

THE MISSING LINK: FINANCIAL EXECUTIVES & PENSION GOVERNANCE

By John Por and Allan Reeve

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The company pension plan is distinct business. It contains all the key ingredients of a business, such as a sponsor, a product, costs, clients and investments. It is a business, however, with some very distinct characteristics:

- It is separate and distinct from the sponsor's core business,
- It contains assets comparable to the operating assets of the sponsor,
- It is a regulated business requiring the advice of specialists (actuaries, auditors, investment managers),
- It is usually managed as two separate functions-- benefits and assets,
- It is a business where pension plan governance is often an "add on" job for busy directors, and
- At times it may not get the management attention it needs from today's busy executives.

A company sponsors a pension plan with objectives related to the retirement income needs of employees, together with financial risk tolerances related to the company's ability to pay. Both the company and the employees have an important stake in the successful operation of the pension plan. The sound and distinct governance of the pension plan is as essential to its long term performance as sound corporate governance is to successful long term corporate performance.

Financial executives are the "lynch-pin" of a successfully operated pension plan. They are crucial to bridging the gap that exists between governance and the day-to-day pension operations.

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THE BUSINESS

The pension business comprises of three policy areas:

Benefit policy, which creates the product and the client base. In turn, it generates the long term liabilities (costs); Funding policy, which establishes the pattern of payment of company costs; and Investment policy, the management of pension fund assets which, if successful, will produce upwards of 80% of the cost of the benefit payments over time.

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In most provinces, the pension legislation establishes an "administrator" (or some similarly titled group) and assigns specific duties for pension benefit administration, communication and liability determination, company payments to fund the plan long term and for asset management activities. Without saying so directly, the various pieces of Canadian pension legislation direct the plan governance role to the administrator.

Since the sponsoring company is usually listed as the administrator on returns to Provincial regulators, this places pension governance squarely on the shoulders of the board of directors (or, as is often the case, on a committee of the board). What can escape the attention of the board is the distinct governance needs of the pension plan and the unique coordination role the board plays in the three policy areas - benefits, funding and asset management.

The board of directors must take a leading role in setting asset management policy, while leaving day-to-day management issues to financial executives. The long term performance of the investment program is just too important to the benefit objectives and the company's financial risk not to do otherwise. The board should at least consciously set policy for:

- Total fund performance objectives considering the nature of plan liabilities,
- Long term asset mix distribution between debit and equity oriented investments most likely to achieve the performance objectives,
- The major asset classes to be included in the portfolio,
- The range of deviation from the asset mix targets that investment managers can effectively use to enhance performance,
- How investment performance is to be measured, and
- Any constraints to be imposed on the investment program.

While these policies are usually done formally, we have found that these decisions are not discussed by the Board to an appropriate degree.

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BENEFIT POLICY is the determination of a desired level of income replacement for retiring employees, taking into account public retirement programs (C.P.P., O.A.S.) and other company benefit and compensation policies. Because pension plans are regulated at both the federal and provincial levels (and change on a regular basis), a periodic review of benefit policy is essential to ensure that the original goal or objective is still being met, and that the plan is tax effective for both the employees and the company. Approval of this policy is another pension governance role for the board.

Plan administration is usually left entirely to the human resource and treasury functions of a company with little or no board involvement as the "administrator" should at least be aware that all minimum regulatory requirements are fulfilled.

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FUNDING POLICY: the company cash flow directed to the pension plan, in addition to any employee contributions, is determined by the actuarial valuation.

The actuarial valuation estimates the value of the pension benefits earned by plan members (liabilities) based on assumptions of future salary growth, future investment returns and demographic assumptions for factors such as mortality and turnover. The liabilities are an excess of assets over liabilities (surplus) or the reverse (deficiency).

The board's primary governance role is to ensure the ongoing financial health of the plan. It provides a link between the fund earnings rate used to establish the company contribution to the plan and the investment return objectives set by the board as part of the asset management governance.

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PENSION PLAN GOVERNANCE - the existing reality

Experience suggests that the independent parts of the pension plan are usually well managed, and the myriad of external service providers render professional and sound advice. What is usually lacking is:

- a recognition that the pension plan needs coordinated governance and management for the independent parts to function effectively (i.e. a proper "wiring" of the pension system),
- pension plan governance by the board which is separate and distinct from corporate governance,
- clarity in decision-making (assigning people to specific duties and responsibilities)
- adequate time allocated to the pension plan business,
- policies that are not coordinated (funding policy assuming an investment return of 7.5% with little or no integration to the 5% real return objective of the investment program),
- the board as administrator is unaware of the legal requirement or of benefit administration, communication and funding,
- boards may discuss day-to-day management issues (such as manager quarterly performance) often without the requisite information on which to make such a decision, one that has been delegated to corporate management, and
- a consistent information flow (the board may see investment results for one and five year periods while manager mandates are based on one year and moving four year periods, often with quite different results!)

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PENSION PLAN GOVERNANCE - the desired future

Now the good news! The pension business lends itself to cascading decision-making, so that decisions of varying impact and requiring different skill sets can be delegated to different pension players. Thus policy, strategic issues and day-to-day operation can be delegated with relative ease.

First and foremost however, is recognition that the pension plan is a highly regulated and specialized business requiring distinct governance and management approaches to ensure its success.

The players in the pension business need to be identified, and their individual roles clearly spelled out and periodically reviewed. A pragmatic feedback system must also be developed that keeps all the players informed and allows discussion and corrective action to take place in an orderly fashion. This avoids surprises at any level.

The information needed for pension decision-making (policy, strategy and day-to-day administration) should be carefully crafted from the same sources, consistently prepared and delivered on time.

Few people understand all the components that contribute to the total pension business. Some understand the benefits - an income for an employee after retirement. The actuarially determined financial health (the actuarial valuation) is less understood. The link between the liability determination and investment objectives is often missing. Keeping up to a sophisticated, multi-country, multi-asset class investment program managed by a number of investment managers is no easy task today.

Thus, the ideal pension governance plan would include a well-informed board, competent management and effective day-to-day administration — each understanding their unique role to this singular business of running a pension plan.

Plan sponsors could be well served by a three-tiered approach to improved pension plan governance.

1. A review process that compares how the plan is supposed to be governed and managed to what is actually taking place. This review would also allow comparisons with current industry best practices and the many regulatory requirements. The end result is an awareness of where improvements and changes can be made.
2. The completion of a responsibility matrix that assigns policies and strategies related to benefit, funding and investment activities, to the various pension players. The mapping of pension decision-making complements the review process.
3. An information process for board members and senior management to increase the understanding of the inter-relationships of the benefits, funding and investment process, and how they are integrated into the pension business.

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Sound pension governance achieved through clear mandates, capable operations, clarity of information flows, feedback loops and regular reviews will provide plan sponsors with improved pension performance, general fiduciary comfort and a well run plan.

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