

# SHAPING UP GOVERNANCE

*By John Por and Allan Reeve  
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“Pension Plans have to identify the risks before they can deal with them.”

It's not surprising that talk of the need for good pension plan governance would elicit reactions from a group of sponsors ranging from muffled coughs to rolling eyes at what many clearly believe is just pie-in-the-sky patter by consultants trying to sell their wares.

Problem is, a concrete tool to improve governance hasn't been readily available to sponsors. But while many organizations may never reach an Enfield-like calamity, pension plan fiduciaries can, in fact, significantly improve the way they govern their pension plan systems. Indeed, improved governance, or "excellence in pension fund management" (a term coined by pension fund guru, Keith Ambachsteer), is claimed to net over 100 basis points to a fund's overall annual performance.

Last year, a model of the essential elements of good governance was developed by Toronto-based investment consultant, Cortex Applied Research, comprised of clearly defined accountabilities, core competency and skills among pension officials, relevant information flow as well as regular reviews. Since then, they've gone one step further, applying it to pension funds of large blue-chip companies, adjusting the model based on their findings of what pension plans are actually doing. Essentially, the model applies total quality management (TQM) to the overall pension management process. And what has emerged from this process is a set of "best practices" principles that sponsors can now use as a new governance benchmark.

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## **IGNORING THE NOT-SO-OBVIOUS**

In working with sponsors, two distinct elements in the governance process emerged that were initially not included in the model. First, there must be a shared common understanding by all decision-makers - fiduciaries and corporate and pension executives - of how a pension plan entity works as a whole. Simply put, however, many did not recognize the complex web of interaction between the liabilities side, run by actuaries and human resources personnel, and the assets side, headed by CFOs and treasurers.

As a result, these component parts are often managed independently and the task of integrating them often falls in the lap of the board of directors - a body established for other tasks - which only bogs down the boards' responsibilities in supervising the plan. Similarly, many organizations that converted their defined benefit plan to a defined contribution plan applied a defined benefit investment structure to their new plan, not appreciating the different tasks and terms of reference involved. For example, a sponsor of a defined contribution plan is not responsible for the overall investment results of the beneficiary's portfolio. And yet, often, there is no change in the

investment policy and plan documents that hold the trustees accountable for the investment program, despite the potential legal ramifications in the long term.

Also, no one could expect the CEO of a company to effectively run the organization without understanding the fundamental principles driving the company's business. So it's surprising that many pension operations don't state explicit investment beliefs or principles to guide investment decisions, as well as other pension management decisions. Yet, it's the only way an investment structure can be coherent. For example, an organization may state that it believes in active management and expects the added value in the long run to be in line with what can be reasonably gained in the capital markets, given the fund's size. With this in hand, the pension organization can then, in say five years, review and understand the source of the fund's performance and adjust expectations accordingly.

"Without fundamental principles in place, a plan goes from pillar to post and gets shoved by legislative changes without a clear route," says Gretchen Van Riesen, Assistant General Manager of Pensions and Benefits for the Canadian Imperial Bank of Commerce (CIBC) in Toronto. "You can link what a pension fund is doing to the philosophy and then you can ask whether you need to rethink what you're doing."

After having a pension fund for 100 years, the CIBC is doing just that. The pension staff approached the bank's trustees in February with the need to review its governance process of the approximately \$1.6-billion fund.

"This helped us to identify at least what to do first," she says. "Governance is an ongoing process. It's not a static report card, but a process of fine-tuning - it's not a magic bullet."

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### **PARTS OF THE WHOLE**

The difference between the supervision of an organization and the management of day-to-day activities is fairly well accepted in the main line of any business, but not in pension entities. Often, job descriptions are very broad-based, which forces trustees, instead of concentrating on policy and providing overall supervision, to handle many of the day-to-day management tasks that should be dealt with at lower levels of management, such as hiring investment managers.

Once the two elements of a belief system and acceptance of an integrated pension model are in place, only then can clear accountabilities and specific job responsibilities be set. That's when plan documents must be dusted, reviewed and revised so that there is a clear delineation of responsibilities and cascading decision-making. A fund should begin by looking at what is the set of decisions that must be made to run a plan, allocating these decisions to the appropriate people, identifying the consequences and then, documenting them. This conscious allocation automatically develops a system of accountability.

Call it a clarification exercise, and one that was undertaken by Montreal's BCE Inc. Each of the committees of its board of directors, including the pension fund management committee, fell in the net of a corporate governance review. The process was launched by first establishing a clear notion of what the pension business is and the activities involved. This resulted in clarifying who specifically looks at such issues as proposed funding and appointments of managers.

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With the accountability structure in place, the flow of who gets what information can then be developed correctly. If the board is responsible for the overall performance of a fund, for instance, there is no reason for directors to see the performance of individual managers, but rather they should be looking at overall performance.

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### **SOUND GOVERNANCE**

What is often taken for granted are "good" fiduciaries. Trustees and directors of boards are recruited from many walks of business life and, therefore, in many organizations, the very people governing a pension system do not have the education or work experience necessary to appreciate and understand the workings of the pension financing model, relevant investment principles and governance.

So organizations need to "manufacture" good trustees by ensuring they receive this knowledge. The simplest solution is for a pension entity to offer workshops and seminars as well as provide packages of information on a regular basis that include bulletins, articles and speeches relevant to pension topics.

That message didn't fall on deaf ears at the Hospitals of Ontario Pension Plan (HOOPP). The Toronto-based fund (worth about \$8 billion in assets) developed workshops that help trustees gain knowledge on the general principles in running a pension plan and fund as well as outlining their individual responsibilities as trustees.

Finally, many funds seem to be going along without an investment belief system that would serve as a guidepost for self-evaluation or just simply seeing whether things are running well. Regular reviews, perhaps every two or three years, are essential in any process of improvement so that all key players can see where the fund has been, where it is today and what route to take for the future. These reviews should be built into the system and written in the investment belief system to ensure that reviews, in fact, do occur.

As corporate governance invades the corporate boardroom, it only makes sense that pension plans should take a similar look at the way they function. There's simply too much at stake.

Says the CIBC's Van Riesen: "At the end of the day, good governance means a pension organization is dealing with risks that have been identified, is managing them and that the trustees are satisfied with what they're doing. It's sleep insurance."

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