

**THE STATE OF GLOBAL PENSION FUND GOVERNANCE TODAY:
BOARD COMPETENCY STILL A PROBLEM**

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PAPER ABSTRACT

A 1997 investigation into the quality of pension fund governance uncovered a widespread board competency problem. This follow-on study analyzes the findings of a new survey on pension fund governance, to which an international group of 88 senior pension fund executives responded. Survey responses indicate that the board competency problem has not disappeared. As was the case in 1997, we found a positive correlation between governance quality and fund performance. The new results also suggest that selection processes for members of the board of governors continue to often be haphazard. Self-evaluation of board effectiveness continues to be the exception rather than the rule. Weak oversight functions continue to lead to difficulties in sorting out the competing financial interests of differing stakeholder groups, and result in organization dysfunction. Examples are lack of delegation clarity between board and management responsibilities, board micro-management, and non-competitive compensation policies in pension funds. We recommend a number of specific actions to address the governance challenges that continue to face pension funds. We also recommend that regulators require pension funds to regularly report on the actions they are taking to strengthen their governance processes.

Why this Paper?

The well-publicized misadventures of such major corporations as Adelphia, Ahold, Enron, HealthSouth, Parmalat, Qwest, Tyco, WorldCom, have triggered important new empirical and more conceptual research efforts in the field of corporate governance ^[1].

Pension fund governance has not yet garnered the research attention that corporate governance has ^[2]. We are aware of only a few published efforts with an empirical dimension. For example:

1. Anthropologists O'Barr and Conley caused a stir with their 1992 book *Fortune and Folly: The Wealth & Power of Institutional Investing*. Based on observing behavior at nine major US pension funds over a two year period, they concluded that the aim of pension fund governance appeared to be focused more on responsibility deflection and blame management than on good governance and creating value for fund stakeholders.
2. Ambachtsheer, Boice, Ezra, and McLaughlin designed a survey that was answered by 50 senior pension fund executives in December 1994 during a symposium titled "Excellence in Pension Fund Management: What Is It?" Asked to estimate the 'excellence shortfall' in their organizations, the median response was a material 66 basis points. Asked to identify the sources of excellence shortfall, the three causes mentioned most frequently were poor decision processes, inadequate resources, and lack of focus or mission clarity.
3. Ambachtsheer, Capelle, and Scheibelhut conducted a predecessor study in 1997 to the one described in this paper. They found a positive correlation between pension

fund governance quality and organizational performance, and identified a number of specific fund oversight and management factors important performance drivers. Governance difficulties similar to those documented in this paper were uncovered. The results were published as “Improving Pension Fund Performance” in the November/December 1998 issue of the *Financial Analysts Journal*.

4. Clark, Caerlewy-Smith, and Marshall studied the problem-solving capabilities of pension fund trustees in the U.K. in 2006 and found these capabilities “surprisingly heterogeneous”, with potentially significant implications for pension fund governance.
5. Clapman et al. listed a litany of governance-related problems in U.S. pension funds and recommended a list of ‘best practices’ governance principles to deal with them in 2007.

The paucity of empirical research to date leaves considerable knowledge gaps in pension fund governance and its effectiveness. The goal of this paper is to fill in some of these gaps. What is that state of pension fund governance today? What are the opportunities for improvement, possibly supported by regulatory measures? Does better pension fund governance lead to better financial outcomes such as investment performance? These are the key questions the paper will address.

One final definitional note before we get into the details of the study. Throughout the paper, we will use the term ‘pension fund governance’ as a broad descriptor covering all aspects of decision-making processes inside pension funds. We will use the more specific terms of ‘oversight’, ‘management’, and ‘operations’ to distinguish between responsibilities and activities typically reserved for boards of governors (or trustees, or directors), responsibilities and activities generally delegated by a board to senior management, and responsibilities and activities generally delegated by senior management to other professionals either inside, or outside the pension fund organization.

Research Design

To gather information on pension fund governance, we designed a survey to be answered by a pre-selected group of senior pension fund executives with titles such as Chief Executive, Chief Investment Officer, Executive Director, VP-Pensions, etc. The common factor among these pension executives was that their funds had supplied return, cost, and risk-related data to *CEM Benchmarking Inc.*, an organization that measures the cost-effectiveness of pension fund organizations around the globe. We received completed surveys from 88 pension executives. For 81 of these 88 respondents, we also had complete sets of fund data ending in 2004. The aggregate assets of these 81 funds amounted to \$1.4 trillion dollars at the end of 2004. Table 1 provides additional information on the characteristics of these 81 funds. Note the sample represents a good mix of funds by both geographical and sponsor-type criteria.

The survey itself consisted of two parts. One part asked the pension fund executives to assign a rank from 6 to 1 to each of 45 statements related to various aspects of the oversight, management, and operations areas of their own pension fund. Each statement was phrased so that the higher the assigned ranking, the more favorable the senior executive's view was of that particular element or activity of fund oversight, management, or operations. For the 81 completed surveys received for which there was also 5-year fund performance data available from *CEM Benchmarking Inc.*, the 45 rankings were averaged to create a single 'CEO Score'. The other part of the survey asked two open-ended questions, one about the key oversight challenges the executives see facing their boards of governors today, and the other about the key management challenges they see themselves facing today.

Table 1 – Characteristics of the Responding Pension Funds at December 31, 2004

Region	% (EW) *	% (DW) **
Australia / New Zealand	4%	1%
Canada	41%	13%
Europe	11%	32%
United States	44%	54%
Sponsor Type	% (EW) *	% (DW) **
Corporate	38%	14%
Public Sector	41%	66%
Other	21%	20%
Size	Median	Mean
Billions of \$USD	\$3.7B	\$17.9 B

* Equal-weighted

** Dollar-weighted

The study will unfold in three parts. We commence by analyzing the responses to the two open-ended questions. From there, we move on to analyze the rankings to the 45 statements about fund oversight, management, and operations. An important part of this analysis will be to compare the 2005 rankings provided as part of this study, with the rankings provided in 1997 by 80 fund executives to the same 45 statements in a prior survey^[3]. The final part of this study will report on tests for any statistical relationship between the 'CEO Scores' representing pension fund organization effectiveness as perceived by its own chief executive, and fund investment performance as measured by *CEM*.

Pension Fund Oversight and Management: Current Issues

The survey posed the following two open-ended questions:

1. *What do you see as the more important oversight issues facing your board of governors (or trustees, or directors) at this time?*
2. *What do you see as the more important organizational issues facing you at this time?*

The survey participant responses to these two open-ended questions are summarized in Tables 2 and 3 below. The original 63 responses to Question #1, and the 60 responses to Question #2 can be provided by the authors on request on an anonymous basis.

Given that the two questions were open-ended, it required some effort to create broad response categories, and to fit the individual responses into these broad categories. In the end, four broad response categories were created. Table 2 shows that two of the four were relevant to both the oversight and management functions (i.e., agency/context and investment beliefs/risk management issues). Of the other two, one was relevant only to the oversight function (i.e., oversight effectiveness issues), the other only to the management function (i.e., strategic planning/management effectiveness issues).

Table 2 – Pension Fund Oversight and Management: What Really Matters?

1. What are the more important <u>oversight</u> issues?	<u>Proportion of Responses</u>
a. Agency / context issues	44%
b. Governance effectiveness issues	36%
c. Investment beliefs / risk management issues	20%
2. What are the more important <u>management</u> issues?	<u>Proportion of Responses</u>
a. Strategic planning / management effectiveness	73%
b. Agency / context issues	15%
c. Investment beliefs / risk management issues	12%

The proportions of responses falling into the four categories tell an interesting story:

1. Responding pension fund executives think their boards of governors face important issues in three areas: agency/context issues (44% of responses), oversight effectiveness issues (36%), and investment beliefs/risk management issues (20%). We think this represents an astute collective assessment by these executives. Without oversight context, there is no legitimacy. Without oversight effectiveness, there can be no common vision. Without a basic understanding of how capital markets function and how risk should be defined and managed, the oversight function cannot be effective.

2. While a number of the responding pension fund executives believe they themselves have a role to play in resolving agency/context (15%) and investment beliefs/risk management (12%) issues, they see their major challenges lying in the strategic planning/management effectiveness area (73%). Again, we think this to be an astute collective assessment which bodes well for the future of pension fund governance. If the fund's chief executive is not prepared to be accountable for results in the strategic planning/management effectiveness area, no clear organization vision will ever be articulated or actualized.

So what were some of the specific oversight and management challenges mentioned in the survey? That is the question we address next.

Specific Governance and Management Challenges

To repeat, the open-ended nature of the oversight and management questions led to 63 and 60 responses respectively, requiring categorization. Table 2 listed the four broad response categories. Table 3 continues that process on a more disaggregated level for the oversight-related and management-related responses. In Table 3, under 'agency/context issues', pension fund executives exhibit a clear awareness of the (sometimes impossible) balancing act DB pension plans typically force upon boards of governors. The reality is that the financial interests of various stakeholder groups in DB plans do not always line up in a nice 'win-win' manner. So instead of providing oversight to the pension organization, boards (and to a lesser degree, management) can get involved in sorting out the respective financial interests of retirees, active workers, future workers, and sometimes even those of bond holders, shareholders, or current and future taxpayers. There is also the related question of trying to understand what light (if any) past, current, and future laws and regulations may throw on these matters.

Table 3 – Pension Fund Governance and Management: Specific Challenges

1. Agency / context issues
 - a. Balancing stakeholder interests
 - b. Understanding the legal / regulatory environment
2. Oversight effectiveness issues
 - a. Appropriate skill / knowledge set for the Board
 - b. Clear delegation to management
3. Investment beliefs / risk management issues
 - a. Understanding context-based risk and its management
 - b. Informed 'investment beliefs' and their relevance
 - c. Shift to risk budget-based investment process
4. Strategic planning / management effectiveness issues
 - a. Resource planning, organization design, and compensation
 - b. Clear delegation from the Board
 - c. Effective IT-based implementation systems

Under ‘oversight effectiveness issues’, the responding pension fund executives point to two fundamental, related challenges that remain unresolved in large swaths of the pensions world. The first is board competency. The second is the critical requirement for boards to understand the difference between overseeing and managing. The board competency issue results directly from the often-deficient methods through which trustees are elected/selected for pension boards. Because there often is a board competency issue, there is often also a board delegation issue. Boards that do not clearly delegate fund managing to fund management, place the organization and its stakeholders at a serious effectiveness disadvantage^[4].

The board competency issue is often also the source of problems in the ‘investment beliefs/risk management’ area. It is not a question of board members becoming experts in this area. That is not a realistic expectation. However, board members must be capable of strategic thinking. That means they should insist on clear linkages between the pension contract, how the organization defines, measures, and manages risk, and how outcomes are measured and rewarded. It is up to management to show the board how this is best accomplished through a liability-anchored, risk budget-based investment process^[5].

We have already expressed the opinion that assignment by the pension fund executives of a high priority to ‘strategic planning/management effectiveness issues’ bodes well for the future. This view is re-enforced by the specific executive focus on resource planning, organization design, compensation, and IT-based implementation systems. In our view, these are indeed critical elements required to build a high-performance culture.

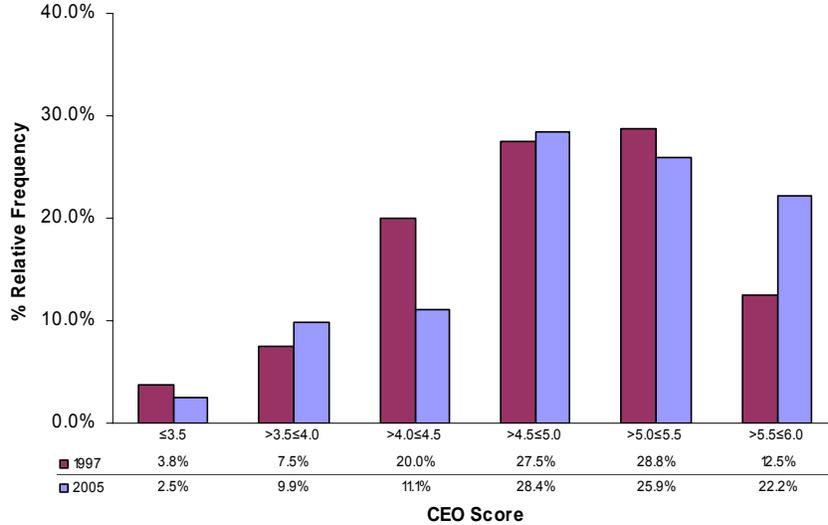
Effectiveness Rankings and ‘CEO Scores’

The survey also asked the pension fund executives to assign a rank from 6 to 1 to each of 45 statements related to various aspects of the oversight, management, and operations areas of their own pension fund. Each statement was phrased so that the higher the assigned ranking, the more favorable the respondent’s view was of that particular element or activity of fund oversight, management, or operations. All 45 statements, ranked by highest to lowest 2005 rankings, are attached as Appendix A. For each completed survey, the 45 rankings were also averaged to create a single ‘CEO Score’ for each of the 81 response sets for which there was *CEM* fund data. Figure 1 below shows the distribution of resulting ‘CEO Scores’ based on the 2005 rankings, as well as those based on the earlier 1997 rankings to the same 45 statements.

With respective means of 4.8 and 4.9, the 1997 and 2005 ‘CEO Score’ distributions suggest a tendency to assign high rankings. This result can be interpreted in one of two ways. The first is that, on average, the pension funds represented in the two surveys really do have, on average, exceptional oversight, management, and operations capabilities. The second interpretation is that there is a tendency in surveys of this nature to rate on the high side. We lean towards the second interpretation, meaning that our analysis should focus on the relative, rather than the absolute values of the statement rankings and overall ‘CEO Scores’. This position is supported by the experience of Capelle Associates with their Organizational Assessment Questionnaire. With nearly 9,000 responses from 35

organizations outside the pensions ‘industry’, the average score on the same six-point scale is 4.9.

Figure 1 – Relative Frequency of CEO Scores 1997 vs. 2005



1997 CEO Scores	2005 CEO Scores
Mean = 4.8	Mean = 4.9
Standard deviation = 0.6	Standard deviation = 0.7

Table 4 lists the six statements receiving the lowest rankings in 1997 and 2005. Remarkably, they are the same six statements, with even the order of the rankings almost unchanged. The strong suggestion is that the selection and evaluation processes for boards of governors were seen to be problematic in 1997, and they continue to be seen as problematic today. This board competency problem is the likely root cause of the other continuing pension fund problem areas suggested by the 1997 and 2005 rankings: board micro management and uncompetitive staff compensation. Table 5 lists the six statements with the largest 1997/2005 ranking changes. The positive news here is that the responding pension fund executives see some improvement over the course of the last eight years in the effectiveness of the fund oversight and management functions, and in their ability to attract and retain desirable employees.

Table 4 – Six Lowest Scoring Statements in 1997 and 2005

Ranking	1997	2005	Ranking
40	Compensation levels in our organization are competitive.	Compensation levels in our organization are competitive.	40
41	My board of governors does not spend time assessing individual investment managers or investments.	My board of governors does not spend time assessing individual investment managers or investments.	41
42	My board of governors examine and improve their effectiveness on a regular basis.	My board of governors examine and improve their effectiveness on a regular basis.	42
43	Our fund has an effective process for selecting, developing, and terminating members of the board of governors.	I have the authority to retain and terminate investment managers.	43
44	I have the authority to retain and terminate investment managers.	Our fund has an effective process for selecting, developing, and terminating members of the board of governors.	44
45	Performance-based compensation is an important component of our organization design.	Performance-based compensation is an important component of our organization design.	45

Table 5 – Six Statements with the Largest Score Changes

Ranking	Statement	Score Change
1	I have clearly-written documents describing our mission, vision, values, strategic positioning, and operations and resource plans.	+ 0.55
2	My board of governors examine and improve their own effectiveness on a regular basis.	+ 0.54
3	Superior investment performance reduces future contributions.	- 0.53
4	I can describe our operational plan relating to what we are going to accomplish in terms of quality, quantity, timeliness, and resource requirements.	+ 0.53
5	Employee turnover is low.	+ 0.43
6	Compensation levels in our organization are competitive.	+0.42

Governance Quality and Organization Performance

A priori, we would expect the quality of pension fund governance to impact pension fund performance. Over the longer term, well-governed funds should be able to generate higher returns (adjusted for risk and expenses) than poorly governed funds. Ambachtsheer, Capelle, and Scheibelhut tested this hypothesis in 1998, using the CEO Scores as defined above as proxies for governance quality. For fund performance proxies, they used a metric called Net Value-Added (NVA) supplied by *CEM Benchmarking Inc.* NVA is a pension fund's excess return over its passively-implemented asset mix policy, net of all investment expenses. In a sample of 80 pension funds, they reported a statistically significant peak NVA/CEO Score co-efficient of 0.4 ($t=2.0$) for the 4-year observation period ending in 1997. Statistically weaker, but still positive regression coefficients were found for 4-year observation periods ending in years prior to, and after 1997.

We repeated this statistical analysis with the new 81 CEO Scores based on the 2004 survey and the 4-year NVA metrics for these 81 funds, as reported by *CEM*. We found a statistically significant peak NVA/CEO Score coefficient of 0.8 ($t=2.7$) for the 4-year observation period ending 2003. Statistically weaker, but still positive regression coefficients were found for 4-year observation periods ending in years prior to 2003. It remains to be seen how the post-2003 pattern of NVA/CEO Score coefficients will unfold. Taking the CEO Score range to be effectively from 3 to 6, a coefficient of 0.8 implies the 'top' CEO Score funds outperformed the 'bottom' ones by an average 2.4% per annum (i.e., 3×0.8) over the 2000-2003 period.

While these now-dual (i.e., based on the 1997 and 2004 CEO surveys) findings of a positive statistical association between proxies for governance quality and fund performance are encouraging, they are subject to some important caveats. First, the governance quality proxies are based on the self-reported ratings by the funds' own chief executives. Second, while the NVA performance metrics for the funds were adjusted for expenses and differences in asset mix policies, they were not given active risk-related 'haircuts' ^[7]. Third, 4-year observation periods are arguably short periods for measuring 'longer term' fund performance. Fourth, the statistical findings do not 'prove' that the causality necessarily runs from governance quality to fund performance. It could also run the other way, with good (bad) achieved fund performance leading to perceived good (bad) governance quality.

Having listed these caveats, we did uncover a statistical clue that supports the proposition that higher CEO Scores do indeed indicate higher levels of governance quality. One of the cost categories in the *CEM* database is 'Oversight / Management Costs', which captures fund costs allocated to the internal governance, management, and control functions. A reasonable hypothesis is that high governance quality funds 'invest' more in these functions than funds with low governance quality. So statistically, there should be a positive relationship between Oversight / Management Costs (OMC) and Pension CEO Scores, after adjusting for fund size. The OMC-CEO Score coefficient in 2004 was in fact 1.4 ($t=3.0$). So again, taking the Pension CEO Score range to be from 3 to 6, the

implication is that high-scoring funds spend an average 4 basis points (i.e., 3 x 1.4) more per annum on the internal governance, management, and control functions than low-scoring funds. This is an additional \$4M per year for a \$10B fund. Clearly, the CEOs and boards of governors of the high-scoring funds are putting their money where their mouth is. This is an encouraging finding.

In Conclusion: Board Competency Still Problematic

A key goal our study was to assess the current status of pension fund governance, and identify opportunities for improvement. So what can we now say about these issues? We conclude that while there appear to have been some improvements at the executive level (e.g., formal strategic planning processes are on the rise, resulting in clearer management focus on such issues as resource planning, organization design, and compensation), board competency continues to be a problem. The selection process for board members is deficient in many cases. Self-evaluation of board effectiveness continues to be the exception, rather than the rule. Weak oversight functions lead to difficulties in sorting out the competing financial interests of differing stakeholder groups. They also lead to organization dysfunction. Specific examples are lack of delegation clarity between board and management responsibilities, board micro-management, and non-competitive compensation policies in pension funds. Despite the cited caveats, the positive correlations found between proxies for fund governance quality and fund performance lends urgency to correcting these shortcomings.

The study suggests the following five opportunities to improve pension fund governance:

- Redesign pension deals to eliminate the ‘competing financial interests’ problem.
- Develop templates for ideal boards of governors composition, and integrate these templates into actual selection processes.
- Initiate board effectiveness self-evaluation processes.
- Achieve clarity between the respective roles of boards and management.
- Adopt high-performance cultures with competitive compensation policies.

The study findings also have public policy implications. The most obvious implication may be for pension regulators to require that pension funds disclose on a regular (e.g., annual) basis what steps they are taking in the five governance improvement opportunity areas listed above.

NOTES

- [1] See, for example, the recent Graham, Harvey, Rajgopal study (2005) which found that most corporate financial executives would sacrifice value-creating projects if it meant falling short of the current quarter's consensus earnings estimate, or break up a smooth progression of reported earnings.
- [2] An ambitious paper by Merton and Bodie (2004) attempts to develop an overall theory of financial system design by bringing together three related theories of finance: neoclassical, behavioral, and institutional. The focus of the institutional theory dimension is to deal with market frictions and agency problems. It stops short of prescribing optimal governance practices and organization structure.
- [3] See the cited 1997 article "Improving Pension Fund Performance" by Ambachtsheer, Capelle, and Scheibelhut (1997).
- [4] A comprehensive framework is provided by Ron Capelle in "Improving Pension Fund Performance: Organization Design and Governance" (1998).
- [5] In the 'old' pension management paradigm, boards of governors were expected to express investment policy as a 'policy asset mix'. There is growing recognition that a risk budget approach based on estimating and managing mismatch risk relative to pension liabilities is part of a superior 'new' pension management paradigm.
- [6] The means/standard deviations of the 1997 and 2005 ranking sets for the six highest scoring statements were 5.46/0.84 and 5.48/0.79 respectively. The comparable metrics for the six lowest scoring statements were 3.70/1.80 and 4.05/1.74.
- [7] There are two approaches to assigning risk-based 'haircuts' to returns: utility-based and arbitrage-based. The question of which approach is superior is yet to be resolved. For further discussion see Ambachtsheer, "Adjusting Investment Returns for Risk: What Is the Best Way?" (2006) at www.kpa-advisory.com.

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APPENDIX A

2005 Rank	1997 Rank	Statements
1	1	I can describe our mission (why we exist).
2	4	I ensure the setting of clear, appropriate, understandable and well-communicated performance standards for our external investment managers.
3	10	I can describe our values (how we work together).
4	13	I can describe our fund's strategic positioning (how we provide better value to stakeholders than alternatives).
5	12	There is a high level of trust between my governing fiduciaries and the pension investment team.
6	11	Developing our asset mix required considerable effort on the part of myself and the governing fiduciaries and it reflects our best thinking.
7	25	I can describe our operational plan (what we are going to accomplish in terms of quality, quantity, timeliness and resource requirements).
8	22	Employee turnover within the pension fund organization is low.
9	3	My governing fiduciaries do a good job of representing the interests of plan stakeholders.
10	16	I can describe our vision of where we should be in the future.
11	14	There is a clear allocation of responsibilities and accountabilities for fund decisions between the governing fiduciaries and the pension investment team.
12	6	I ensure the setting of a clear, appropriate, understandable and well-communicated framework of values and ethics for our employees.
13	18	We examine and improve our internal processes on a continuous basis.
14	19	Those reporting directly to me understand and share our vision, mission, values, strategic positioning, operation plan and resource plan.
15	7	People in our organization do what they say they will do.
16	9	People in our organization collaborate well on teams and projects.

17	24	My governing fiduciaries approve the necessary resources for us to do our work.
18	17	I ensure the setting of clear, appropriate, understandable and well-communicated performance standards for our employees.
19	2	My superior investment performance reduces the future contributions of the underwriters of the pension promise (usually company shareholders or taxpayers for DB plans).
20	15	My governing fiduciaries set a clear, appropriate, understandable and well-communicated framework for values and ethics.
21	31	My governing fiduciaries hold me accountable for our performance and do not accept sub par performance.
22	29	I can describe our resource plan (obtaining and optimally utilizing the required human, financial and information technology resources).
23	5	I ensure that our organization does not accept sub par performance from our employees.
24	21	My organization uses its time efficiently (well focused and does not waste time).
25	8	My superior investment performance enhances benefit security and the potential for higher pensions for plan participants.
26	32	My governing fiduciaries understand and share our vision, mission, values, strategic positioning, operation plan and resource plan.
27	23	My organization uses its time effectively (deals with the right issues).
28	35	My governing fiduciaries have good mechanisms to understand and communicate with plan stakeholders.
29	39	I have clearly written documents describing our vision, mission, values, strategic positioning, operational plan and resource plan.
30	30	My governing fiduciaries do a good job of balancing overcontrol and undercontrol.
31	33	My governing fiduciaries set clear, appropriate, understandable and well-communicated standards for our organizational performance.
32	20	My governing fiduciaries and related committees use their time efficiently (focused and do not waste time).
33	26	I ensure that the organization has a good process for selecting,

		developing and terminating employees.
34	27	Managing the pension fund is perceived to be an important part of our sponsoring organization(s).
35	28	My governing fiduciaries and related committees use their time effectively (deal with the right issues).
36	38	I have the necessary people and budget to do the work.
37	34	I have the necessary managerial authority to implement long term asset mix policy within reasonable limits.
38	36	My governing fiduciaries have appropriate turnover (neither too high nor too low).
39	37	My governing fiduciaries have superior capabilities (relevant knowledge, experience, intelligence, skills) necessary to do their work.
40	40	Compensation levels in our organization are competitive.
41	41	My governing fiduciaries do not spend time assessing individual portfolio manager effectiveness or individual investments.
42	42	My governing fiduciaries examine and improve their own effectiveness on a regular basis.
43	44	I have the authority to retain and terminate investment managers.
44	43	Our fund has an effective process for selecting, developing and terminating its governing fiduciaries.
45	45	Performance based compensation is an important component of our organizational design.