Defined Benefits: the role of governance

Introduction

The first Briefing Note of this series explored the history of private sector Defined Benefit (DB) pensions in the UK, the volatility of funding positions, the challenges facing different stakeholders and the options available to help schemes face these challenges. This second Briefing Note explores the role that is played by trustees in ensuring that schemes are well run and, as far as is possible, deliver in full the benefits accrued to members.

This note explores:

- The role of DB pension scheme trustees;
- The benefits of good governance and examples of good practice;
- The current gap between good and poor governance;
- The relationship between scale and governance; and
- Improving scheme governance.

Trustees acting in the interest of members

Established under trust law, private sector occupational pension schemes are required to be governed by trustees, appointed to act in the interests of the beneficiaries of the trust; who, in the case of DB pension schemes, are mainly the members of the scheme and their surviving beneficiaries. Trustees have a duty to deliver the purpose of the trust, a duty of care (as set out in the Trustee Act 2000) and a fiduciary duty to the members of the scheme; the latter summarised by Professor John Kay as meaning:

"… that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed" [1]

In 2015, the Law Commission report on the subject of investment intermediaries and their duties[2] explored the subject of fiduciary duty, focusing in particular on pension schemes as institutional investors. Among other findings, the review made a number of recommendations for the Pension Regulator's (TPR) trustee toolkit and guidance, many of which were incorporated[3] with links to the Law Commission guidance to trustees.[4]

The Law Commission review established that pension scheme trustees should:

- Act within the scope of their powers;
- Not exercise a power "fraudulently";
- Not act under the dictation of another;
- Not fetter their discretion;
- Treat beneficiaries even-handedly; and
- Take into account relevant considerations and ignore irrelevant considerations.

Good governance matters

It follows that good governance of a pension scheme should result in better outcomes for all stakeholders than poor governance. Good governance should, first and foremost help secure the benefits of members, but can also aid society in supporting pensioners and therefore reducing the need for taxpayer support in later life. It should also reduce costs and volatility of costs for scheme sponsors.

Good governance in the form of knowledgeable and engaged trustee boards has become ever more important in the complex regulatory, commercial, economic and social environment in which schemes operate. Compared to other territories, the role of trustee is particularly complex in the UK due to the UK's scheme specific funding regime, the requirement to assess sponsor covenant and the very complex benefit structures flowing from successive legislation on matters such as indexation, revaluation, anti-franking and guaranteed minimum pensions (GMPs). The closure of schemes can make governance even more complex.

Trustees need, collectively, to be capable of dealing with issues around:

- The strength of the employer covenant, which means being able to assess the strength of the company's balance sheet and cash position as well as spotting any potential changes in the position, particularly if there are any plans for a change of control;

- Actuarial concerns including the funding position of the scheme and longevity trends;
- The administration of the scheme and data quality; and
- Investment strategy and asset allocation.

The closure of the majority of private sector schemes at least to new members and often to all future accruals, has also been a stimulus for the provision of better governance. As current employees and senior executives of a scheme sponsor become more distanced from the DB scheme, it can become harder to recruit trustees and harder to secure an alignment of interest between the sponsor and the trustee board. This is because funding the DB scheme can come into conflict with investment in the business, maintaining jobs and improving pay and benefits for those not in the DB scheme. Bridging the gap may require more effort and better governance.

What does good governance deliver?

Good governance, particularly when in place throughout the life of a scheme, should in theory lead to:

- Better assessment of risks (economic, covenant, operational, investment and funding) and the development of improved risk management strategies. The ability to assess and respond strategically to a comprehensive assessment of risks faced by the scheme is at the heart of TPRs approach to integrated risk management;
- More considered investment strategies and ultimately better investment returns and/or better alignment with the investment objectives of the scheme;
- Better value operational and investment costs;
- Better data regarding members and the trajectory of liabilities;
- Lower deficits and/or shorter recovery periods where deficits do exist;
- More security and certainty for scheme members and full payment of accrued benefits.

Chart 1: Evidence for a 'good governance' premium

Canadian research	2006 study: Ambachtsheer et al found a positive statistical relationship between good governance and investment performance (in a sample of 81 schemes from around the world). Schemes with good standards of governance (self-assessed by schemes and with size of scheme controlled for) added 1-2% per annum in investment performance when compared to less-well governed schemes.
Swiss research	2014 study: Ammann and Ehmann constructed objective governance scores for Swiss pension funds (sample of 139) based on organisational structure, target setting and investment strategy, investment process, risk management, monitoring and transparency. The scores were then compared to investment performance and found a positive relationship. The research also highlighted the relationship between scheme size and investment performance with larger schemes performing better.
Australian research	2014 study: Research by the McKell Institute explored the relationship between governance structures and performance and concluded that mandating independent directors of superannuation schemes would not add significantly to the performance of schemes. It concluded that the current governance arrangements with representative trustees drawn from membership and employers delivers superior standards of conduct and performance.

There is some, albeit limited, evidence of a good governance premium; in other words, a quantifiable benefit that emerges from applying good standards of governance [Chart 1[6]]. However, many studies, including the Pension Regulator's own, employ self-assessment techniques. Few studies have developed objective measures of good governance.

In the UK, Clark and Urwin[5] have also shone the light on the benefits of good governance and illustrated that their sample of 'best-practice' schemes achieved at least 2% per annum more return than their benchmarks.

Ideally, good governance will be in place early in the schemes life and significant problems will not arise. However, improving the governance of a scheme becomes important when scheme funding is under strain, where the scheme is closed and maturing, when investment returns are low and/or particularly volatile and where the sponsor covenant is weak or about to change. Where all of these factors come together, good governance is critical. Any one of these conditions might suggest the need for an increase in the governance budget attributed to a scheme.

What does good governance look like?

While not codified in law, what constitutes good governance and what is expected of pension scheme trustees has been clarified through case law and new regulation over the course of the second half of the 20th century and first part of the 21st century. TPR initiated a debate on the subject of 21st century trusteeship in 2016.[7]

In its discussion paper, TPR suggests a number of characteristics of good governance, supplemented below by some identified by the OECD in its work on pension scheme governance:[8]

- Trustee boards with diversity of membership;
- Boards that meet regularly and are led by an effective chair;
- Regular evaluation of trustee competence and board performance;
- High standards of integrity and competence, particularly investment knowledge, supported by regular training and adequate time for continuous development;
- Mechanisms for managing conflicts of interest;
- Strong and regular engagement with the scheme sponsor;
- Structured investment and risk assessment policies and processes;
- Regular monitoring and reviews of agents (administrators, investment consultants, investment managers, actuaries and others) including the value for money delivered to the scheme, a complex assessment in both DB and Defined Contribution (DC) schemes.

The governance gap

A combination of growing environmental complexity, volatile and sustained deficits and high profile corporate failures has led to an increase in government and regulatory scrutiny of DB pension scheme governance. As early as 2000, the Government had concerns about the investment decisions being made by pension scheme trustees. It established a review of institutional investment by Paul (now Lord) Myners.[9] The findings of the review highlighted the lack of investment expertise on the part of lay trustees.

Several research studies have pointed to a number of weaknesses in the governance of pension schemes internationally,[10] including issues of competency, planning, leadership, and selection and evaluation.

One area of weakness cited in research is overall board diversity, competency and the competency of individual trustees/board members in particular in relation to investments and risk management. In the UK, many pension scheme boards consist of mainly non-professional trustees drawn from the sponsoring employer and scheme membership. While many have gained considerable pensions experience, some find themselves with limited support and training to equip themselves with the required knowledge and skills. Where trustees lack knowledge and confidence, decision-making can be poor or trustees may find themselves unwilling to make decisions or fail to appropriately challenge professional advisers.

Research by TPR in 2015[11] highlighted particular knowledge gaps with half (51%) of schemes with non-professional trustees reporting not all of their trustees had the levels required by the regulators Trustee Knowledge and Understanding (TKU) code of practice. 5% reported that none of the trustees have the required knowledge while 10% had not heard of the code. The same report indicated a lack of training, with trustees not taking up opportunities to update their knowledge and a third of schemes not having either a training log or plan.

Strategic planning and the ability to step back from day-to-day management decisions have also been highlighted as one of the weaknesses of some boards. Strategic focus can get squeezed out by the sheer volume of day-to-day matters. Some boards report not having goals and objectives against which to assess strategy and performance.

A lack of effective leadership from a chair can also hamper some schemes. Although most scheme boards do now have a formal chair, this is not mandated for DB schemes. Weak leadership can lead to ineffective management of conflicts of interest, poor decision-making and disengaged trustees. However, boards can also suffer if the chair exerts excessive influence on decision-making and other trustees feel unable to contribute or challenge.

The rise of the professional trustee

Professional trustees and chairs of UK pension schemes have historically been in the minority in private sector schemes. However, by 2015, 52% of all schemes and 72% of large schemes had either a corporate or professional trustee on the board.[12]

The debate about professional trustees is not one-sided. TPR's response to its governance consultation stresses the important role that lay trustees play.[13] Some commentators have suggested that the role of DB scheme trustee has become too complex for lay trustees drawn from the workforce and that only professional trustees have the experience and knowledge to provide the governance required. However, others continue to support the role that lay trustees have in adding to the diversity of the trustee pool.

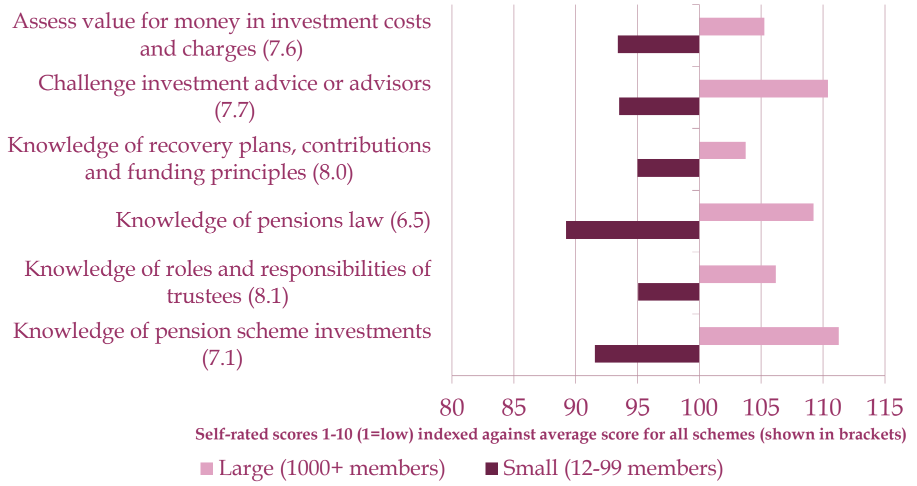
TPR's research also revealed that boards made up of only professional trustees spent more time on trustee duties, have a better (self-reported) knowledge of pensions and feel better able to assess value for money for the scheme. To date, these self-reported improvements have not been validated by independent research and other research suggests that having member representation can strengthen boards in other ways.[14]

The relationship between scale and governance

The same TPR research identifies a positive correlation between the size of a pension scheme and the quality of governance; in other words the larger the scheme, generally, the better the governance. The relationship is not absolute with some small schemes having good governance and some large schemes exhibiting signs of poor governance. Smaller schemes (12-99 members) meet less frequently than larger schemes (1000+ member), have fewer trustees, spend less time on trustee duties, are less likely to know how funds are invested, are less likely to have sub-committees and tend to consist of less qualified trustees. While not all small schemes may need the same level of governance as larger schemes, there are clearly some standards that should prevail across all schemes, regardless of size.

Smaller schemes (when compared to large schemes) score less well on a number of self-rated competencies including knowledge of pensions and

Chart 2: Smaller schemes consistently rate their knowledge and ability lower than larger schemes



investments, their ability to challenge investment advice, and assess value for money of investment costs and charges (Chart 2).

In general, smaller schemes reside with smaller sponsors and face a number of challenges, namely:

- Good governance comes at a price (both the direct costs of paying for trustees and the indirect costs of support for the trustee board). Sponsors can be reluctant to fund governance costs in addition to contributions, leading boards to meet irregularly and having less access to good data and information about the scheme;
- Recruiting high quality trustees with appropriate knowledge and understanding, particularly member-nominated trustees (MNTs), can prove harder for schemes with very few members;

Trustee boards of smaller schemes can have more limited access to professional advice (legal, actuarial, investment) which can hamper decision making.

What are the implications for UK schemes?

If the argument that good standards of governance for DB schemes is becoming ever more critical and the evidence is that smaller schemes struggle to deliver strong governance both hold true, then it should follow that encouraging better governance standards amongst smaller schemes or having fewer larger schemes should deliver better outcomes to members and to other stakeholders.

Consolidation is the direction of travel in the DC market, in particular for master trusts. It is less clear whether or how it is possible to deliver this outcome in the DB sector (beyond the consolidation of schemes that share associated sponsors). Scheme mergers are complex, can drive up short term costs and benefits may take several years to emerge.

Consolidation of schemes is a topical subject with the Government, the Pensions and Lifetime Saving Association (PLSA) DB taskforce and a number of other industry commentators debating the subject in some detail. The Work and Pensions Select Committee has published its own findings on the subject.[15] The report points to recent improvements in scheme governance but concludes that consolidation of smaller schemes would lead not only to better governance, but also to greater economies of scale in investment and administration.

It seems likely, at the date of publication of this paper, that the subject will be discussed again in the forthcoming Government Green Paper on DB pensions.

Where next for governance standards?

It is clear from the latest consultation response from TPR that the regulatory focus will continue to drive up the quality of UK scheme governance through a range of initiatives, in particular:

- More targeted education and tools to raise the standards of poor trustees;
- Setting out what is meant in practice by the higher standards for professional trustees and the specific qualities and skills chairs are expected to bring to trustee boards;
- Tougher enforcement against trustees who fail to meet the required standards.

Conclusions

The UK regulator continues to press hard for higher standards of governance of UK pension schemes and sees good governance as a necessary condition to secure scheme member benefits. Research (albeit with small samples) suggests that high standards of governance can deliver better benefits for all stakeholders including scheme sponsors. However, standards across UK schemes are variable with smaller schemes, in particular, less likely to rate themselves as highly on a number of important measures of quality.

Driving up standards and addressing what should be done for those schemes that demonstrate weaknesses in governance, potentially increasing risks to the members, will continue to be the focus of regulatory and policy attention for some time. Part of the debate will be the question of whether smaller schemes should consolidate, the feasibility of consolidation and the benefits that should accrue from consolidation.

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