# STACKING GOVERNANCE:
## BUILDING BLOCKS

***By John Por and Allan Reeve***
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> “Effective pension plan governance requires sponsors to pull together all the scattered pension pieces into one unified system.”

As a plan sponsor once said, "If we ran our business the way we run our pension fund, we would be bankrupt within a year." If ever there was a need for a practical pension governance framework, it would be today. While the re-engineering upheaval of the corporate landscape has dwindled the resources applied to activities considered marginal - the pension plan being one of them - pension assets of organizations have grown to rival corporate operating expenses. This, as the pension world becomes increasingly complex, comprised of an aging workforce prone to early retirement, new investment legislation fueled by a few infamous court cases.

Sound pension governance is as essential to effective pension fund performance as sound corporate governance is to competitive corporate performance. While many people talk about governance, it is an elusive concept. An effective system holds decision-makers accountable for results and can change course to reflect past experience. This is a surprisingly stringent test, and few organizations make the grade.

The unified framework for good governance pulls the key areas of the pension plan - funding policy, benefit policy, pension administration, and asset management - into a coherent whole. Without such a framework, the different pension-related activities scattered within and/or outside an organization will be muddled by perceptions, flawed conventional wisdom and misinformation rather than directed by informed decision-making.

**THE BUCK STOPS**

Decisions regarding a pension plan are usually made by different levels within a hierarchy, which can include the board of directors and its pension committee, the CEO, senior executives and managers. While delegation of decision-making is an accepted way of life in the course of a company's "normal" business, it doesn't seem to be the case in running a company's pension fund.

In fact, decision-making boundaries are often murky. Certain asset management decisions, such as those regarding the plan's funding policy or method of performance measurement, are best left with the board. Others, relating to more day-to-day duties like monitoring of external managers and predicting market movements, are better left with senior executives who have investment expertise. However, boards frequently spend much of their time on issues such as market movements, which are clearly not within their domain.

Generally, the different levels of pension fund management rarely know what they are supposed to do. Without clear and well-documented decision-making boundaries, there is a danger that discussions on fund performance, for example, will centre on trivia, leaving important policy decisions unattended or in the hands of lower, less-skilled, managerial levels, with costly consequences.

The running of a pension plan should be based on a cascading decision-making framework, in which the decisions affecting policy, strategy and day-to-day management, and which require varying levels of knowledge are outlined and assigned to different pension players.

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**PEOPLE POWER**

In every business, there is a core competency that the system as a whole should possess to be successful. These competencies are identified, documented and carefully nurtured, but the part-time pension decision-makers rarely find time to do the same. This can be particularly troublesome as the first wave of pension managers will likely retire soon and take with them important knowledge and experience. Unless their skills are documented and preserved, their successors will have a tough challenge to overcome.

What financial executives may often overlook is the need to balance the pension service available with the complexity of a fund's investment structure. If a pension organization cannot afford or is not willing to buy a certain amount of expertise, the investment structure should be simplified accordingly. A stable of outside managers, for example, can only be managed effectively if their performance, style and characteristics of their aggregate holdings are analyzed in detail - an expensive and labour intensive proposition.

Organizations can significantly improve the scope and level of professional services they receive by identifying and concentrating on those areas that provide the greatest benefit, but they must not be reluctant to question the value of their services.

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**INFORMATION FLOWS**

Accountability can only be exercised with proper information, however, the information flow to different decision-makers are often designed on an ad hoc basis. For example, total fund performance for one- and ten-year periods may be provided to one level of decision makers, while another level receives data on one- and four-year periods. In addition, these varying results are often extracted from different sources. This can all lead to quite different conclusions.

The process for information flow needs to be conscientiously designed and consistently delivered. Otherwise, the information reaching decision-makers will likely reflect the needs of a lower level, and will inevitably be fragmented and often contradictory and irrelevant. The messages carried must be made explicit, since senior executives are expected to apply managerial judgment, not demonstrate their ability to solve quantitative puzzles.

## REALITY CHECKS

Where most governance systems break down is in getting feedback and reviewing what has worked and what hasn't. Every system is set up based on a certain purpose and assumptions, which can range from achieving the value-added promised by active management to the success of market timing. As times and people change, the system is modified to include new activities. Over time, the system shows little resemblance to what it was originally designed for.

As experience is gathered and the impact of previous decisions are felt, governance structures must have regular periodic reality checks so that adjustments can be made to the pension system.

To be sure, hierarchical decision-making is prone to ignore the past. High-level decision-makers don't have much time to reflect, while lower levels, unless specifically encouraged, are reticent to report unfavorable experience. And it can't be taken for granted that people in the loop will push beyond the obvious to assess underlying causes.

Still, without such a review process, decision-making will remain a prisoner of assumptions and conventional wisdom, and learning will be stymied. As the philosopher Santayana wrote, "Those who cannot remember the past are condemned to repeat it".

Most of these pitfalls can be overcome by developing a decision-making map, which can help an organization focus on the objective of the pension plan. Sponsors should remember, though, that sound pension fund governance does not just happen - and definitely not overnight. Crafting an effective system takes leadership and effort, however, the investment in a high return proposition.

*John Por is President and Allan Reeve is a former Managing Director of Cortex Applied Research, Toronto, ON, Canada*

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