

# PENSION GOVERNANCE

*By John Por, President, Cortex Applied Research Inc  
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Pension assets of organizations are often comparable in size to operating assets. Given this, it is hard to understand why the governance of the pension plan gets so little attention.

Sound pension governance is as essential to sound pension fund performance as sound corporate governance is to long-term corporate performance. There is evidence that the lack of effective governance of the pension system can lead to investment under-performance of up to 80 to 130 basis points. In this article, the requisite components of an effective pension governance framework are described.

Due to the upheaval of the Canadian corporate landscape in the past few years, organizations have been de-layered, re-engineered, and made lean. Attention to pension assets has taken a back seat to other issues. Unfortunately, the pension world has become more complex with a global investment environment, new investment vehicles and products, and legislation fuelled by court cases.

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## **GOVERNANCE IS PRACTICAL CONCEPT**

There is a need for a practical pension governance framework. Without one, the different complex pension activities scattered throughout and outside the organization are driven by perceptions and flawed conventional wisdom and myths, rather than fact-based direction. These activities include human resources, treasury, MIS, actuaries, investment advisors and managers.

- *Definition of governance:*
  - An effective system holds its decision-makers accountable for results and can change course to reflect past experience.

This is a surprisingly stringent test: few organizations make the grade. Effective pension plan governance has four necessary components. These are discussed below.

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### **CLEAR ACCOUNTABILITES**

Pension decision-making usually takes place through different levels of the hierarchy: Board of Directors, committee of the Board, CEO, senior executives, or managers. While for most business activities delegation is accepted as the norm, in the pension business that does not seem to be the case. The decision-making boundaries between the Board (and its pension committee), senior financial and human resources executives, and the pension manager are often murky. While high-impact decisions such as fund policy, asset mix policy, allowable asset classes and method of fund performance measurement are best left with the Board, others, such as monitoring external managers, are best left with senior financial executives. Boards often spend time overseeing external managers' performance and predicting market movements, activities that are clearly not their domain.

The various decision-making levels are rarely aware of what they are supposed to do. Without clear and well-documented terms of reference that are acknowledged and adhered to, there is a danger that discussion will centre around trivia and that important policy decisions will be left unattended or made by lower managerial levels, with costly consequences. The good news is that the pension business lends itself to cascading decision-making whereby decisions of varying impact requiring varying levels of knowledge (Policy, strategic, and day-to-day management) can be assigned to different pension players.

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### **REQUISITE KNOWLEDGE**

In every business there is a requisite core competency that the system as a whole should possess to be successful. In the course of normal business activities, these competencies are identified, documented, and carefully nurtured. Companies rarely find the time to do the same with the pension business. The first wave of pension managers will likely retire soon, and unless processes are put in place to document and preserve their core competencies, their successors will have a tough challenge. What financial executives often overlook is the need to maintain a balance between the available pension core competencies and the complexity of the investment structure.

As a rule of thumb, if the company cannot afford or is unwilling to pay for specialist advice – an admittedly expensive proposition - the simplest structure is the most cost effective.

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### **INFORMATION FLOW**

Accountability can only be exercised with the relevant information. This is an area where even limited intervention can yield considerable improvement in pension governance. In the last decade, much has been learned about investments, but the information flow has not caught up to this level of knowledge.

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There are glaring inconsistencies with the information reaching different decision makers. Total fund performance versus cost is rarely provided, and reference to internal policy and its implementation is lacking. Varying results are often derived from different conclusions. The nature of hierarchical decision-making requires that the messages that the information carries be made explicit. Senior executives are expected to apply managerial judgment, not solve riddles.

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### **FEEDBACK LOOP**

Most governance systems lack a clear feedback loop. The pension system must have clear feedback loops to provide reality checks. They could range from the expected value added by active management to evaluating the success of market timing decisions. As times and players change, the system is modified, new activities are included and over time the system will change to one bearing little resemblance to its original design.

*"Those who cannot remember the past are condemned to repeat it."* Hierarchical decision-making is prone to ignore the past. Therefore, it is essential that the pension governance prescribe periodic feedback to examine and document the past for effective management.

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### **HIGH ROI SOLUTION**

To avoid the pitfalls listed above, the organization should develop a decision-making map that lists the major pension related decisions by impact (policy, strategic, and day-to-day management), assigns them to the appropriate decision-making level, and re-engineers the information flow accordingly. This will help the organization focus on the primary mission of the pension plan, and pull the different pension related activities (funding policy, benefits policy, pension administration, and asset management) into a coherent whole, which is the prerequisite of sound decision-making.

Sound pension governance does not just happen, and definitely not overnight. Crafting a sound pension governance framework takes leadership, effort, and courage, but not so doing calls for unwarranted optimism. Investing in pension governance is a high return proposition.

*John Por is President of Cortex Applied Research, Toronto, ON, Canada*

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