governance processes; and**
- **trustee board structure.**

Guidance would need to be published to allow consistent assessment and appropriate discounts to be applied. On the basis of limited resource, the PPF itself is not in a position to assess such disclosures and so a voluntary certification process would need to be established. We suggest that such certification can be provided by pensions professionals including pension scheme auditors.

The discount on the levy will have to be sufficient to incentivise disclosure and acknowledge good governance behaviours whilst bearing in mind the Steering Group's recommendation for a "modest" recognition.

However, given the complexities and many ambiguities currently present, and in the light of a lack of quantitative research, it is not possible to recommend an appropriate level of discount at the current time.

Example

Taking the risk management element of disclosure, we could look to the Turnbull guidance³ that provides guidance on the application of the relevant section of the UK Code of Corporate Governance:

Trustees would be asked for an annual statement including evidence that they have:

- considered what are the significant risks and how they have been identified, evaluated and managed;
- assessed the effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses in internal control that have been reported;
- considered whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- considered whether the findings indicate a need for more extensive monitoring of the system of internal control.

The intention would be to provide high-level but meaningful information in order to assist the PPF and the auditor or other person authorised to certify the disclosure to understand the main features of the risk management process.

³ FRC Internal Control: Revised Guidance for Directors on the Combined Code, October 2005

We would expect to see the following risk areas included in such a disclosure (the list is not exhaustive):

- covenant risk
- funding risks
- investment risks
- governance risks
- operational risks including data quality
- communication risks

Requirements

- Agreement on the areas of governance practice that should be covered by the disclosure
- Drafting of suitable guidance both for trustees and assessors, indicating the level of detail required and the elements of good practice that need to be evidenced in order to be eligible for the discount
- Translation of assessment into a levy discount including deciding whether there should be a sliding scale of discount.
- Additional guidance on the certification process itself, including format and submission of the certificate, authorised professionals, cost guidelines etc
- Agreement on frequency of submission

Advantages

- Detailed disclosure addresses the shortcomings of the checklist approach allowing trustees to provide a better indication of the quality of their governance practices
- Such disclosure, particularly if shared with members and sponsors demonstrates trustee accountability to stakeholders
- Could be added to the scope of the annual audit process
- Likely to lead to an improvement in governance practices over time for adopters

Disadvantages

- Detailed disclosure will take significantly greater effort than a checklist approach. There will be time and cost implications for the preparation of such disclosure in addition to the cost of the certification process
- Consistency of approach will be very difficult to achieve, at least at the outset, even with detailed guidance
- Consistency is made all the more difficult when acknowledging that whilst the principles of good governance are universal, the practical application does, and should, vary by scheme
- It is likely that this approach will be “self-selected” by those schemes for which the economic benefit will outweigh the costs of disclosure. It is therefore unlikely to promote universal improvements in practice and behaviour

Addressing the disadvantages

If it is concluded that detailed disclosure gives a better indication of the quality of governance and risk management there has to be an acceptance that there will be time and cost implications. In addition, the lack of universal requirement or self-selection is not necessarily beneficial to the industry as a whole. These might be addressed to some degree. The following provides some examples:

Limit disclosure to key governance practices

Since risk management is of priority to the PPF, disclosure might be contained to a detailed description of the trustees' risk management programme with particular focus on funding and investment risks.

Introduce for a proportion of schemes only

In the same way that stock exchange listing requirements often impose higher governance requirements on companies, detailed disclosure and certification could apply only to certain schemes. Size of scheme (which will correlate to PPF risk) is an obvious metric. This would limit the compliance costs, but would need careful thought with regard to fairness.

Introduction of regulatory requirements to disclose

The Regulator might wish to establish a requirement for all schemes to make certain disclosures which might be used or built upon for the purposes of PPF levy assessment. The Regulator and PPF would need to work together in establishing the required standards. See below under "Develop the existing framework further first"

Conclusion

There are many benefits to a detailed disclosure option but it is not without its difficulties: primarily the time and cost implications and the issues around creating appropriate guidance and applying it consistently. Reducing the scope of the disclosure may help but with it there is a loss of ability to reflect more broad governance practices within the levy formula.

Develop the existing framework further first

Allowing the regulatory regime to develop and drive governance disclosure standards would achieve wider accountability to members, sponsors and other stakeholders than doing so through the levy system. However, such standards could provide the basis for incorporating governance practices into the levy in due course.

If we consider the argument that governance is a means to an end then we could conclude that we need do nothing further since the impact of governance will be greater benefit security and well managed investment risk, both of which are, or will be, reflected in the levy already.

However, PPF and the Steering Group are keen to reinforce the regulatory messages about good governance and to encourage and to reward good practices where feasible.

Practical application and outcomes under the levy system

One of the Steering Group's objectives in looking at governance was to encourage universal improvement in governance practices over time. On the assumption that we are considering a discount on the RBL only, this is unlikely to be achieved:-

- Some schemes will be sufficiently well funded with a strong sponsor covenant to attract only a relatively small or zero risk based levy. That said, the PPF will be concerned to make sure they stay that way and good governance will certainly be a factor.
- Some schemes at the opposite end of the scale will be so poorly funded and with weak covenant that even if a discount were applied for good governance, it is very likely that their levy would be capped in any event.
- Smaller schemes may consider that reporting costs outweigh the benefit of a discounted levy.

In both cases, there would appear to be little or no financial incentive to submit governance information. (It would be a matter for further discussion as to whether a scheme with a capped levy should be eligible for a governance related discount and whether a scheme without an RBL could be offered a discount on the scheme-based levy instead.) Of course, the status of schemes can and does change over time and so at some point during its lifetime, a scheme will fall into the middle band where it may well benefit from a governance related discount.

Allow the regulatory regime to develop further

As we commented earlier, there has been a step change in the regulatory regime in recent years. As with any significant change, it takes a while for systems, standards and expectations to bed down. One option, then, could be to allow this process to develop further without changing the existing landscape.

Whilst the Regulator encourages the use of tools and guidance, there is insufficient articulation of the overall expectation for scheme governance and a lack of agreement as

to the desirability of improved governance and its purpose. The principles underlying the newly revised Code of Corporate Governance and its associated disclosures, could be usefully applied to the pensions industry, in particular the Code's holistic framework beneath which sit best practice guidance and tools. Whilst we would not necessarily advocate disclosures to the extent of corporate disclosures, PPF could perhaps encourage and work with the Regulator to revisit the proposal made a number of years ago to require trustees to make a governance disclosure in their annual report. Done within an overarching governance code (we would point to the existing investment governance principles as a good starting point), notwithstanding the risk of boiler plate compliance, disclosure and accountability to members and other stakeholders may have a more substantial impact on behaviour than trying to achieve this through the levy system.

We would envisage the PPF building on these principles in due course in bringing governance into the levy assessment. It would also allow the PPF to monitor the governance practices of larger schemes that may sit just outside the RBL but for whom an unexpected but significant event might impact covenant or funding level.

Advantages

- Expectations, including disclosure requirements, for good governance are set universally and are managed by the Regulator, who will provide support through best practice guidance and tools.
- Disclosure, and the audit thereof, will become accepted practice.
- PPF can then use pre-existing disclosures to assess schemes for levy discount purposes.

Such an approach would be akin to the funding regime which is established by the Regulator but where PPF assesses schemes' funding against its own prescribed funding standard.

Disadvantages

- An immediate missed opportunity to increase the momentum of improving standards of UK pension fund governance.
- Timing and delay in rewarding good practices given the reliance on the Regulator to develop the regime further, entailing as it would, drawing up and consulting on proposals.

Addressing the disadvantages

We are aware that the Regulator has issued a tender document⁴ for the appointment of a governance advisor, perhaps indicating that it is going to be looking at pension scheme governance in the very near future. That being the case, there is a real opportunity for PPF and the Regulator to work together to develop a fit for purpose risk-based governance framework.

⁴ Tender: UK-Brighton: pension services, 2010/S 119-180552, published 23 June 2010

Conclusion

By adopting a phased and coordinated articulation of required governance standards there is less opportunity to drive immediate improvements in governance standards. However, there are advantages in the PPF and the Regulator developing an appropriate code or regime in tandem which can be used to grant levy discounts in due course.

6. Conclusions

Governance has a significant role to play in the management of key pension scheme risks. Incentivising good governance behaviour through the risk-based levy is possible but there are considerable challenges.

In this report we identify and consider the advantages and disadvantages of three approaches:

- A simple checklist of governance activities and tools.
- Detailed disclosure and certification on a voluntary basis.
- Develop the existing framework further first

With any approach there is a trade-off between ease of data and information submission and the level of insight provided about the quality of governance practices which ultimately tells us about how well the key risks are being managed.

The difficulties are compounded, we believe, by a lack of consensus in the industry as to what constitutes good governance and what it can achieve, and the wide variability of practice. However, the Pensions Regulator has a central role in bringing together and improving industry consensus. A regulatory initiative to drive standards in governance and related disclosures could provide the standard against which the PPF would assess schemes for RBL purposes in due course. The PPF could be instrumental in helping to make these changes.

There are still challenges to be addressed in taking this proposal forward; each of the options presented leaves a measurable gap between the aspiration and the practicality of delivery even before we address the challenge of what should be the magnitude of the discount itself.

In our view, perhaps the most attractive route identified in this report is for PPF to work with the Regulator in the near term in developing a code or regime with appropriate focus on factors that might correlate to high risk cases for the PPF. Such a framework would provide a platform for possible incentivisation of good governance practices through discounts to the RBL, albeit from a future date.

Rachel Brougham
Mercer Limited
August 2010

Appendix: A. Background research

Overseas regulatory bodies

We chose to look specifically at the USA and the Netherlands (on the basis that these both have maturing defined benefit pension schemes).

USA

The USA's Pension Benefit Guarantee Corporation (PBGC) was the only organisation comparable to the PPF. It is financed by premiums which are set by US Congress and imposed on defined benefit plan sponsors. These do not take into account governance practices; there is a flat-rate premium based on the number of participants (or members), a variable-rate premium which only applies to certain under-funded plans and is based on the extent of under funding, and a termination premium imposed on certain sponsors on the termination of a plan. The PBGC's operations are also financed by investment income, assets from pension plans taken over by the PBGC, and recoveries from the companies formally responsible for these plans. The PBGC receives no funds from general tax revenues.

In order to carry out its functions, the PBGC issues regulations interpreting such matters as the termination process, establishment of procedures for the payment of premiums, and assessment and collection of employer liability.

PBGC uses the Early Warning Program to monitor certain companies with underfunded defined benefit pension plans to identify corporate transactions that could jeopardize pensions and to arrange suitable protections for those pensions and the pension insurance program. The key to the program is identifying those companies that represent PBGC's biggest risks and stepping in early to negotiate additional protections when problems are identified. PBGC has therefore developed specialised tools, technology and financial expertise, and also relies on information sharing among the Department of Labor, the Internal Revenue Service and the Securities and Exchange Commission. In addition, the plan administrator is obligated to report to the PBGC certain reportable events that could potentially cause financial difficulty.

For further information, please visit the below site:
<http://pbgc.gov/FAQ/premiumfaq.html>

Netherlands

Membership of a pension fund is obligatory for virtually all employees in the Netherlands and the employer must ensure that the pension benefits it provides are funded through a pension provider that is separate from the employer. Whilst there is no organisation similar to the PPF, there are two bodies that supervise pension institutions.

De Nederlandsche Bank (DNB) is responsible for safeguarding financial stability and for exercising prudential and material supervision of the Dutch pension fund sector and pension funds' compliance with pension regulations. Prudential supervision is described as supervision focusing on the financial solidity of pension funds and material supervision relates primarily to the content of the administration agreement between employer and pension provider. In order for the DNB to exercise adequate supervision, all Dutch pension funds are required to make periodic statement reports to DNB. These statements comprise of financial information and data on pension fund membership and type of pension scheme. DNB also has several legislative powers to help it carry out its supervision objectives such as the power to issue warnings and impose fines.

The Netherlands Authority for the Financial Markets (AFM) is responsible for supervising the operation of the financial markets and conduct of financial undertakings. The supervision carried out by AFM primarily relates to communications from the pension provider to employees who are acquiring or have acquired pension rights.

For further information, please visit the below sites:

<http://www.statistics.dnb.nl/index.cgi?lang=uk&todo=Pen>

<http://www.dnb.nl/openboek/extern/id/en/pf/41-117250.html>

<http://www.afm.nl/en/professionals/over-afm>.

Australia

Australia's pensions market is primarily defined contribution. However, it is notable for its strict certification requirements on trustees, both individually and collectively as a board, to declare themselves fit to govern through compliance with a "Fitness and Propriety" Operating Standard. They must have adequate financial, technical and human resources to conduct operations and must implement a risk management framework.

For further information, please visit the following site:

<http://www.apra.gov.au/Superannuation/>

The Financial Services Authority's ARROW Framework

The ARROW Framework is used by the Financial Services Authority (FSA) to assess and monitor risks to its statutory objectives. This will determine the level of scrutiny a regulated firm receives; allowing the FSA to focus its attention and resources on the risks and associated firms that matter most.

The FSA carries out an assessment of the risk posed by each regulated firm. This involves defining the inherent or gross risks within a firm, its controls (the "primary risk controls of the firm, which should directly reduce the inherent business risk"), its oversight and governance (the "secondary and pervasive controls of the firm") and other mitigants (the amount of excess capital and liquidity)⁵. It is the level of risk associated with each of these categories that ultimately determines the nature of the FSA's relationship with a firm. Its risk assessment is extensive and includes a site visit. Also, it will take further action where necessary to mitigate risks. Of course, the FSA is a large body with the resource to support such a framework.

The ARROW score for oversight and governance is also taken into account for the FSA's Pillar 2 assessment (where it provides guidance to firms on the amount of capital they should hold, given their risk profile, strategy and capital resources). If the oversight and governance of a firm is considered to be low risk, it can reduce the amount of recommended capital by 10%. If considered high risk, it can increase recommended capital by up to 50%.⁶

The FSA is financed wholly by fees charged to authorised firms and also collects the levy for the Financial Services Compensation Scheme (FSCS). A firm's ARROW score for oversight and governance does not affect its FSA fee or FSCS levy. This is determined by, for example, the type of business it carries out and the number of authorised people within it.

For further information, please visit the below site:

<http://www.fsa.gov.uk/Pages/about/index.shtml>

The Association of British Insurers' Institutional Voting Information Service (IVIS)

This service produces detailed analysis on companies in the FTSE All-Share index and is subscribed to - and therefore funded - by a range of institutional investors and investment institutions (subscribers hold approximately 35% of the equity value of the FTSE All-Share).

The IVIS team reviews company reports and accounts and meeting notices for compliance with corporate governance best practice. It also engages with market participants and companies where appropriate. It uses a colour coding system to highlight the seriousness of corporate governance related issues (a "red top" = a cause for concern, an "amber top" = self explanatory, a "blue top" = no issue and a "green top" = an issue which has been resolved). IVIS does not adopt a "one size fits

⁵ *The FSA's risk-assessment framework handbook (dated August 2006)*

⁶ *The FSA's Pillar 2 assessment framework handbook (dated May 2007)*

all” approach to assessing corporate governance and will take into account a company’s individual circumstances when making decisions on colour coding.

The level and quality of disclosure in company reports and accounts will vary, but is generally conducive to an objective assessment of corporate governance. Also, meeting notices will provide detailed and useful additional information. Further engagement with market participants and companies is clearly required to reach decisions on colour coding, but there are only c.600 companies in the FTSE All-Share index - compared with thousands of UK defined benefit (DB) occupational pension schemes – which makes this approach more feasible.

For further information, please visit the below site:

<http://www.ivis.co.uk>

The Institute of Chartered Secretaries and Administrators’ Transparency in Governance Award

This is an initiative launched by Institute of Chartered Secretaries and Administrators (ICSA) in partnership with Hermes Equity Ownership Services. It rewards high standards of disclosure in a company’s report and accounts, with the aim of encouraging improvements both in the disclosure process and in governance performance itself.

Annual reports of all FTSE 100 and FTSE 250 companies are reviewed by ICSA and Hermes, with only those meeting the highest standards of disclosure being short listed.

As mentioned above, the level and quality of disclosure in company reports and accounts will vary but it is generally more conducive to an objective review of corporate governance practices. Also, in this case, ICSA and Hermes have limited their review to FTSE 250 companies.

For further information, please visit the below site:

<http://www.icsa.org.uk/events/icsa-awards/icsa-hermes-awards>

National Association of Pension Funds (NAPF) Pensions Quality Mark

The NAPF award is for employers sponsoring defined contribution (DC) pension schemes (both trust- and contract-based), which meet three core tests, one of which relates to scheme governance.

In respect of the governance element of the Quality Mark, NAPF requires that “governance arrangements must be in place to ensure that the scheme is operating in the best interests of members. This could take a variety of forms including trust boards, management committees or an annual scheme review”.

The application process includes a series of limited disclosures on scheme governance which are self-certified, although the NAPF reserves the right to verify disclosures. The administration costs of the Quality Mark are met through a modest application and ongoing servicing fee for schemes attaining the Mark.

The Pensions Quality Mark was launched in 2009 and has been awarded to c.50 schemes at the time of writing.

For further information, please see the below:

<http://www.pensionqualitymark.org.uk>

Regulated Industry

We looked at OFWAT and its regulation of water companies. OFWAT is financed by licence fees charged to regulated water companies.

Water companies are required by their license to submit an annual return covering their activities in the previous financial year. This is the primary source of information required by OFWAT. In monitoring water companies, it also relies on whistle blowers and information provided by other relevant parties. If a water company falls short in any area, OFWAT will take the action necessary to protect consumers' interests, which may include legal steps such as enforcement action and fines.

The level of disclosure in annual returns and OFWAT's analysis of these is extensive, but there are only c.30 water companies currently regulated by OFWAT. OFWAT's assessment of water companies' performance does not affect their licence fees. These are subject to limits set out in each water company's licence and negotiations with HM Treasury. Fees are generally based on an estimate of OFWAT's costs at the start of each year and will vary depending on the size of each company's turnover. Any excess fees not spent at the end of the year are returned to HM Treasury and can be used to offset against future fees. Water companies are of course able to pass the cost of licence fees on to consumers.

For further information, please visit the below site:

<http://www.ofwat.gov.uk>

Input from members of the PPF's Relationship Team

We are grateful to PPF Relationship Managers, Pat Martin and Graham Bowtle, for their time and input to our research. We were particularly interested to hear whether, in their opinion, there were trends in governance related activity amongst schemes entering the PPF assessment period.

Some key issues shared with us included:

- Contingent assets are perhaps not being taken advantage of by trustees as much as they could be
- Once in the PPF assessment period, trustees often have little apparent sense of urgency when carrying out the requisite tasks
- Trustees often do not appear to have a grasp of data issues, nor do they fully understand their responsibility to resolve these once in the assessment period. The quality of data is generally worse where there has been a change of administrator.

In spite of the above, the relationship team is seeing improvements in areas where the Pensions Regulator (TPR) has recently launched governance related initiatives. For example, in the management of conflicts of interest, the monitoring of employer covenant and levels of trustee knowledge and understanding.

A view from independent trustees

We are grateful to Chris Martin of Independent Trustee Services and Mark Ashworth of Law Debenture for their time and input to our research. We were particularly eager to get their views on the current state of scheme governance, and the effect appointing an independent trustee has on this.

Some key views are outlined below:

- The quality of scheme governance is still hugely variable.
 - Large schemes by asset size tend to have better governance structures in place and the resources to support them. These schemes are less likely to pose a risk to the PPF
 - “Distressed” schemes where governance will be very low down the priority list and the significant risk to the PPF will already be reflected in the levy
 - Schemes in the “middle ground” where things are perhaps ticking along but not enough time has been invested in putting in place a good scheme governance framework
- Independent trustees can do a lot to improve pension scheme governance practices. However, the appointment of an independent trustee does not in itself guarantee better scheme governance. Trustees need to ensure they select the right individual and be clear on their definition of independence.
- Good scheme governance has not yet been sufficiently defined within the industry. This should be done before we start trying to measure it objectively
- Agreed that ticking boxes for modest reward was not appropriate – it would promote the wrong type of behaviour.
- Demonstrating good scheme governance for PPF levy purposes could be seen by employers as an additional expense.
- If allowing for scheme governance in the RBL is a public policy initiative to improve practice within the industry, they would suggest this is better left to TPR. The PPF should focus purely on a quantitative analysis of the key risks.

Appendix: B. Assessment of mitigating actions

Sponsor insolvency / covenant	Annual presentation from sponsor based on credit rating agency information
	Quantitative assessment of reliance on sponsor based on current investment strategy
	Quarterly review of covenant capacity in cash terms vs contribution requirement
	Protocol establishing an ongoing requirement to share information which would have an impact on the covenant
	Independent assessment of employer covenant
	Confidentiality agreements in place
<p>The insolvency of the sponsor is the trigger for PPF assessment. Whilst trustees are unlikely to be able to influence the risk of insolvency, they are able to adapt funding and investment strategies in response to changes in sponsor covenant. Assessing and monitoring covenant is, therefore, a key trustee activity and can be carried out in a number of ways. However, as with all other governance practices, there is not a single right approach to covenant assessment and monitoring.</p> <p>Effective covenant assessment and monitoring (which also relies on trustees being able to understand and interpret the information presented in order to make appropriate decisions), therefore, ought to manifest itself through improved member security and better managed investment risk.</p>	
Underfunding	Strong basis (technical provisions) – financial and demographic assumptions - and short recovery period
	Robust discussions with employer as part of funding process, managing conflicts of interest and taking advice independent to that provided to the employer
	Group underwrites the total costs through funding and deficit recovery regime
	Surplus cushion required before contributions suspended
	Annual funding checks to monitor progress against funding objective
	Contractual arrangement covering the 3+ year period of the Statement of Funding Principles
	Public statements from sponsor's board about support for the fund
	Explicit guarantees, contingent assets

Investment	Liability driven investment strategy
	Dynamic investment strategy
	Risk budget determined in conjunction with sponsor, taking into account sponsor covenant, within which trustees manage their strategy
	Regular monitoring of investment performance with appropriate triggers for pre-determined action
	Delegations made to expedite decision-making and / or implementation
<p>Improved scheme funding and better management of investment risk are two key outcomes of better governance. However, it is a question of combining the appropriate governance processes for a particular scheme with appropriate governance behaviours in order to maximise potential outcomes.</p> <p>Deficit recovery contributions are already taken into account to the extent that they have been paid and so strong technical provisions and a short recovery period should be reflected in year on year improvements in the underfunding risk, all things being equal.</p> <p>Additional security through contingent assets is already recognised although is limited to those contingent assets that are recorded in accordance with the PPF’s contingent asset regime. We know that many schemes have additional security that does not fit the PPF regime but nonetheless is additional meaningful security for the benefit of the members. However, PPF has indicated that although it reviews the contingent asset regime periodically, it would not wish to weaken it in order to take into account arrangements that are currently ineligible.</p> <p>In this review of the levy, the PPF is looking to introduce investment risk to the formula. This will be accounted for by calculating the levy on the deficit that is derived by stress testing the assets and liabilities.</p> <p>At a strategic level, therefore, those schemes whose strategies more closely reflect the liabilities (eg LDI) or have embarked on a programme of de-risking, subject to the parameters and flexibility of the stress tests, ought to demonstrate less volatility in funding level and hence be charged a lower levy than might otherwise be the case.</p> <p>Those practices that enable schemes to be better positioned to take advantage of market opportunities through appropriate delegation will manifest themselves in improved outcomes, be it better investment returns or reduced investment risk.</p> <p>It is fair to conclude that governance activity which supports funding and investment will be reflected in improved outcomes which are already taken account of within the levy formula. Making allowances for good governance in the formula would, in effect, be double counting the benefits.</p>	

Trustee competence	Effective decision-making process – planning, conflicts, advice, risks, challenge, debate etc
	Strategic and active risk management
	Active relationship management – sponsor, advisers, members
	Conflicts of interest policy agreed and implemented
	Knowledge/experience/training of trustees on investments/funding/covenants issues
	Participation of an independent trustee from the approved list of the Pensions Regulator
<p>Strategic risks i.e. risks relating to the way in which the trustees govern the scheme are perhaps the most difficult types of risk to assess meaningfully.</p> <p>There is an opportunity here to reinforce the Regulator’s current governance campaign (including for example trustee training, management of conflicts, internal controls etc). However, as the FRC noted in its review of the combined code of corporate governance:-</p> <p>“There is a recognition that the quality of corporate governance ultimately depends on behaviour not process with the result that there is a limit to the extent to which any regulatory framework can deliver good governance.”</p> <p>There is, therefore, limited value in asking trustees to confirm completion of the Trustee Toolkit or the existence of governance tools (such as conflicts of interest policies, risk registers and business plans) except as a minimum compliance level, unless we understand how they are used. This cannot be done without additional disclosure and commensurate cost.</p>	
Quality of records	Regular data reconciliations (member information)
	Data and calculations audit
	Existence checks
	Regular updates of scheme documentation
	Monitoring complaints and taking appropriate action
	Appropriate oversight of operational functions
<p>Poor quality of records can cause delays and potential miscalculation of liabilities. Putting it right can be an expensive and lengthy exercise and may eat into the funds otherwise available for securing PPF benefits. It is therefore in PPF’s interest that data is in good order in respect of the schemes it accepts.</p> <p>However, TPR has recently consulted on tougher requirements for record keeping which should lead to improvements in the quality of data in any event.</p>	

Appendix: C. Acknowledgements

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The Pensions Regulator:	Phil Spary, Policy Lead (Accountant)
NAPF:	James Walsh, Senior Policy Adviser: Workplace Pensions

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MERCER



MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Mercer Limited
Clarence House, Clarence Street
Manchester M2 4DW
+44 (0)161 832 5688

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