The Submission of

William M. Mercer Limited

to

the Royal Commission on Workers’ Compensation in British Columbia

Part A: Governance Review

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TABLE OF CONTENTS

Section

I. FUND GOVERNANCE OVERVIEW
   (1) Development of an Investment Policy
   (2) Implementation of the Investment Policy
   (3) Monitoring of the Investment Policy

II. INDUSTRY BEST PRACTICES

III. REVIEW OF EXISTING BRITISH COLUMBIA'S WORKERS' COMPENSATION BOARD GOVERNANCE STRUCTURE
   (1) Key Participants
   (2) Key Decision Processes
   (3) Decision-Making Tools

IV. EVALUATION OF EXISTING BRITISH COLUMBIA'S WORKERS' COMPENSATION BOARD GOVERNANCE STRUCTURE
   (1) Macro-Organizational Structure
   (2) Allocation of Responsibilities between Participants in the Governance Structure
   (3) Decision-Making Tools

Appendix A - WCB Accident Fund - Investment Governance Structure
Appendix B - Summary of Decision-Making Process of Key Fund Related Decisions
Appendix C - Key Fund Related Decisions: Decision-Making Process
Appendix D - Existing Decision-Making Paths For Critical Decisions
Appendix E - Proposed Decision-Making Paths For Critical Decisions
Appendix F - WCB Governance Practices Evaluation Summary
FUND GOVERNANCE REVIEW

Executive Summary

The purpose of this document is to assist the Royal Commission on Workers’ Compensation in British Columbia (the “Commission”) in assessing the governance structure implemented by the Panel of Administrators of the Workers’ Compensation Board (the “Panel”) to assist in overseeing the effective operation of the Workers’ Compensation Accident Fund (the “Fund”). The report will explore the following four areas:

I. Fund Governance Overview

The fund governance overview identifies critical issues that must be considered in an effective governance structure. This section of the report includes key considerations in the development of an investment policy, a discussion of critical investment policy implementation issues and an assessment of the important issues relating to the effective monitoring of the investment policy.

II. Industry Best Practices

This section of the report outlines current industry best practices for fund governance. Mercer has drawn upon its experiences working with large pension plan sponsors as well as organizations similar to the British Columbia Workers’ Compensation Board (the “WCB”) in assessing the leading edge standards in Canadian corporate governance.

III. Review of Existing British Columbia’s Workers’ Compensation Board Governance Structure

In this section of the report, the current WCB governance structure is examined in detail. The study of the governance structure includes an evaluation of the key participants, the key decisions and the mechanisms used to monitor the Fund.

IV. Evaluation of Existing British Columbia’s Workers’ Compensation Board Governance Structure

In this section of the report, the current WCB Fund governance structure is assessed by comparing the principles developed in section I and section II of this report to the current governance model documented in section III of the report.
Where necessary, the report considers changes to the existing governance practices. The report offers an alternative Fund governance structure for consideration by the Commission. The report also identifies the following areas of concern and/or specific considerations for the reform of the Fund governance system:

- The investment policy decisions should be formally linked to the setting of funding policy through the use of a transparent and rationale decision-making model.

- A strong formal linkage should be introduced to the governance model between the interests of the primary stakeholders and the critical investment and funding decisions. The preferred method for introducing this linkage would be through the reconstitution of the Board of Governors of the WCB.

- The responsibility for monitoring the performance of the bond portfolio (invested by the Treasurer) should be transferred from the Investment Committee to the Ministry of Finance.

- A formal report should be prepared by the Investment Committee outlining the feedback provided by industry groups in connection with changes to assessment rates.

- The contract for an external actuary to the Fund should be tendered every five years.

- The investment monitoring process should incorporate an analysis of the risk to return parameters for each investment manager with a mandate under the Fund.

- Investment monitoring reports should be prepared by an investment consulting firm, incorporating a full qualitative analysis of each investment manager.

- A formal written delegation policy should be adopted for the governance structure.
I. Fund Governance Overview

(1) Development of an Investment Policy

The following issues should be given formal consideration in the process of developing an investment policy.

(a) Risk

The primary risk associated with the Fund is that the assets in the Fund will be insufficient to pay all of the promised benefits to beneficiaries under the legislation.

(b) Identification of Stakeholders

The stakeholders in the Fund can be divided into two groups; the primary stakeholders and the secondary stakeholders.

The primary stakeholders in the Fund include parties in the system that rely on the Fund fiduciaries to protect their financial interests. The primary stakeholders include the present and future claimants under the WCB plan (the “Claimants”), as well as the participating companies actively contributing to the Fund (the “Companies”).

The primary concern of the Claimants is to ensure that there are adequate funding levels in the Fund to ensure that present and future payments can be met. It is also in the interest of the Claimants to ensure the preservation of the system to ensure the continuation of current benefit levels and the continued operation of the WCB system.

In certain circumstances and in certain sectors of the economy, the interests of the Claimants may be represented by organized labour. In other cases, the interests of the Claimants may diverge from organized labour. This may occur where political objectives of organized labour differ from those of ordinary claimants. Accordingly, it may be appropriate in to have the interests of the Claimants represented by representation from both organized labour as well as direct WCB claimants.

It is the primary concern of Companies to limit the ongoing contribution requirements to the Fund. At the same time, Companies are seeking to provide some level of consistency in benefit costs over time.

On the issue of investment policy, it is in the interests of both of the primary stakeholders to invest the Fund in a manner that maximizes investment returns.

On the surface the interests of the two primary stakeholders seem to diverge on the issue of funding policy. It would appear to be in the interest of the Claimants to establish
conservative funding policies. This approach would involve adopting a lower discount rate, which would tend to increase contribution requirements and understate potential planned surpluses. Conversely, it would appear to be in the interests of the Companies to adopt more aggressive funding policies, with a higher discount rate, that will tend to yield lower contribution rates over the long-term and overstate plan surpluses.

In reality, the interests of the primary stakeholders tend to converge on the issue of funding. It is in the interest of the Claimants to ensure a funding level that provides security for the benefit promise, while avoiding increasing funding costs, to the extent that they challenge the ongoing viability of the system or cause the Companies to lobby for the reduction of future benefit levels. At the same time, the Companies are seeking the most cost effective way to properly fund the promised benefits in order to avoid future unexpected increases in assessments.

The secondary stakeholders in the Fund include parties in the system that do not rely on the Fund fiduciaries to protect their financial interests. The secondary stakeholders include the government in power, as well as the Panel. Rather than having their interests protected by the Fund fiduciaries, the secondary stakeholders act in certain circumstances as fiduciaries of the Fund, in protecting the interests of the primary stakeholders.

The interest of the existing or future government in the operation of the Fund may change over time. When taking office, it may be in the best interest of a government to overstate a deficit or understate a surplus. Conversely, after being in power for a period of time, the interests of the government may change. It may be advantageous to understate a funding deficit or overstate a surplus, in order to demonstrate the effective management of the overall system.

It is in the interests of the Panel to ensure that there are sufficient assets to provide benefit payments to the fund beneficiaries. An effective way to protect this interest is to maximize funding levels in the Fund. This policy will minimize the chances of a future Fund shortfall that may raise questions about the management of the Fund.

(c) The Nature of the Economic and Term Structure of the Liabilities

The economic and term structure of the obligations underlying any set of assets, should influence the setting of an effective long-term investment policy. The economic structure of the liabilities refers to economic factors such as inflation, interest rates and productivity, which impact the liabilities. The term structure refers to the timing of future payments, when obligations fall due and the duration of the liabilities. By examining these factors, it is possible to devise a preliminary strategy that would mitigate any divergence in the growth of assets and liabilities.

At the present time, the liabilities underlying the Fund are indexed (linked to inflation). While the liabilities are uncertain in term, for funding purposes, they can be considered as perpetuities.
A theoretical match for these liabilities would be 10 year Real Return Bonds (“RRBs”). This means that having a portfolio of 10 year RRBs would ensure that the assets and liabilities would grow in tandem. Given that such securities are not available, the challenge is to select a long-term policy that meets the objectives of the Panel, given the economic and term structure of the liabilities described above.

(d) Long-Term Asset Mix Policy

Asset mix policy defines the following parameters of a portfolio:

- the overall percentage of assets in equities and fixed income;
- the duration and term structure of the fixed income portfolio;
- the level of cash;
- the allocation between domestic and foreign equity; and
- market capitalization levels for the equity holdings.

Long-term asset mix policy is the key component of an investment strategy. In 6 separate studies performed recently in Canada and the United States, long-term asset mix policy accounted for approximately 90% of the variation in total fund returns. The remaining 10% of performance variation was attributed to security selection by the investment managers. The results of those studies are illustrated in the following chart.

<table>
<thead>
<tr>
<th>Value Added from Balanced Management</th>
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<tr>
<td></td>
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<tr>
<td>3rd Percentile</td>
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<tr>
<td>16th Percentile</td>
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<tr>
<td>Median</td>
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<tr>
<td>84th Percentile</td>
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<tr>
<td>98th Percentile</td>
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</tbody>
</table>

* Average of six studies performed from 1986 to 1993 and collaborated by Mercer studies and client assignments

Source:
Historically, most insurers have utilized asset/liability studies as the primary tool to assist them in setting an appropriate long-term asset mix policy. More recently, pension plan sponsors and investment committees overseeing similar funds have recognized that setting long-term asset mix policy without recognizing the nature of the underlying obligations can lead to inconsistent policies and results. As a result, asset/liability studies have become the principal asset mix modeling tool.

In an asset/liability study, different long-term policies are tested under a variety of economic environments, in order to evaluate the behavior of the sponsor’s risk measures. Risk measures may include required levels of contributions, benefit security measures and the impact on profitability.

The primary objective of the study is to identify the linkage between the behavior of economic variables, such as inflation and interest rates, and the behavior of the underlying obligations. The challenge then becomes selecting a long-term asset mix policy that controls any divergence between the growth of assets and liabilities.

In some cases, the asset mix policy may be designed to incorporate some level of divergence of asset and liability growth, if there is viewed to be some quantifiable advantage in doing so. For example, the long-term asset mix may be set to permit the assets to grow at a faster rate than liabilities, even though this policy may introduce higher volatility levels to the investment returns and the funding position of the Fund.

(e) Asset Mix Policy Tactical and Strategic Implementation Practices

As mentioned in the previous section, long-term asset mix policy accounts for approximately 90% of the variation in total fund returns. As a result, the establishment of the long-term asset mix policy is the most critical step in establishing an investment strategy. Once the long-term asset mix policy is established, the policy must address the tactical and strategic practices of the Fund. Specifically, the sponsor needs to address permitted asset class ranges, re-balancing practices and the inclusion of asset classes not specifically addressed in the long-term asset mix policy.

The issues of asset class ranges and re-balancing address the amount of flexibility the investment managers and/or the fund itself will be given to stray from the long-term asset mix policy. Often some degree of flexibility will be provided in order to allow for tactical or strategic asset mix shifts.

Where a sponsor employs balanced manager(s), the manager(s) is normally given the power to deviate from the policy within certain tolerances (e.g.: plus or minus 10% of the stated policy), with the belief that the manager(s) can add value through this deviation. Studies have shown that, historically, the median manager has actually subtracted value by attempting to shift between asset classes. However, there are some managers that
have consistently been able to effectively manage asset mix shifts, thereby, providing returns in excess of those achieved through security selection alone.

Where the sponsor opts for a specialist structure (multiple managers, each managing a separate asset class), then it is prudent to implement a formal re-balancing discipline.

Re-balancing refers to the practice of systematically selling one asset class and using the proceeds to purchase assets in another asset class in order to shift the asset mix back to its target level, or within the asset mix pre-established range. For example, if a portfolio has a 50% equity and 50% bond asset mix, and equities significantly outperform bonds in a given quarter, then the asset mix at the end of the quarter may have shifted to 55% equities and 45%. A formal re-balancing policy would necessitate the liquidation of a portion of the equity holdings and the purchase of bonds, in order to reposition the portfolio to its 50/50 long-term asset mix target.

The frequency and range trigger used to re-balance depends on the beliefs of the plan sponsor. Some sponsors automatically re-balance on a quarterly basis, regardless of the asset mix drift. Other plan sponsors only re-balance if the asset mix has drifted beyond a certain trigger level (e.g. plus or minus 5%). In some cases, re-balancing disciplines may also be applied to balanced manager mandates.

A final consideration involves the decision to permit the investment of fund assets in asset classes that are not formally considered in the asset and liability study. Such asset classes under consideration may include high yield bonds, managed futures, global bonds, small cap equities and emerging market equities. In some cases, the investment manager, is given the discretion to invest in some or all of these additional asset classes on a tactical basis for the purpose of enhancing return, reducing volatility or increasing diversification.

In order to assist in the policy formulation on permitted asset classes a qualitative review would be undertaken for each asset class under consideration. The review would analyze the potential risks and rewards associated with each asset class under consideration and assess their impact on fund performance and characteristics. The analysis would include an assessment, both empirically and exceptionally, of the return to risk characteristics of the asset class, the correlation of the asset class with other asset classes and the performance of the asset class in strong and weak markets.

This analysis would help determine which asset classes should be included in the policy and the appropriate investment limits for each additional asset class. The policy would normally determine whether each additional asset class is to be treated as equities or bonds for the purposes of determining the overall asset mix of the fund.

The review of alternative asset classes is an important element in the investment policy, as it may introduce opportunities for the manager to enhance fund returns, thereby, improving the ability of the fund to meet the long-term obligations underlying the assets.
It is generally not feasible to properly consider these asset classes in an asset/liability study, since small allocations of this nature, will, generally, not yield any meaningful analysis.

The one alternative asset class permitted by the Fund is real estate. The investment policy permits an investment of 0 - 7% of the Fund in Canadian real estate. For the purposes of the investment policy, real estate investment is classified as equities.
(2) Implementation of the Investment Policy

The following issues must be considered and incorporated in a comprehensive investment policy.

(a) Active versus Passive Fund Management

Passive or indexed fund management refers to an investment style that matches an investment fund’s composition and performance to a published index for the asset class (i.e. the TSE 300 for a Canadian equity fund).

The selection of active or passive management may be impacted by the philosophy of the Panel towards the efficiency of capital markets. This decision is typically made separately for each asset class and in each major geographic region.

Organizations that view capital markets as efficient, believe that all relevant market information is immediately incorporated in the market price of a security. If this is the case, active management should not be able to consistently beat the market index. At the same time, passive management controls the risk of under-performance by linking the fund return of an asset class to the market.

Proponents of active management believe that markets are not inherently efficient. Accordingly, active managers, with better access to market information, may be able to consistently and systematically beat the market.

Active management introduces an additional element of risk which can be defined as the risk of the manager under-performing the market in an asset class. This risk can be identified in both relative and absolute terms. The active investment style employed may outperform or under-perform the median active manager in the asset class.

At the same time, the median active manager may out-perform or under-perform the passive index in the asset class. This means that, even where an active manager out-performs the median in a specific asset class, the manager may still be under-performing relative to the passive benchmark.

An additional consideration in the decision to select active or passive management involves the fees charged for active management. As the following table illustrates, investment management fees levied for active management generally exceed those levied for passive management. The reason for this difference in fees relates to the additional information gathering requirements associated with security selection in an actively managed portfolio.
Investment Manager Fees

<table>
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<tr>
<th>Median* Investment Management Fees (bps)</th>
<th>Account Size ($Cdn)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$10M</td>
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<tr>
<td><strong>Canadian Equities</strong></td>
<td></td>
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<tr>
<td>Active</td>
<td>48</td>
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<tr>
<td>Passive</td>
<td>15</td>
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<tr>
<td><strong>Canadian Fixed Income</strong></td>
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<tr>
<td>Active</td>
<td>45</td>
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<tr>
<td>Passive</td>
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<tr>
<td><strong>U.S. Equities</strong></td>
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<td>Passive</td>
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<td><strong>International Equities</strong></td>
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<td>Active</td>
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</tr>
<tr>
<td>Passive</td>
<td>20</td>
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</tbody>
</table>

*Source for median of active fees is Mercer database which contains over 90% of the externally managed funds in Canada
*Source for passive fees is median of fee schedules of three major passive investment management firms, as disclosed to Mercer

This fee differential requires the active manager to out-perform the passive index by more than the fee differential, in order to add value to a fund. As the size of a fund increases, the spread between active management and passive management decreases, thereby making active management more viable.

Given the size of the Fund, it may be possible to narrow the spread between active management costs and passive management costs to under 25 basis points on Canadian equity and bond investments. By accessing the provincial equity pools, this fee differential could be further narrowed for the Fund. This reduced fee differential makes active management relatively more attractive for the Fund, to the extent that the Panel believes that capital markets are inefficient.

At the same time, “mega” funds in Canada, such as the Fund, must be mindful of how nimble they can remain in a relatively small Canadian equity market, if the entire Canadian equity portfolio is actively managed. The majority of the largest funds in Canada (with assets in excess of $5 Billion) employ passive management for a portion of their Canadian equity portfolio, due to the sheer size of the Canadian equity component of their portfolios, relative to the Canadian equity market.

Finally, the decision to employ active management may differ depending on the asset class under consideration. Empirical evidence suggests that active management is more successful in certain asset classes and capital markets than it is in others. As the following chart indicates, active U.S. equity managers have had difficulties out-
performing passive indexes (such as the S&P 500). In contrast, non-North American equity managers have more consistently been able to out-perform international equity indices (such as the EAFE (Europe, Australia and Far East) index).

Canadian equity managers have also had success in outperforming the Canadian equity indices. In contrast, Canadian bond managers have not been able to consistently outperform the Canadian bond indices.

### Annualised Performance Before Investment Management Fees

#### Canadian Equities (ending December 31, 1997)

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<tr>
<th>Period</th>
<th>Mercer Q1</th>
<th>Mercer Median</th>
<th>TSE 300</th>
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<tr>
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#### Canadian Bonds (ending December 31, 1997)

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#### U.S. Equities (ending December 31, 1997)

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<th>Mercer Q1</th>
<th>Mercer Median</th>
<th>S&amp;P 500 ($Cdn)</th>
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<tr>
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#### International Equities (ending December 31, 1997)

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<tr>
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<th>Mercer Median</th>
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<td>7.5%</td>
<td>6.5%</td>
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#### Number of Funds

- **Funds > TSE 300**: 22, 23, 27, 25, 26, 21, 27, 26, 28, 33
- **Funds > SCMU**: 23, 27, 29, 34, 37, 41, 42, 46, 46, 46
- **Funds > S&P 500**: 4, 4, 6, 5, 5, 6, 3, 4, 11, 9
- **Funds > MSCI EAFE**: 8, 12, 10, 13, 16, 16, 18, 32, 40, 31

- **Q1 - TSE 300**: 1.8%, 2.2%, 2.4%, 2.2%, 2.2%, 1.7%, 1.3%, 2.1%, 3.2%, 4.1%, 5.2%
- **Median - TSE 300**: 0.9%, 1.1%, 1.5%, 0.7%, -0.2%, 0.7%, 1.2%, 0.7%, 2.6%
- **Q1 - SCMU**: 0.3%, 0.1%, 0.2%, 0.2%, 0.3%, 0.2%, 0.3%, 0.3%, 0.2%, 0.6%
- **Median - SCMU**: 0.0%, 0.0%, -0.1%, -0.2%, 0.0%, -0.1%, 0.0%, -0.2%, -0.2%, 0.0%
- **Q1 - S&P 500 ($Cdn)**: 0.0%, 0.0%, 0.1%, -0.6%, -0.3%, -1.3%, -1.5%, -1.9%, 0.1%, -0.5%
- **Median - S&P 500 ($Cdn)**: -1.2%, -0.7%, -1.1%, -1.9%, -2.3%, -2.7%, -3.9%, -4.2%, -3.0%, -4.2%
- **Q1 - MSCI EAFE ($Cdn)**: 0.0%, 0.0%, 0.1%, -0.6%, -0.3%, -1.3%, -1.5%, -1.9%, 0.1%, -0.5%
- **Median - MSCI EAFE ($Cdn)**: 2.1%, 3.1%, 2.6%, 1.3%, 1.2%, 0.1%, -0.2%, 1.8%, 2.6%, 1.0%
- **Number of Funds**: 10, 14, 15, 18, 23, 31, 39, 47, 52, 53
- **Funds > MSCI EAFE**: 8, 12, 10, 13, 16, 16, 18, 32, 40, 31
The Panel should decide on the use of active or passive management on an asset class by asset class basis, depending on the Panel’s belief with respect to the efficiency of each particular market, and the ability of the managers to add value to the appropriate passive index.

A review of the historical performance of active managers in an asset class provides a first level of analysis. At the same time, the Panel will need to determine whether historical trends will continue. This can be accomplished by reviewing environmental factors to determine whether there are present changes to the environment or to the underlying indices that may provide managers more opportunity to outperform or detract from a manager’s ability to add value.

In addition to this analysis, it would be prudent to review historical performance in an asset class during different phases of an economic cycle, in order to determine whether managers in the market are able to consistently outperform the market. Finally, the Panel should ensure that the passive indices being used for historical comparison are reasonable and in line with the asset class indices expected to be used as benchmarks in the long-term asset mix policy.

(b) External versus Internal Fund Management

For smaller funds, external fund management can introduce economies of scale. The costs associated with operating a smaller fund can be reduced by utilizing an external manager that can aggregate transactions and spread them out over its different fund mandates. In addition, the cost of employing investment specialists in different asset classes can be allocated among a larger number of investment funds.

As the size of an investment fund grows, a fund can achieve a critical mass which will enable it to support the fixed salary costs and research costs associated with employment of in-house investment management. Based on the current size of the Fund (presently at approximately $7 Billion), the employment of in-house staff to invest Canadian assets could be accommodated. It is important to note that the investment of the Canadian bond portfolio is already being handled in-house.

Internal management would provide the WCB with better control over the Fund investments, including individual purchase and sale transactions. It may enable the Panel to better control and co-ordinate the application of its investment policy to the Fund. However, if internal management is employed, the WCB must be confident in its ability to attract and retain investment talent in a very competitive market.

A major advantage of external management over internal management is the arms-length relationship of the investment manager with the governance structure. This arms length relationship enables a body overseeing a fund to properly monitor and evaluate the
performance of the investment manager without creating the perception of a potential conflict of interest.

At the same time, external management provides the opportunity to introduce different fund managers with offsetting investments styles. This approach provides opportunities for the diversification of a portfolio and the introduction of divergent view points and new ideas.

Currently, the Fund employs external management for the majority of the Fund assets. The one exception to this policy is in the Canadian bond asset class. Presently, the Treasurer of the WCB is charged with the responsibility of managing the Canadian bond portfolio. This may be appropriate at present, due to the present composition of the Canadian bond market, in which government bonds comprise approximately 85% of the market.

This crowding out of private bonds has resulted in a more homogeneous bond market that makes it difficult for a manager to over perform or under perform the index by a large amount. In this type of environment, it may be acceptable for the Canadian bond portfolio to be actively managed in-house.

The management of a passive bond fund introduces additional levels of complexity in attempting to match the duration and convexity of the index. These additional complications made it difficult and expensive to manage a passive bond fund internally.

However, as government debt is retired over the next several years and corporate issues comprise a larger proportion of the bond market, the Panel may wish to reconsider this policy, as this environment may become more conducive to successful external active management.

The management of either US or EAFE equities, on an active basis, involves the investment of significant resources. Our investment manager research in Canada, the US and UK indicates that most of the investment managers with above average long-term performance have made large investments in both systems and manpower in order to produce consistently strong performance.

Success in actively managing a US and EAFE portfolio requires intensive research at the country, sector or industry and company level. Many investment managers also employ separate teams to assess the effects of short-term and long-term currency hedging strategies on their portfolios. These factors strongly suggest that external management of non-Canadian equities would be prudent for an actively managed non-Canadian equity portfolio.

If a passive approach is adopted for foreign equities, then the Panel has two implementation options:
(1) Use external managers specializing in the area of passive management. This approach would reduce the need for internal resources and potentially reduce costs. Large index managers have the capability to ‘cross securities’ between portfolios, thereby reducing transaction costs and minimizing tracking error (the difference between the fund return and the index return).

(2) Use internal management to effect the passive strategy. In order to ensure the cost effectiveness of this approach, a synthetic or derivative based strategy could be employed. This structure would involve the purchase by the Fund of Canadian treasury bills and the establishment of ‘swap agreements’ with a third party that obligates the Fund to pay the treasury bill yield in return for a foreign index return.

Alternatively, this approach could be achieved through the purchase of index futures on various foreign exchanges. If this approach is adopted, then detailed written policies with respect to the use of derivatives that reflected this practice would need to be adopted.

If the preferred approach of the Panel for foreign equities is to employ an active management, using internal management, this could be effectively achieved by employing a passive manager in each country to run ‘country funds’ and employing an internal team to set the country weightings. This approach is currently in use by some Canadian investment managers who either believe that the country level decision is the most important decision or have determined that the capital investment required to build a successful internal foreign equity team is not economically viable.

Due to the small size of the Canadian equity market, it would be a viable approach to employ internal management to actively manage a Canadian equity portfolio, given the size of the Fund.

(c) Balanced versus Specialist Manager Structures

In a balanced manager structure, one or more managers are employed to invest the entire fund in multiple asset classes. Balanced managers manage the asset mix between the permitted categories of investment. This process would, subject to overall constraints placed on the investment manager(s) selected, preclude investment committees from making strategic asset mix decisions (other than deciding on the amount of assets allocated to each balanced manager).

Under a specialist management structure, a plan sponsor sets and manages the asset mix and selects individual managers to manage all or a portion of the assets in each asset class. In this manner, the plan sponsor can employ specialists with specific proficiencies in individual asset classes and also select the investment management style in each asset class.

Under a balanced management mandate, the strategic asset mix decision falls to the investment manager. Although a number of investment managers have added value...
through short-term asset mix shifts over time, studies have shown that the median active balance manager has subtracted value through asset mix timing decisions. By employing a specialist manager structure, with the asset mix decision held constant by the company over time (through frequent re-balancing back to the target asset mix), higher long-term rates of return may be achievable.

Generally, where the fund investment policy allows the investment of fund assets in a number of different asset classes, a specialist structure will result in the appointment of several specialist managers. Most investment management fee schedules work on a declining scale. By splitting the mandate between a number of specialist managers, investment management expenses for a fund may increase.

As the following chart illustrates, the prevalence of specialist arrangements in Canada increases with the size of the fund. In excess of 60% of all funds in excess of $2 billion employ a specialist manager structure. The percentage of specialist manager funds decreases if the size of the fund is below this threshold level. This structure in the Canadian marketplace suggests that the investment community supports the notion that specialist structures can add value. At the same time, economies of scale must be created before the fee premium associated with specialist arrangements can be offset by higher returns.

Currently, the Panel employs a specialist structure to invest the current assets of the Fund. Given the large size of the Fund, this approach seems reasonable.
(d) Number of Managers

A multi-manager structure may enable a plan sponsor to appoint specialist managers in specific asset classes. It may also facilitate the appointment of more than one manager within an asset class that employ complementary investment styles or partially offsetting styles. This process of style diversification within an asset class may enable a plan sponsor to better control the risk parameters of the portfolio.

At the same time, a multi-manager structure often introduces additional levels of expense. Most investment management fee schedules work on a declining scale. By splitting the mandate between a number of managers, investment management expenses may increase. In addition, ongoing monitoring costs associated with the fund would be higher in a multi-manager arrangement, since monitoring must be performed separately for each investment mandate.

As a result, the size of a fund becomes a factor in this decision. The larger the asset base of a fund, the higher the average balance will be for each manager and the smaller the fee premium that will be associated with the multi-manager arrangement over the single manager structure. As the following chart indicates, the number of managers employed by a Canadian fund tends to increase with the size of the fund.

![Canadian Pension Funds Number of Managers](chart)

*Note: This is comprised of both internally and externally managed funds.*

*Source: CPF Directory 1997*
In a multi-manager structure, the optimal number of investment managers differs from fund to fund. The optimum number of managers may depend on:

(i) the number of asset classes in which the investment policy will permit the fund to invest - the larger the number of asset classes and different markets in which a fund can invest, the more managers may be required for the fund.

(ii) control of expenses - as discussed earlier, the introduction of multi-managers reduces the asset holding of each manager, thereby increasing the fees paid to each investment manager. Accordingly, the optimal number of managers may depend on the asset level in a fund.

Currently, the Fund employs two active Canadian equity manager and invests in a number of provincial equity pools (both active/passive, domestic/foreign and real estate). Due to the size of the Fund, a multi-manager structure can be maintained on a cost effective basis.

By utilizing the actively managed provincial pools, the Fund is accessing actively managed, multi-manager pooled investment vehicles that reduce the multi-manager fee premium by spreading the fees over a number of investment funds.

It is important to note that there is a separate provincial equity pool for each asset class. Accordingly, this Fund investment decision does not necessarily restrict asset mix decisions by the Panel.

(e) Style Diversification

Style diversification refers to the practice of selecting more than one manager in an asset class with styles that offset. Much like diversification between asset classes, style diversification may enable a fund to reduce volatility in an asset class by a proportionately greater amount than the potential reduction in returns over the same asset class. Accordingly, this practice can assist a fund in maximizing returns while, at the same time, controlling volatility.

The following table identifies the investment styles that were rewarded or punished by the Canadian stock market, on an annual basis, between 1986 and 1997. As the table indicates, different styles and capitalization levels were optimal in different phases of the market. These results would suggest that it is difficult to apply one style that will properly position a fund in all phases of a market cycle. By employing style diversification, this element of volatility can be controlled.
Investment Styles in Canada

<table>
<thead>
<tr>
<th>December Ending</th>
<th>Inferior Style</th>
<th>Superior Style</th>
<th>Spread Between Best &amp; Worst Styles %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>Large Cap Growth</td>
<td>Small Cap</td>
<td>5.6</td>
</tr>
<tr>
<td>1987</td>
<td>Small Cap</td>
<td>Large Cap Value</td>
<td>15.2</td>
</tr>
<tr>
<td>1988</td>
<td>Large Cap Growth</td>
<td>Large Cap Value</td>
<td>6.1</td>
</tr>
<tr>
<td>1989</td>
<td>Small Cap</td>
<td>Large Cap Growth</td>
<td>4.9</td>
</tr>
<tr>
<td>1990</td>
<td>Small Cap</td>
<td>Large Cap Growth</td>
<td>7.0</td>
</tr>
<tr>
<td>1991</td>
<td>Large Cap Growth</td>
<td>Large Cap Value</td>
<td>15.8</td>
</tr>
<tr>
<td>1992</td>
<td>Large Cap Value</td>
<td>Small Cap Growth</td>
<td>39.8</td>
</tr>
<tr>
<td>1993</td>
<td>Large Cap Growth</td>
<td>Small Cap Growth</td>
<td>23.5</td>
</tr>
<tr>
<td>1994</td>
<td>Small Cap Growth</td>
<td>Large Cap Value</td>
<td>17.5</td>
</tr>
<tr>
<td>1995</td>
<td>Small Cap Value</td>
<td>Large Cap Value</td>
<td>3.7</td>
</tr>
<tr>
<td>1996</td>
<td>Large Cap Growth</td>
<td>Large Cap Value</td>
<td>14.2</td>
</tr>
<tr>
<td>1997</td>
<td>Large Cap Growth</td>
<td>Large Cap Value</td>
<td>24.6</td>
</tr>
</tbody>
</table>

Where a multi-manager structure is being employed in a particular asset class, there is the potential for the offsetting styles to reduce the gains associated with active management. Where managers with offsetting styles are employed, the returns may begin to approach those of the index, while maintaining the active management fee differential. Accordingly, care must be taken to ensure that the risk diversification benefits associated with employment of style offsets in a multi-manager, multi-style structure, are not muted by the creation of an index-like portfolio.

Summary of the WCB Investment Policy

The following provides a summary of the current investment policy of the Fund in relation to the above-noted investment policy implementation issues:

Active versus Passive

Like most large funds, the Fund employs a mix of asset and passive management.
External versus Internal Fund Management

For asset classes other than Canadian bonds, external management is utilized. For much of the Canadian equity and the non-Canadian mandates, provincial equity pools are utilized as the primary investment vehicles. A provincial pooled is utilized for the purposes of Fund investments in real estate.

Balanced versus Specialist Manager Structures

Currently, a specialist structure is employed to invest the current assets of the Fund. Given the large size of the Fund, this approach seems reasonable.

Number of Managers

Currently, the Fund employs two active Canadian equity managers, and invests in a number of provincial equity pools (both active/passive, domestic/foreign, as well as real estate). Due to the size of the Fund, a multi-manager structure can be maintained on a cost effective basis.

Style Diversification

Multiple managers are employed in the Canadian equity asset class to achieve effective style diversification. The provincial equity pools also employ a multi-manager approach in each asset class to take advantage of the benefits of effective style diversification.
(3) **Monitoring of the Investment Policy**

A cornerstone of the governance process is the implementation of a formal procedure to monitor the investment policy. The monitoring procedure imposes a discipline that requires a plan sponsor to formally assess the effectiveness of the investment policy and the assumptions incorporated in that policy and to assess the individual performance of each manager entrusted with an investment mandate in the fund.

(a) **Effectiveness of an Investment Policy**

Over the last 15 years, as formal performance monitoring has become the accepted standard for proper fund governance, many new universe measures or benchmarks have been developed. One common way for plan sponsors to assess the performance of their fund is to measure it against one of these established universes.

An implicit assumption incorporated in this type of relative measurement is that the investment policies underlying the universe are relatively homogeneous. In some cases, this may be a reasonable assumption, but in others, it could create either a false sense of security or concern.

While an external measure can assist in the evaluation process, it is critical that a plan sponsor employs a method of evaluation that focuses internally on the policy that has been developed for their specific plan. This type of analysis requires the plan sponsor to revisit fund objectives and re-evaluate the original rationale behind the investment policy decisions.

An investment policy is effective if, in the long run, it accomplishes the goals of the plan sponsor. A universal goal of all plan sponsors is benefit security. Other common objectives can be the minimization of contribution levels or the volatility of contributions. The success or failure of the policy should be measured against the stated fund objectives.

The success of any investment policy depends on the periodic review of the policy, the assumptions used to develop the policy and other current environmental factors that may affect the policy. Any changes in these inputs may result in a required modification to the policy. Major shifts in economic, demographic and market conditions may create an environment that may not have been considered at the policy setting stage. For this reason it is imperative that a formal review of the policy, including an assessment of environmental inputs, be undertaken periodically and that any resulting modifications to the policy are incorporated on a timely basis.

The current practice of the Investment Committee of the WCB is to review the investment policy on an annual basis or more frequently, if warranted.
Recommendations are made to the Panel on potential modifications of the investment policy, as required, following each review.

(b) Evaluation of Investment Managers

The evaluation of each investment manager should involve a quantitative assessment of the investment performance of each manager as well as a qualitative assessment of the investment manager.

(i) Quantitative Analysis

The quantitative assessment of an investment manager involves an evaluation of the recent investment performance of each manager with a mandate under the plan. The evaluation will assess the investment returns of the manager over different time periods since the time that the manager was hired until the end of the monitoring period.

The investment returns earned by the manager are normally measured from both a relative and benchmark perspective.

A benchmark measure for a particular asset class may be expressed as the passive benchmark plus an excess spread to reflect compensation for the additional costs and potential volatility associated with active management.

Investment performance is also measured using a relative performance measure. In this manner, the manager is compared to the other investment managers managing money in a particular asset class.

Where there is a sufficient population for comparison purposes, the manager may be evaluated against a universe of managers applying a similar investment management style in the same asset class. This form of style isolation will often provide a better comparator, by insulating the comparison process from poor results or strong results that are related only to a phase of the economic cycle that rewards or punishes the style of the manager being evaluated.

By simultaneously applying both benchmark and relative measures, an investment committee can determine whether the manager is meeting the return expectations required to support the benefit levels that are to be paid out of a fund, while at the same time ensuring that the manager is performing well relative to an appropriate peer group.

Quantitative analysis should also include an assessment of the risk profile of a fund manager. A typical measure of risk is the standard deviation of the quarterly returns against a benchmark over a rolling 4 or 5 year period.

Modern portfolio theory is based on the assumption that investors are risk averse. As a result, the capital markets must reward investors with higher rates of return in order to take on higher levels of risk, as measured by higher volatility or a
larger standard deviation of quarterly returns. Accordingly, if an investment manager is providing median returns with a volatility level well in excess of the median manager, these results may not be acceptable.

A common way to measure this risk return tradeoff is to utilize a Sharp ratio, which looks at a ratio of return earned by a fund to the level of volatility exhibited to the fund. In this manner, managers with different investment styles can be evaluated on the basis of return produced for each unit of risk assumed.

Currently, both benchmark and relative measures are used to assess the managers with mandates to invest Fund assets. No risk to return analysis is currently being performed.

(ii) Qualitative Evaluation

Poor returns, in isolation, may not necessarily represent sufficient justification for the termination of a manager. In some cases, poor returns may reflect the fact that the investment style and process employed by the manager may be temporarily out of favour in a particular phase of the market cycle. By terminating the manager at that juncture, a plan sponsor may be missing out on the recovery associated with a phase of the market that rewards that same style.

However, disappointing investment performance, coupled with qualitative or structural changes to the organization, may be cause for terminating a manager. In fact, poor performance may be a direct reflection of adverse structural changes to an investment manager.

Adverse changes to an investment manager may include the following:

Changes to the personnel - the primary asset associated with an investment manager is the investment professionals it employs. Where one or more of the key investment professionals employed in an asset class leave the employ of the investment manager, this movement may significantly alter the style and future performance of the investment manager.

Where this occurs, an assessment needs to be made of the remaining members of the management team, to determine whether it will continue to deliver the mandate for which the original team was selected. Smaller investment management teams tend to be more dependent on a single individual or a few key individuals. As a result, they are more susceptible to changes occurring in investment style and performance resulting from the termination of a key investment professional.
Fund Governance Overview
Monitoring of the Investment Policy

**Organization** - changes to the organizational structure of the investment manager, such as a change in the controlling body, the introduction of a new controlling organization or any other change to the ownership or share structure of the management team, may introduce instability to the investment manager. This may result in fund manager turnover or create distractions for the investment management professionals, which may, in turn, adversely impact future performance of the manager.

**Style Changes** - Even subtle shifts in the investment style of a manager, in particular asset class, may be cause for concern. A manager is normally selected on the basis of their approach to managing assets within a particular asset class. This approach may or may not be rewarded during different phases in the market cycle. However, if the manager continues to consistently apply its approach, it should be fairly rewarded over the long-term.

In many cases, more than one manager may be selected in an asset class, in order to provide some form of style diversification. Where the investment style of a manager changes, the manager may no longer fit within the fund investment policy.

**Asset Migration** - Large net client movements may be a symptom of major structural changes to the organization. Where this trend is detected, it may be a signal to a plan sponsor to review the qualitative performance as well as the quantitative issues discussed above in connection with the investment manager in question.

This type of qualitative assessment is normally undertaken by an external investment consulting firm, who dedicates time and resources to interviewing and profiling managers on a regular and systematic basis. At present, no formal qualitative analysis of managers of the Fund is incorporated in the monitoring process, except for the interviewing of managers of the Fund.

**Summary of the WCB Investment Policy**

The following is a summary key features of the Fund monitoring procedures:

**Effectiveness of an Investment Policy**

The current practice of the Investment Committee is to review the investment policy on an annual basis or more frequently, if warranted. Recommendations are made to the Panel on potential modifications of the investment policy, as required, following each review.
Evaluation of Investment Managers

Both benchmarks and relative measures are used to assess the managers with mandates to invest Fund assets. No risk to return analysis is currently being performed.

A formal qualitative assessment is not currently being performed. The Investment Committee is relying on the obligation on the fund managers to raise major structural changes during periodic meetings with the Investment Committee.
II. Industry Best Practices

This section of the report outlines current industry best practices for fund governance. Mercer has drawn upon its experiences working with large pension plan sponsors as well as organizations similar to the WCB in assessing the leading edge standards in Canadian corporate governance.

The principles of good governance developed in this section will be applied in our evaluation of the existing WCB governance structure in section IV of this report.

The primary focus of effective governance is on the establishment of a system that ensures responsible decision-making. The decision-making structure should ensure that decision-makers are incorporating into their decisions appropriate analysis and information, as well as a clear understanding of the interests of the primary stakeholders of a fund.

Investment management is a time-consuming responsibility that warrants attention at high levels. At the same time, there is a large volume of constant activity at a lower level that must be managed. Therefore, efficiency and the use of appropriate expertise by those responsible for high level decision-making is essential. Decisions concerning delegation and monitoring practices are as important as decisions concerning the investment policy itself.

The primary elements of good decision-making are as follows:

- the use of relevant information and expertise;
- the avoidance of conflict of interest; and
- the imposition of checks and balances in the system, where there is vulnerability to error, conflict of interest, fraud or other malfeasance.

An effective governance process does not ensure that all decisions made turn out to be “correct” decisions in the long run. It does, however, ensure that decisions are made rationally.

The following is a discussion of the critical principles involved in the establishment of an effective governance model.
(a) Full Information

Responsible and effective decisions can only be made if the decision-maker has access to all relevant factual information at hand. Along with the factual information, analysis and advice from experts is often needed, unless the decision-maker has the expertise to perform analysis on its own. An effective governance system will ensure that decision-makers have an appropriate flow of information and analysis to support the decision-making process.

In addition to having a flow of good quality information and analysis, it is also necessary for the responsible party to possess or have access to the skills and expertise necessary to properly assess the information provided and arrive at an effective conclusion. This process may necessitate the inclusion of more than one party, to ensure that the appropriate range of skills is applied to the decision.

Decision-makers must have a clear understanding of the full context of the decision. This may include a familiarity with the nature of the accountability chain, as well as the sources and format of the information and analysis that they will be drawing upon.

To equip decision-makers with the necessary context and background, an effective governance system may include a mechanism for educating new decision-makers at the time of appointment.

Many decisions have an impact on more than one part of an organization. Accordingly, it is critical that a mechanism be implemented to integrate the information and decisions generated in one department within the organization with other departments.

A common method of accomplishing this outcome is to establish formal links between related parts of a governance structure. An example of such linking devices is to appoint key individuals to two distinct committees or decision-making bodies. Joint reporting documents incorporating the input of different governance functions can also assist in this integration process.

Finally, informed decision-making should include a clear understanding of the interests of the stakeholders. This understanding should be cultivated through direct interaction with the stakeholders and, in certain circumstances, might require the decision-maker to actively seek input from stakeholders.

(b) Timely Attention to Decisions

An effective governance system will provide for timely decision-making. Issues that require ongoing attention should be attended to with sufficient frequency to discover problems as they emerge, rather than after the fact.
It is also necessary to have a mechanism for detecting and addressing unexpected problems that require immediate attention.

(c) Efficiency

An efficient governance system facilitates the timely and accurate flow of information and effective decision-making. The following three critical factors can help enhance the efficiency of a governance system:

- streaming and prioritization of information and inputs;
- summarizing and consolidating information; and
- effectively storing information to permit easy access.

(d) Clear Division of Responsibility

An effective decision often involves the participation of more than one person and/or skill set. By involving more than one party in each critical decision, the governance model can ensure that different skills and perspectives are being incorporated in the decision.

For example, the decision to set the investment policy for a fund may involve one party who gathers the investment information, one party who compiles the information in a report, one party who makes a recommendation and a final party who makes the decision.

This allocation of decision-making authority needs to be formally documented, so that the appropriate “road map” for each decision path is followed.

(e) Effective Delegation Practices

Delegation is the assignment of a task or responsibility to another party. Generally, where delegation occurs in a fiduciary environment, such as the management of a benefit fund, the person who delegates a task or function retains ultimate responsibility for the actions of the delegate.

In an effective governance model, it is important that delegation can occur, in order to ensure that responsibility is allocated to the best person to discharge the duty. In certain cases, this may involve the employment of external expertise. In other cases, it may involve the delegation of a task to another party within the organization that has more time to dedicate to the task.
Within a governance structure, delegation of tasks or decisions should be regulated to ensure that:

- the selection of the delegate takes into account the suitability of the delegate for the assigned task;
- procedures governing the supervision or monitoring of the delegate, and reporting by the delegate are established; and
- the scope of the delegated authority or task is clearly defined.

These principles of responsible delegation apply equally to the delegation of major decision-making or monitoring tasks, as well as to the delegation of routine administrative functions.

(f) Checks and Balances

An effective governance structure will build checks and balances into the process for making critical decisions and performing essential administrative activities. By introducing diverse perspectives and interests to critical governance activities, the governance system can facilitate the free flow of ideas and information, while reducing the potential of having conflicts of interest influence the decision-making process.

Common methods for introducing checks and balances to the governance system include:

- the appointment of persons of diverse backgrounds and loyalties to critical decision-making bodies;
- the introduction of formal lines of reporting by the decision-makers to stakeholders;
- the introduction of ratification requirements of key decisions by the stakeholders; and
- the introduction of joint decision-making responsibilities between different parties with different backgrounds and loyalties.

This principle of checks and balances to ensure unbiased decision-making is normally reinforced through the introduction of a formal conflict of interest policy.

(g) Documentation

The effectiveness of a governance structure cannot be judged by the effectiveness of the decisions made. With the benefit of hind-sight it is possible to second-guess many decisions.

Generally, when courts have assessed the effectiveness of a governance structure, they have evaluated the decision-making process followed by the plan sponsor. They have evaluated the method in which the decision was made, including the information considered in the decision.
Even where sound decision-making principles are followed, it may be difficult to reestablish those procedures at a later date, in the event that a decision is subsequently challenged. Where there is turnover in the decision-makers, this becomes an even larger challenge. As a result, it is imperative that the reasons for each decision as well as the decision-making process are properly documented.

Where decisions involve more than one party or department, it is important that the flow of information between the two parties is documented. This process would involve the preparation of formal written reports and the submission of formal written recommendations.

As outlined above, an analysis of the performance of the existing governance structure of the Fund relative to these principles of good governance has been undertaken in Section IV of this report.
III. Review of Existing British Columbia’s Workers’ Compensation Board Governance Structure

In this section of the report, the current WCB governance structure relating to the Fund is examined in detail. The study of the governance structure includes an evaluation of the key participants, the key decisions and the mechanisms used to monitor the Fund.

Sources of Information

The governing structure outlined in this section and in Appendices A through D has been obtained through a detailed review of the following documentation:

1. the legislation applicable to the WCB;
2. the governance documentation prepared by the Panel and the Investment Committee;
3. recent reports and resolutions prepared by the Panel and the Investment Committee which relating to the operation of the governance structure; and
4. the agreements between the WCB and the fiscal agent.

This documentation review was supplemented by discussions with the Treasurer of the WCB and her staff, the internal actuary of the WCB and the Office of the Chief Investment Officer of the Ministry of Finance. In some cases, the written documentation or legislation was unclear as to the operation of the governance structure. In those cases, we have relied upon the information provided by the participants in the governance structure to establish the true operation of the governance system.

Overview

Our assessment of the governance model has been undertaken on the following three different levels:

1. an assessment of the roles of the key participants in the governance model;
2. an assessment of the involvement of participants in the key decisions impacting the Fund; and
3. an assessment of the mechanisms used to monitor and support the key decision made relating to the Fund.

Appendix A provides an overview of the WCB governance model.
(1) **Key Participants**

The following are the key participants in the governance structure for the Fund and a description of the role that they play in the process. Appendix B outlines the roles played the participants in the key decision-making processes.

(a) **The Ministry of Finance**

The Ministry of Finance performs the following three roles in relation to the Fund:

- pursuant to Section 67(2) of the British Columbia Workers’ Compensation Act (the “Act”), the Minister of Finance, has a duty to supervise and direct the investment of the Fund;

  The exact nature of the “supervisory role” of the Ministry of Finance under Section 67(2) of the Act is not clear. Historically the Ministry of Finance has played an active role in supervising decisions relating to the Fund. Over the last few years, the Ministry of Finance has not actively exercised this discretion. However, in light of Section 67(2) the Ministry of Finance could choose to exercise its influence in the investment of the Fund if it chose to do so.

- the Ministry of Finance also acts as the “fiscal agent” of the Fund. In this role of fiscal agent, the Minister of Finance monitors transactions for compliance with the investment policy and applicable legislation, provides record-keeping services, and establishes settlement, safekeeping and securities lending arrangements on behalf of the Fund.

  The Ministry of Finance acts as fiscal agent for all crown corporations in British Columbia. This fiscal agency relationship between the Ministry of Finance and all crown corporations has been established as an additional safeguard for the funds of crown corporations in order to ensure the financial stability of the Province.

- the Ministry of Finance acts as an investment manager for the portion of the Fund in invested in Provincial pooled funds (passive Canadian equities, foreign equities and real estate).

(b) **The Panel**

Pursuant to Sections 82(a)(iv) and 67(2) of the Act, the Board of Governors is responsible for the operation and investment of the Fund. Pursuant to Section 81 of the Act, the Board of Governors consists of thirteen (13) voting members: five (5) governors representing Claimants, five (5) governors representing Companies, two (2) governors representing public interests and one governor who is appointed as chair.
Pursuant to Section 83.1 of the Act, the Board of Governors has been replaced by a Panel of Administrators. Accordingly, the Panel is now responsible for the operation and investment of the Fund. Currently, the Panel is comprised of five (5) members (including one vacancy). Each of the Provincial Vice-President of the British Columbia Government Employees Union, the Deputy Minister of Women’s Equality, the President of the Pulp and Paper Employee Relations Forum and the Executive Director, National Institute of Disability Management and Research sit on the Panel, which is chaired by the Deputy Minister, Ministry of Finance.

(c) The Senior Executive Committee of the WCB

The Senior Executive Committee is comprised of the President and the four Vice-Presidents of the WCB (Vice-President Finance/Information Services, Vice-President Prevention, Vice-President Rehabilitation & Compensation Services Divisions and Vice-President Human Resources & Corporate Planning).

The Senior Executive Committee (or the President acting alone), must review and approve all matters that are submitted to the Panel, prior to the Panel’s review. For example, the Senior Executive Committee approves the preliminary assessment rates prepared by the Assessment Department and Actuarial Department before the rates are submitted to the Panel for approval.

(d) The Investment Committee

Pursuant to Sections 82(b)(i) and 83.1 of the Act, the Panel established the Investment Committee to assist in the development of investment strategies and management of the Fund.

The Investment Committee is comprised of five (5) voting members: the President, Vice President Finance/Information Services (“VP Finance”) and three external appointments. The selection of the three external appointment is based on the investment expertise, with no consideration given to the stakeholder affiliation of the member.

The following three WCB staff members sit on the Investment Committee as non-voting members: the Treasurer, Internal Actuary and Senior Portfolio Manager. The Chief Investment Officer from the Ministry of Finance also sits on the Investment Committee as a non-voting member.

The Panel has delegated the day-to-day operation and monitoring of the Fund to the President and VP Finance. As both the President and VP Finance sit on the Investment Committee, much of the responsibility for the day-to-day operation and monitoring of the Fund is conducted through the Investment Committee.
(e) **WCB Vice President of Finance ("VP Finance")**

As outlined above, the VP Finance (who reports to the President) is a voting member of the Investment Committee. The VP Finance also oversees the work of a number of departments which participate in Fund related decisions, including the Treasurer, the Internal Actuary and the Assessment Department.

(f) **WCB Treasurer**

The Treasurer and her staff have been delegated the responsibility and authority to manage the fixed income portfolio.

The Treasurer has also been delegated a number of other responsibilities in relation to the Fund, including, the implementation of the investment policy and other reporting responsibilities.

(g) **Investment Managers**

The fixed income portfolio is managed by the Treasurer. There are two external managers who each manage a portion of the active Canadian equity portfolio.

The remaining equity portfolio (including foreign equity) and real estate portfolio fall under the responsibility of the Ministry of Finance, as these portfolios are invested in Provincial pooled funds.
(2) **Key Decision Processes**

The following are the major fiduciary decisions that may impact on the long-term viability of the Fund. Appendix C outlines the participants and inputs into the key Fund decisions.

(a) **Setting the Investment Policy**

The investment policy relating to the Fund is contained in the “The Workers’ Compensation Board of British Columbia Statement of Investment Policies and Goals for the Accident Fund” (the “Policy”). The Policy was established by the Panel effective December 8, 1995 and any changes to the Policy are approved by the Panel (however, there have been few changes to the Policy since its inception). The Policy sets out the critical investment policy decisions, including: investment objectives, permitted categories of investment and asset mix ranges.

The Investment Committee plays three critical roles in relation to the investment policy:

- it exercises the decision-making authority that has been delegated to it by the Panel. The Investment Committee sets the asset mix (within the asset mix range set by the Panel) and decides the manner in which assets will be invested, in terms of active vs. passive management;

- it monitors the performance and financial position of the Fund; and

- it recommends changes to the Policy in its annual report to the Panel and, when appropriate, throughout the year.

The Ministry of Finance, in its capacity as fiscal agent, monitors transactions for compliance with the Policy and reports to the Investment Committee. The Treasurer also monitors market developments, proposes changes to investment policy and strategy of the Fund.

(b) **Selection of Investment Managers**

Under the terms of the Policy, the Panel appointed the Treasurer as the manager of the fixed income portfolio and delegated the authority to select and appoint the external investment managers to the Investment Committee.

In addition to appointing the external managers, the Investment Committee also sets specific benchmarks for each investment manager. The fiscal agent works with the Investment Committee to set these benchmarks.
The Treasurer monitors the performance of the external managers on an ongoing basis, through monthly and quarterly reports prepared by the managers and the fiscal agent. The Investment Committee also monitors and reviews the performance of the managers in its quarterly meetings. The Investment Committee prepares both a semi-annual report and an annual report to the Panel on the performance of the managers and the Fund.

(c) Establishment of Funding Policy

The Funding policy consists of two primary decisions; the establishment of assessment rates and the establishment of a formal funding target.

Establishment of Assessments Rates

The Assessments Department and Actuarial Department (both reporting to the VP Finance), in consultation with the external actuary, prepare preliminary assessment rates for review by the VP Finance.

After the VP Finance has approved the preliminary assessment rates, the rates are submitted to the Senior Executive Committee. After review and approval by the Senior Executive Committee the rates are submitted to the Panel.

The Panel reviews the rates and then instructs the Assessment Department and Actuarial Department to take the rates to stakeholders (primarily employer representatives) for review and input. The assessment rates may undergo minor variation after meetings and consultation with stakeholders. However, there is no requirement that the stakeholder feedback be incorporated in the assessment rates. The Panel approves the assessment rates after the industry consultation process has concluded.

Establishment of Funding Target

The preliminary funding target is prepared internally at the WCB by the VP Finance. The target figure is then submitted to the Senior Executive Committee for approval.

The final funding target figure is approved by the Panel before publication in the Panel’s annual report to industry.

(d) Approval of Valuation

The Actuarial Department, in consultation with the external actuary, prepares the annual valuation report. The critical decision incorporated in the valuation is the establishment of the discount rate used to discount the liabilities of the Fund. The external actuary officially “approves” the actuarial valuation and then the valuation is submitted to Panel for approval.

The Auditor General reviews and approves the valuation before it is published in the Annual Report.
(e) Selection of the Actuary

The current external actuary was originally appointed approximately 20 years ago and has continued to consult as external actuary since this appointment. The internal audit department has suggested that the external actuary position be put out to tender. If the position is put up for tender, the Panel will select the new appointment.

(f) Establishment of Governance Process

As outlined above, the Panel is responsible for the operation and investment of the Fund. The Panel has delegated responsibility for functions relating to the operation of the Fund and established a general governance structure in the Policy.

The Policy sets out the tasks and responsibilities retained by the Panel and those which have been delegated to the Ministry of Finance (as fiscal agent or as manager of the Provincial pooled funds), the Investment Committee, the Treasurer and the investment managers. The Policy also prescribes time frames for completion of the various Fund related functions.

The Ministry of Finance performs an annual review of the governance structure.

(g) Custody

Historically, the Ministry of Finance was appointed as fiscal agent under the Act, and the role of fiscal agent included custodial functions. The Act was amended in the 1980s to remove this appointment from the legislation. However, prior to the change in legislation, the WCB and the Ministry of Finance entered into a Fiscal Agency Agreement, under which the Ministry of Finance remained the fiscal agent and resumed its custodial functions.

The Ministry of Finance has entered into an agreement with Royal Trust, whereby Royal Trust acts as the custody of the assets. The fiscal agent monitors the activities of Royal Trust. The Auditor General audits the activities of the fiscal agent on a regular basis. The also Treasurer monitors the activities of the fiscal agent.

(h) Establishment of the Expenses Policy

The Act specifically outlines categories of expenses that may be paid from the Fund. However, within the discretion given to the WCB, the Controller and his supervisor, the VP Finance, make recommendations to the Panel regarding the expense policy of the WCB. The Panel sets the expense policy.

(i) Selection of Other Advisors

As and when needed, the Investment Committee selects and appoints external experts. The monitoring of these external experts and reports created by these external experts are decided upon on a case by case basis.
(3) Decision-Making Tools

(a) Monitoring of the Investment Policy

The Policy is formally reviewed on an annual basis. A detailed report relating to the Policy is prepared for this annual review by the Investment Committee. This annual report includes recommended amendments to the Policy, information relating to the structure and objectives of managers, significant activities and changes during the year, planned future activities, the annual financial statements, the most recent actuarial report and the report prepared by the fiscal agent.

The content of the Policy is continuously reviewed on an informal basis and recommendations for changes to the Policy are proposed by the Investment Committee, when necessary.

In recent history, asset and liability monitoring has been performed every two years to ensure that the asset mix matches the liability structure.

Transactions are monitored by the Fiscal Agent for compliance with the Policy as they occur.

(b) Monitoring of Investment Managers

The Panel reviews the investment performance of each manager and the Fund through a review of the semi-annual and annual reports prepared by the Investment Committee.

The investment monitoring report includes the following:

- an assessment of current market conditions;  
- an evaluation of the performance of the Fund;  
- an assessment of the performance of each component of the Fund mandate;  
- a review of the investment policy;  
- a summary of conflict of interest reporting activities; and  
- a breakdown of investment management fees.

The Investment Committee reviews manager performance during each quarterly meeting. Each manager must provide the Investment Committee, with monthly portfolio listings (including the book value and market value of Fund holdings) and transaction listings, as well as a quarterly performance report.

On an annual basis, or whenever change occurs, managers must provide the Investment Committee with their policies and procedures relating to voting rights on securities, soft dollars, professional standards, conflict of interest and internal controls.
Annual meetings are held by the Investment Committee with each manager to review strategy, performance and fees and expenses.

In addition to the foregoing, external managers have an ongoing obligation to advise the Treasurer of any changes in their organization, personnel or investment process. Each investment manager must be available for meetings or discussions on a reasonable basis and permit a tour of their premises and a review of their internal control system at least once a year.

Transactions are monitored by the Fiscal Agent for compliance with the Policy as they occur.

(c) Delegation Policy

There are a large number of decisions and tasks relating to the Fund that are delegated. The important tasks and decisions relating to the Fund that are delegated are formally documented. For example, decisions and tasks relating to the investment of the Fund are delegated in the Policy.

There does not appear to be a general delegation policy which contains general principles and rules of delegation that apply to all delegated acts.

(d) Conflict of Interest Policy

The Panel has established a conflict of interest policy which requires all people involved in the investment of the Fund and all employees of the WCB to disclose conflict of interest situations. All people involved in the investment of the Fund and all employees of the WCB are also required to disclose their beliefs concerning the conflict of interest of another party. A party that has a conflict of interest is required to refrain from acting in relation to the Fund.

The Investment Committee maintains a conflict of interest register.

(e) Review of Fees and Expenses

Fees and expenses of WCB staff are reviewed by both an internal controller and the internal auditor on an ongoing basis.

On a yearly basis the Investment Committee reviews the fees and expenses of the fund managers.
(f) Audit Procedures

The audit department of the WCB (reporting to the President of the WCB) audits the treasury department to ensure the security of the assets held by the treasury department (the fixed income portfolio). The audit department prepares an annual report to the Investment Committee relating to its audit.

The Auditor General audits the Treasury Department of the WCB, in its capacity as manager of the fixed income portfolio, on a yearly basis. The Auditor General audits the fiscal agent on a periodic basis. This audit of the fiscal agent includes an audit of the fiscal agent as manager of the WCB equity portfolio.

The Auditor General also approves the annual valuation of the Fund before the valuation is published in the WCB Annual Report.

(g) Valuations

Formal valuations of assets and liabilities are prepared on an annual basis.
IV. Evaluation of Existing British Columbia’s Workers’ Compensation Board Governance Structure

The assessment of the current WCB governance structure applies the principles developed in section I and section II of this report to the governance model documented in section III of this report.

Where necessary, the report will consider changes to the existing governance practices. The report has offered an alternative structure for consideration by the Commission. The Report has also identified the following additional areas of concern and/or specific considerations for the reform of the governance system:

Overview

Our analysis will focus on the following three distinct levels of the governance structure:

(a) We will first examine the macro-organizational structure. This analysis will involve an assessment of the key decisions impacting the long-term preservation of the WCB program and explore the allocation of the responsibility for these key decisions. The analysis will also assess the level of stakeholder input into these key decisions. Finally, this section will assess the potential interrelationship of each key decision on the overall welfare of the system and evaluate any critical inputs and outputs relating to these decisions.

(b) We will assess the existing allocation of the responsibilities between the parties participating in the governance system. This assessment will include an evaluation of the effectiveness of the existing allocation of responsibilities and discuss potential changes to the existing allocation of responsibilities between parties.

(c) We will assess the specific tools and mechanisms employed to support the governance structure, including the formal monitoring process in place to ensure the continued compliance with the Policy adopted by the Investment Committee.

We have included as Appendix F, a summary of the key governance principles, as identified in Section II, together with an assessment of the effectiveness of the existing Fund governance structure in relation to these key governance principles. As well, we have identified key areas of concern and/or potential improvement of the Fund current system.
(1) Macro-Organizational Structure

Historically, the Panel, and its predecessor, the Board, have done an effective job in managing the Fund in a deficit environment. The Panel has controlled assessment rates, funding policy and investment policy in a deficit environment in a manner that has improved the funding position of the Fund, while supporting the existing benefit levels.

At this stage in the Fund’s history, the Fund and the governance system, charged with maintaining the Fund, will need to introduce mechanisms to manage the rational accumulation of fund surplus.

More than ever before, there will be pressure to modify the existing governance structure to better connect the funding policies and the investment policies in order to effectively manage the accumulation of surplus and the control of the future assessment rates.

Assuming a fixed benefit level, the following are the four critical decisions involved in setting the investment policy and the funding policy:

1. setting the asset mix policy (the allocation of assets between the different allowable asset groups);
2. setting the funding assumptions (the discount rate used to value the fund liabilities);
3. setting the target funding levels for funding purposes; and
4. setting the assessment rates.

As Appendix D illustrates, each of these four critical decisions are presently being controlled by the Panel. However, there is no formal mechanism or discipline that links the asset mix decision (a critical decision in the formulation of the investment policy) to the funding policy.

The following economic model formally and rationally links the setting of the investment policy to the setting of the funding policy.
Investment and Funding Decision Making Model

The linkage between funding and investment policy depends on the following three economic factors:

1. The economic value of both the current years’ assessment and the liability for obligations incurred to date;
2. The expected long-term annual rate of return generated by the investment policy; and
3. An explicit funding target.

The economic value of the liabilities is calculated using a riskless discount rate. The riskless discount rate used for this calculation must reflect both the term structure (duration) and the economic structure (real or nominal) of the underlying obligations.

For the WCB obligations, the best theoretical match for the discount rate is the yield on a Government of Canada ("GOC") real return bond with a 10 year term to maturity. Since only 25-30 year real return bonds are available in Canada, this rate needs to be eliminated. A reasonable estimate of this riskless discount rate at the end of 1997 is about 3.75%.

The expected (i.e. long-term) annual return generated by the investment policy depends on the asset mix selected by the investment policy. For purposes of this calculation, we assume a real rate of return on equities equal to 6.75% over the long-term. This represents an assumed long-term risk premium of 3.0% over the riskless rate of return.

The appropriate funding target reflects the economic value of the liabilities and incorporates an explicit risk margin. The risk margin incorporated reflects the risk built into the investment policy.

Typically, the risk margin is set using “value at risk” principles. A rule of thumb for this type of calculation requires that the margin set in the system is sufficient to cover a 1 in 40 downside event to the fund investments or a two (2) standard deviation under-performance event. As a first approximation, we suggest that the risk margin equals 35% of the proportion of the Fund invested in equities (i.e. a 35% safety margin for 100% equities or a 17.5% safety margin for a 50% equity composition).
A risk adjusted annual assessment (in the aggregate) based on the above three factors can be calculated as using the following formula:

1. The economic value of the current year’s assessment
   Plus
2. The interest on the funding target
   Less
3. The expected return on the funding target
   Plus
4. The amortization of annual deviations from the funding target as well as the risk margin on changes to the liabilities.

The risk adjusted assessment will vary from period to period with the following factors:

- financial market conditions, such as the level of yields on real return bonds;
- the funded status of the Fund relative to the funding target; and
- the equity content of the investment policy.

Smoothing mechanisms can be incorporated in the formula to enhance the stability of the assessment rates.

Under this model, the targeted funding level is established to support the level of volatility that is built into the investment policy.

Provided that a sufficient security margin is built into the funding policy to allow for normal market fluctuations, the benefits security for Claimants has been satisfied. At this stage, the remaining primary stakeholder with an active interest in the Fund is the Companies.

The higher the equity content adopted in the asset mix policy, the lower the ongoing assessment rates are expected to be into the future. This means that the mechanism will fairly reward the Companies for taking on additional investment risk, through the expected reduction of future assessment rates.

Given the relative historical risk and return orientations of equities versus bonds, the maximum funding level required to insulate the Fund, where it is invested 100% in equities, would be a funding target of 135%. Accordingly, this would be the maximum funding level target that should be set, based on this rational model. Where equity exposure is reduced, the funding targets could be reduced to reflect a lower level of volatility for the Fund.
Where the funding target incorporated in the funding policy exceeds the funding target yielded by this model, the present generation of contributing Companies are not being fairly compensated for the risks they are undertaking with the capital they are building up in the Fund through their contributions to the Fund.

It is also important that the discount rate assumption incorporated in the funding process be set rationally. In the future, the liabilities should be discounted using the actual market rate of return. As discussed above, the best proxy for the market rate of return on these liabilities would be the rate of return provided by real return bonds.

Any safety margin required to be built in the system would be incorporated rationally into the model through the funding target. Where safety margins or reserves are being buried implicitly in other funding assumptions, they will have the effect of distorting the ultimate funding targets and result in inefficiencies and inequities in the assessment rates.

Any distortions of this nature will result in an inter-generational inequity, as future assessment rates may be reduced as a result of the over-contribution of current Companies. In effect, the current generation of shareholders of the Companies are over-paying for existing WCB benefit levels, to the advantage of future shareholders of the Companies.

In addition, to the extent that inflated assessment rates put pressure on the continuation of future benefit levels, a policy involving the inefficient setting of funding assumptions and assessment rates may jeopardize the future operation of the system or the ability of the system to continue to deliver existing benefit levels to existing or future Claimants.

By utilizing a transparent and rationale model to set investment and funding policies, the Panel is increasing the integrity and effectiveness of its governance system. A rational and open decision-making system facilitates the documentation of considerations for key decisions and protects participants in the governance structure from any appearance of wrong doing or conflict of interest.

None of the Workers’ Compensation Boards interviewed (including Ontario, New Brunswick, Alberta and Saskatchewan) currently utilize a model that formally and rationally link the investment policy to the funding policy. However, some of those provincial Workers’ Compensation Boards in better funding positions are currently struggling with this issue.

The Panel has taken a preliminary step in this direction. In response to recommendations from the Auditor General of British Columbia (in a February 1998 report on internal and external accountability), the Panel committed in its 1997 annual report, to a formal funding target of 110% – 115%. Through the use of the proposed integrated funding and expensing model, this funding target would be derived based on the investment policy set for the Fund.
As Appendix D illustrates, the current decision-making model places the primary responsibility for these critical issues in the hands of the Panel. While the Panel has input on these decisions from the Ministry of Finance, there is no formal input into the system from the primary stakeholders of the Fund. As the primary stakeholders will be critically affected by the decisions taken on these issues by the Panel, it is important that they are provided with a mechanism to have some direct influence on the decision-making process.

In the past, the Board of Governors had been structured to include five governors representing labor and five governors representing employers out of the thirteen governors. The composition of the Board of Governors provided a link between the primary stakeholders and the setting of the funding and investment policies. When the Board was abolished and replaced by the Panel, the linkage between the critical decision processes and the stakeholders was, largely, lost.

In order to ensure the proper consideration of the interests of the primary stakeholders, it is important to re-establish this linkage. This could be done either through reconstituting the Board of Governors or by mandating a change in the composition of the Panel in order to accommodate majority equal representation of Companies and Claimants. Our preference would be a formal return to the Board of Governor’s with its statutory composition.

Each of the Workers’ Compensation Boards interviewed (Ontario, New Brunswick, Alberta and Saskatchewan) had the primary decision-making body formally and strongly linked to the primary stakeholders, through representative appointments.

At the same time, the reintroduction of this linkage would help to strengthen the integrity of the governance structure. The linkage would help the Panel to avoid the appearance of conflict of interest in the decision-making process and ensure the proper consideration of the concerns and interests of the primary stakeholders.

In Appendix E we have provided a proposed governance model to control the critical Fund decision-making processes.
(2) Allocation of Responsibilities between Participants in the Governance Structure

The following section provides considerations for the reform in connection with the present allocation of responsibilities among the participants in the governance structure.

(a) Setting the Investment Policy

The investment policy is set by the Panel with input and recommendations from the Investment Committee.

The Investment Committee is directly appointed by the Panel. The guidelines for the appointment of the Investment Committee are laid out in the Policy and the Panel has the authority to amend the Policy to change the composition of the Investment Committee. Because of the close relationship between these two parties, the potential exists to question the independence of the Investment Committee from the Panel and the degree of independence from the Investment Committee.

The information gathering process, the recommendations and the ultimate decision-making responsibilities all fall to the Panel and the Investment Committee. While the Ministry of Finance has supervisory responsibilities in the decision-making process, over the last few years the Ministry of Finance has not actively exercised its discretionary powers.

The best way to ensure the proper consideration of the investment policy by parties with different perspectives and interests is to reestablish a representative Board.

Until this has been achieved, it may be advisable to introduce an independent third party to the procedure to be consulted on major changes to the investment policy. In order to re-establish the linkage between the primary stakeholders and the critical decisions affecting their interests, it would be beneficial to ensure that the composition of this external party includes the direct participation of the primary stakeholders in the Fund, Companies and Claimants.

(b) Selection of Investment Managers

The existing fixed income portfolio is managed by the Treasurer and her staff. The monitoring of the performance of the bond portfolio is conducted by the Investment Committee. Since the Treasurer is an employee of the WCB and the Treasurer sits as a non-voting member of the Investment Committee, this raises a potential conflict of interest in the evaluation process.

To combat this perception, and thereby strengthen the governance process, an unrelated party should be provided with the responsibility of monitoring the fixed income portfolio. This unrelated party should be given primary responsibility for the monitoring process or
the authority to approve the recommendations of the Investment Committee on the
maintenance or replacement of the Treasurer as the Investment Manager for the fixed
income portfolio. Potentially, the Ministry of Finance could assume this role.

(c) Set Funding Policy

Set Assessment Rates

Assessment rates are set by the Assessment Department and the Actuarial Department of
the WCB in consultation with the external actuary. The preliminary assessment rates are
reviewed by the VP Finance and the Senior Executive Committee and submitted to the
Panel for approval. Prior to approving the rates, the WCB consults with provincial
employers, who provide input on the assessment rates. Following the conclusion of the
feedback process, the assessment rates are finalized by the Panel.

A critical step in this process is the consultation with the Companies, who are primary
stakeholders in the Fund. It is not clear in this model the nature or extent of this approval
process. It would be important to ensure that this review process accesses a
representative sampling of the Companies in the Province. At the same time, it is
important that proper consideration is given to the concerns expressed by the
stakeholders.

A formal industry committee should be set up with representations from each primary
assessment group. This will ensure proper representation and composition of the
Companies.

At the same time, a report should be prepared summarizing the specific comments and
concerns raised by this industry review committee. As the Investment Committee
undertakes the most of reporting and information gathering responsibilities related to the
Fund, the report should be prepared by the Investment Committee, for review by the
Panel. The report would ensure that proper consideration was being given to the input
provided by this industry committee.

The ultimate control for setting the rates should continue to reside with the Panel and not
with the industry committee, as it is in the interests of the industry committee to limit
assessment rates, even at the expense of existing benefit levels. However, it is important
that this group of primary stakeholders has a formal forum for expressing their views and
providing their input to the assessment process.

Setting Target Surplus

Surplus targets are set by the Panel, after the Senior Executive Committee of WCB has
reviewed the target. As with the other key investment policy and funding decisions, it is
important from a governance standpoint that more than one body and perspective be
incorporated in the decision-making process.
The best way to ensure the proper consideration of the funding target by parties with different perspectives and interests is to reestablish a representative Board.

Until this has been achieved, it may be advisable to introduce an independent body with equal representation from the Companies and the Claimants to approve the funding target set.

(d) Approval of Valuations

The valuation incorporates critical funding assumptions that will impact on the funding status of the Fund and the present and future assessment rates required to support current benefit levels. As with the other funding and investment policy decisions, it is important that the interests of the primary stakeholders are incorporated in the valuation assumptions.

Until a representative Board is reconstituted, an independent joint body with representation from the Companies and the Claimants should be charged with the responsibility to ratifying the valuation report.

(e) Selection of Actuaries

The Panel is responsible for selecting the external actuary. The current external actuary has operated in this capacity for approximately twenty years.

While there is no evidence that the external actuary has not properly served the Panel and its predecessor, the Board of Governors, it would be appropriate to publicly tender this relationship periodically, perhaps every five years.

The tender process will provide a formal evaluation process for the existing actuary and ensure that the WCB is receiving state-of-the-art consulting capabilities at a reasonable price. The tender process will also serve to generate new ideas regarding the future operation of the Fund.

At the same time, the tender process will strengthen the governance process by removing any implication of undue influence or conflict of interests in this relationship.

(f) Setting of Expenses Policy

The policy on expenses is set by the Panel, with the input of the Controller and the VP Finance of the WCB. Since the expense policy may have an impact on the funding position of the Fund, it would be proper to have the input of a party external to the WCB on changes to this policy.

As decisions of this nature have an impact on the primary stakeholders, it may be advisable to introduce an independent body with equal representation from the Companies and the Claimants to provide input in connection with this issue.
(3) Decision-Making Tools

For the most part, the tools and systems in place to assist the Panel and the Investment Committee in monitoring the Fund are comprehensive and meet or exceed the current practices of similar committees in Canada. There is also strong evidence that the procedures in place are being properly followed and carried out.

We have identified the following specific areas of concern and/or specific modifications to the existing monitoring procedures in place for the Fund:

A. Historically, an asset/liability modeling report has been commissioned with an external actuary to occur every two years. This process helps to ensure that the investment mix selected properly matches the liability structure. However, there is evidence to suggest that the recommendations provided in these reports are not always strictly followed. In the last report, there was a recommendation to increase the equity exposure in the Fund. This asset mix shift has not been adopted by the Panel.

In the future, these exercises should continue to occur every two years. The asset/liability study should be expanded to rationally link the asset mix policy with the expected liability structure, the funding targets and the assessment rates. This would be the critical stage in the governance structure which formally and rationally links the investment policy with the funding policy.

B. Each manager is evaluated against a benchmark and using relative performance measures. The risk and return characteristics of the Fund as a whole are then evaluated against a benchmark.

Individual investment managers do not appear to be evaluated in a manner that assesses their risk parameters. By focusing only on returns, it is possible that a manager could be out-performing its benchmark by introducing large amounts of volatility to help him achieve that target. It is important that the risk and return characteristics of each fund manager managing a portfolio for the Fund be evaluated.

C. Currently, monitoring reports are prepared by the Investment Committee and reviewed by the Panel. In many public governance models, the monitoring report is prepared by an external consulting firm.

This act of external delegation introduces an extra element of objectivity into the procedure by introducing a third party assessment from a party who is removed from the appointment decision.
An external monitoring report should incorporate a formal qualitative analysis of managers of the Fund.

D. There is no formal written delegation policy in place. In an effective governance model, it is important that delegation can occur, in order to ensure that responsibility is allocated to the best person to discharge the duty.

A formal delegation policy would outline situations where responsibilities may be delegated to another party and also situations where responsibilities must be delegated to another party (where the party responsible does not possess the proper skills or information to effectively discharge the task).

The delegation policy would normally outline the selection criteria for proper delegation and outline the required monitoring and reporting necessary between the delegate and the delegator.
WCB ACCIDENT FUND - INVESTMENT GOVERNANCE STRUCTURE

Ministry of Finance

• supervisory role over the investment of the Fund pursuant to ss. 67(2) of the Workers Compensation Act
• Fiscal Agent
• manage investments in Provincial pooled funds

Panel of Administrators

Responsibility for Operation and Investment of the Fund pursuant to ss.82(a)(iv), ss.67(2) and ss.83.1 of the Workers Compensation Act

Investment Committee

Voting Members:
• President
• Vice President Finance/Information Services
• 3 external members
Non-Voting Members:
• Treasurer
• Chief Investment Officer (Ministry of Finance)
• WCB Actuary
• WCB Senior Portfolio Manager

Treasurer

• manage fixed income portfolio with other internal staff

Other Advisors

Quarterly Report to Investment Committee

Quarterly Report to Investment Committee

Quarterly Report to Investment Committee

Annual Report to Panel

Ongoing Auditing and Reporting
# APPENDIX B

## Summary of Decision-Making Process of Key Fund Related Decisions

<table>
<thead>
<tr>
<th>Governance Criteria</th>
<th>Ministry of Finance</th>
<th>Panel of Administrator</th>
<th>Investment Committee (IC)</th>
<th>VP Finance/Info Services</th>
<th>Treasurer</th>
<th>WCB Actuary</th>
<th>External Actuary</th>
<th>Auditor</th>
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<td>Permit categories of investment</td>
<td>Make Recommendations &amp; Ratify Panel’s Decision</td>
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<td>Make Recommendations</td>
<td>Make Recommendations</td>
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<tr>
<td>Set asset mix ranges</td>
<td>Make Recommendations &amp; Ratify Panel’s Decision</td>
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<tr>
<td>Set Asset Mix Within Range</td>
<td>Make Recommendations &amp; Ratify Panel’s Decision</td>
<td>Decide</td>
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<td><strong>Selecting Investment Managers</strong></td>
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<td>Set Performance Benchmarks</td>
<td>Ratify Decisions of Panel and IC</td>
<td>Decide &amp; Ratify IC’s Decisions</td>
<td>Decide and Monitor</td>
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<td>Set actuarial assumptions related to liabilities of the fund</td>
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* In addition to approval by the VP Finance, the Senior Executive Committee (comprised of the President and the four Vice-Presidents of the WCB) must approve the assessments rates, target surplus figures, and the valuation before these issues are submitted to the Panel.
### Key Fund Related Decisions: Decision-Making Process

<table>
<thead>
<tr>
<th>Key Investment Decisions</th>
<th>Ministry of Finance</th>
<th>Panel of Administrator</th>
<th>Investment Committee (IC)</th>
<th>VP Finance/Info Services</th>
<th>Treasurer</th>
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<tbody>
<tr>
<td>Set Investment Policy</td>
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<td>Ø Permitted categories of investment</td>
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<td>Ø Set Asset Mix Ranges Within Range</td>
<td>Ratify</td>
<td>Decide</td>
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<td>- monitor transactions as they occur for compliance with the Policy and applicable legislation</td>
<td>Decide &amp; Ratify</td>
<td>Decide &amp; Ratify</td>
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<td>- approve IC recommendations to change the Policy before recommendations are submitted to the Panel when the change relates to targets, the asset mix ranges and permitted categories of investments</td>
<td>Decide</td>
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<td>- prepare an annual report for Panel on the performance of fund (investment performance and further strategies)</td>
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<td>- quarterly report to the IC on the performance of fund and managers</td>
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<td>- advise IC of changes to the government’s position on investment related issues</td>
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<td>- custodial reports</td>
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<tr>
<td>- Fiscal Agent and IC set sub-benchmarks within each asset class (cash manager)</td>
<td>Decide &amp; Ratify</td>
<td>Decide</td>
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<tr>
<td>- prepare quarterly report to the IC on the performance of the fund and managers compare the performance of each manager to the sub-benchmarks)</td>
<td>Decide</td>
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<td>- prepare quarterly report to the IC as manager of the pooled funds</td>
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<td>- advise the Treasurer of issues relating to the fund and external managers, as they arise</td>
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<td>- submit a monthly portfolio valuation to the Treasurer</td>
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<table>
<thead>
<tr>
<th>Minors of Finance Panel of Administrator Investment Committee (IC)</th>
<th>Vice President, VP Finance/Information Services &amp; 3 external members</th>
<th>Non-Voting: Treasurer, WCB Actuary, Chief Investment Officer (Ministry of Finance) &amp; Senior Portfolio Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voting: President, VP Finance/Information Services &amp; 3 external members</td>
<td></td>
<td>1. Review Policy at least annually and when a change to the Policy is necessary</td>
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<tr>
<td>Non-Voting: Treasurer, WCB Actuary, Chief Investment Officer (Ministry of Finance) &amp; Senior Portfolio Manager</td>
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<td>2. Recommend amendments to the Policy: each voting members of the IC approves the recommendation prior to submission to the Panel</td>
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<td>3. The non-voting representative from the Fiscal Agency (Ministry of Finance) must approve recommendations that relate to targets, asset mix ranges and permitted categories of investments prior to submission to the Panel</td>
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<td>4. Monitor and advise IC of changes to the government’s position on investment related issues that may affect the operations of the fund</td>
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<td>5. Advise Panel of significant changes to the fund as they arise</td>
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<td>6. Quarterly meeting: review fund (Fiscal Agent’s Report), current economic outlook and current asset mix</td>
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<td>7. Prepare semi-annual report on investment performance of the fund and managers for the Panel</td>
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<td>8. Prepare annual report regarding the Policy for the Panel</td>
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<td>9. Monitor external managers on a regular basis through discussions and meetings</td>
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<td>10. On a quarterly basis, provide input to the IC on the external managers</td>
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<td>11. Prepare quarterly report to the IC as manager of the fixed income portfolio</td>
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</table>

- propose changes to Policy and strategies of the fund |
- monitor market development |
- each manager must prepare a quarterly performance report to the IC |
- each manager must provide the IC with a monthly portfolio listing (book and market value) and a transaction listing
<table>
<thead>
<tr>
<th>Key Investment Decisions</th>
<th>Ministry of Finance</th>
<th>Panel of Administrator</th>
<th>Investment Committee (IC)</th>
<th>VP Finance/Info Services</th>
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<th>Managers</th>
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<tbody>
<tr>
<td></td>
<td>Voting: President, VP Finance/Information Service &amp; 3 external members  Non-Voting: Treasurer, WCB Actuary, Chief Investment Officer (Ministry of Finance) &amp; Senior Portfolio Manager</td>
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<td>- review assessment rates prepared by VP Finance, Actuaries and Assessment Dept.*</td>
<td>- VP Finance reviews and provides input to work prepared by Actuary and Assessment Dept.*</td>
<td>- prepare assessment rates in conjunction with Actuary and Assessment Dept.* - first draft submitted to VP Finance</td>
<td>- consult to WCB Actuary Dept. and Assessment Dept.*</td>
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<td>- after preliminary approval by the Panel, the rates are sent to industry (primarily employers) for input</td>
<td>- assessment rates reviewed by Senior Executive Committee** prior to submission to the Panel</td>
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<td>- approval of the assessment rates after industry input</td>
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## Key Investment Decisions

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<th>Panel of Administrator</th>
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<td>Set Governance Process</td>
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<td>- review governance structure of fund annually</td>
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<td>- audits Royal Trust (custodian)</td>
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<td>- authorize disbursements from the fund not related to benefits</td>
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* The Assessment Department is an office of the WCB. The Assessment Department reports to the VP Finance.

** The Senior Executive Committee is comprised of the President and 4 Vice-Presidents of the WCB (Vice-President Finance/Information Services, Vice-President Prevention, Vice-President Rehabilitation & Compensation Services Divisions and Vice-President Human Resources & Corporate Planning).
EXISTING DECISION-MAKING PATHS FOR CRITICAL DECISIONS

APPENDIX D
PROPOSED DECISION-MAKING PATHS FOR CRITICAL DECISIONS

Diagram:

- Panel of Admin
  - Asset Mix
  - Discount Rate
  - Funding Targets
  - Assessment Rates
- Companies
- Claimants
- Ministry of Finance
- Government
## WCB Governance Practices Evaluation Summary

<table>
<thead>
<tr>
<th>Critical Governance Principle</th>
<th>General Comment</th>
<th>Specific Areas of Concern</th>
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</thead>
</table>
| The decision-makers have access to required information | Effective information gathering and reporting activities in relation to the Fund have been established. Comprehensive review channels have also been established. | ➢ There has been a failure to link critical Fund decisions. There is no formal mechanism linking the asset mix, discount rate, funding targets and assessment rates.  
➢ The services of an external investment consulting firm should be employed for Fund monitoring exercises.  
➢ Both the risk and return characteristics of each individual investment manager should be reviewed.  
➢ A more comprehensive qualitative analysis of investment managers should be incorporated into the monitoring procedure. |
<p>| Establishment and maintenance of a comprehensive conflict of interest policy | A comprehensive conflict of interest policy has been established. Documentation suggests that the conflict of interest register is properly maintained. | ➢ The Treasurer manages the fixed income portfolio and sits on the Investment Committee. This situation creates a potential conflict of interest because the Investment Committee evaluates all managers, including the Treasurer. |
| Timely attention to decisions | Effective ongoing monitoring and reporting practices permit timely attention to decisions. |  |</p>
<table>
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<tr>
<th>Critical Governance Principle</th>
<th>General Comment</th>
<th>Specific Areas of Concern</th>
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<tbody>
<tr>
<td>Efficiency of the governance system</td>
<td>Effective reporting and review channels help to ensure that information is properly streamed, prioritized and reviewed on a timely basis.</td>
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<tr>
<td>Clear division of responsibilities</td>
<td>Most tasks relating to the maintenance of the Fund have been clearly delegated to specific parties.</td>
<td>➢ The supervisory role of the Ministry of Finance needs to be more clearly defined.</td>
</tr>
<tr>
<td>Effective delegation practices</td>
<td>There is evidence of effective delegation of tasks related to the Fund and proper documentation of such delegation.</td>
<td>➢ There is no general delegation policy in place.</td>
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<tr>
<td>Checks and balances</td>
<td>Currently, the Panel is not comprised of equal and significant representation from the primary stakeholders of the Fund, Claimants and Companies. As a result, the critical linkage between primary stakeholders and critical decisions relating to the Fund is lost. The Panel (or other decision-making body) should be comprised of equal and significant representation from each primary stakeholder.</td>
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<tr>
<td>Documentation</td>
<td>There is detailed documentation recording important decisions as well as the decision-making processes relating to the Fund.</td>
<td>➢ Some of the documentation relating to the Fund needs to be updated or expanded. For example, the Fiscal Agency Agreement needs to be updated.</td>
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