

THE PLAYERS:

WHY PENSION PLAN GOVERNANCE NEEDS A FACELIFT

By John Por and Tom Iannucci

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“Pension officers no longer can afford to give short shrift to 401(k)-related risks, say Por and Iannucci, who offer the following leadership guide for plan sponsors.”

At the risk of adding to the already myriad concerns of corporate America, a new issue is emerging that should be of concern to everyone involved in the governance of a corporate pension plan – the phenomenal success of the 401(k). What began as simply an opportunity to exploit a loophole in the Internal Revenue Code has become today a massive pool of capital that millions of Americans will have to depend upon in their retirement. The time has come for a fresh perspective on the whole area of pension governance – one that recognizes the unique risks and issues associated with the 401(k) plan.

A key concern is that, while the governance issues associated with defined benefit plans have been reasonably thought through by virtue of extensive experience and history, the same cannot be said for the 401(k) marketplace. As 401(k) plans are still in relative infancy compared to the mature defined benefit market, their future is still uncertain and the governance risks too vague to predict. Unless corporations understand the true nature of their fiduciary risk in this regard, however, there will be trouble ahead as we look to the 21st century.

401(k) pension plans differ from defined benefit plans in many ways, but primarily as a result of the very nature of the pension agreement itself. In a defined benefit plan, the sponsor is committed to paying a predetermined pension benefit regardless of the investment performance of the plan's fund. The sponsor, therefore, bears the risk for such items as investment manager selection and monitoring, asset allocation and performance issues. In 401(k) plans, however, each member's pension benefit is tied directly to the choices that she makes in terms of fund and manager selection. As plan participants are also responsible for their own asset allocation decisions and, to some extent, for monitoring their funds, each member bears the risk of investment underperformance.

Plan sponsors, however, do not always recognize the implications of this shift in responsibility. Although a 401(k) plan may reduce sponsors' direct exposure to investment risk, it does not absolve them of all responsibility. At a minimum, sponsors of 401(k) plans are still expected to:

1. Provide an effective investment program that will allow members to satisfy their retirement needs, including both pre- and postretirement investment options;
2. Select and monitor investment managers prudently;
3. Safeguard the physical assets of the plan;
4. Ensure high-quality benefits and investment administration;
5. Provide plan members with the education and information they need to make informed investment decisions;
6. Develop the knowledge level of the fiduciaries involved in the management of the plan; and
7. Maintain an effective reporting and monitoring system covering all key aspects of the 401(k) plan.

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In fact, far from eliminating risk, 401(k) plans may expose the corporate sponsor to new and greater risks, primarily due to potential member dissatisfaction. After all, sponsors cannot expect plan members to have the same level of investment knowledge as the traditional pension committee. Yet, by definition, 401(k) plans require employees to take ownership of critical investment decisions, the same function the committee performs with defined benefit plans.

Given this new type of responsibility, plan members could become dissatisfied with a number of things, from the investment options offered in their plan to the performance of active managers, from the costs or fees associated with the fund to the quality of the investment and retirement education provided by the sponsor. Plan sponsors should be aware that they may not be fully absolved from potential legal action in respect of such contingencies.

What should the prudent plan sponsor do to reduce fiduciary risk? A logical first step is to identify what is meant by prudent governance. Many would argue that it is impossible to eliminate all of the risks that a corporate sponsor could have in respect of its plan members, but this is really not the objective of governance. Instead, the focus should be on exercising a high and acceptable standard of care based on an understanding of the risks that plan members now face. By addressing these risks in a logical and thoughtful way, sponsors will be able to demonstrate that appropriate processes were created, executed, and monitored without fail. This requires a system of decision-making and oversight that:

- ❖ Complies with relevant pension and fiduciary legislation;
- ❖ Is specifically designed to identify and manage relevant risks;
- ❖ Will help ensure a high-quality 401(k) pension program; and
- ❖ Clearly demonstrates prudence on the part of the sponsor and a concerted effort to look after the best interests of both plan members and the shareholders or taxpayers.

When a company makes the important decision to introduce a 401(k) plan, it must be initially determined which decisions should be borne by the company and which by the plan member. For example: Should a sponsor delegate the responsibility for choosing plan investment options to employees or offer preset portfolios? Furthermore, the decision-making process should be approved at the appropriate levels (i.e., by senior executives and boards of directors) so that there is a higher level of visibility and commitment. Unfortunately, this is not common today in the offices of corporate America.

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RISK HIERARCHY

That is why corporations need to establish a hierarchy of risks in order to be effective risk managers. The foundation of sound 401(k) governance rests on establishing a clear understanding of the many decisions involved in the investment process and clearly determining which decisions reside with the sponsor and which with the plan member. Investment options, member education, member communications, committee structure and procedures, monitoring and oversight requirements, and fiduciary education are key areas that require detailed risk analysis. Ensuring that plan fiduciaries are knowledgeable is equally important, as fiduciaries must make the critical policy and oversight decisions that affect the success of their 401(k) pension program. At the heart of the typical corporate pension system lie numerous committees charged with various policy, strategy, and operational oversight and decision-making duties. These committees are generally made up of individuals for whom the oversight of the pension plan represents only a fraction of their day-to-day responsibilities.

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To ensure that these committees function effectively--despite time constraints--proper support, guidance, and coordination of the committee system is necessary. This is particularly important in cases where plan members are directly represented in the committee structure.

In their efforts to roll out a new plan quickly, sponsors typically focus most of their attention on identifying the investment options to be offered and hiring investment managers. Relatively little time is devoted to clarifying the objectives of the plan, identifying the relevant risks, and determining the sponsor's stance with respect to each risk area. Underestimating the importance of these issues may have negative consequences for the plan in the long term.

There are several positive steps a sponsor can undertake in the process of establishing a risk management framework that is well-suited for the 401(k) plan of the future.

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1. PLAN THE PLAN

First, identify and agree upon key implementation issues prior to making plan design or investment manager decisions. This requires the development of a risk management framework to guide the decision-making process and a plan "blueprint" based on senior management's input. The blueprint can be used subsequently by actuaries or other consultants to design the investment program. Then prepare a critical path that will ensure efficient and cost-effective implementation of the newly designed pension plan.

2. EDUCATE FIDICIARIES

Next, provide education to prepare fiduciaries for the unique issues and responsibilities inherent in the soon-to-be implemented 401(k) plan. Then prepare a member communications strategy to ensure that participants understand the nature of the new pension arrangements. Finally, design the decision-making structure, including preparation of relevant committees' terms of reference or mandates, and ensure that the different committees have the requisite knowledge to discharge their responsibilities. (Experience suggests that no one debates this in principle, but few fiduciary bodies devote the necessary effort to ensure that this knowledge is in place.)

3. ESTABLISH GOVERNANCE REVIEWS

401(k) plans that have been in operation for some time can benefit from reviewing their governance processes in light of industry "best practices." This review should focus on areas of decision-making, fiduciary development, design of the investment program, member communications and education, governance reporting systems, and committee operations.

4. AGREE ON RISK MANAGEMENT AND INVESTMENT PHILOSOPHY

The continued effectiveness of a 401(k) plan hinges on having a clear and agreed-upon understanding of the risks being managed and the investment philosophy inherent in the design of the investment program. Without sufficient clarity on these issues, 401(k) pension programs invariably will carry a risk profile that is not understood and specifically approved by the sponsors, therefore exposing sponsors to potential liability. The plan will receive criticism from vocal segments of the plan membership and corporate management, and thus will be subject to continual modification in an effort to meet the expectations of all stakeholders. To prevent this, sponsors are well advised to develop a comprehensive policy document describing in detail the risk and investment principles guiding the 401(k) pension plan.

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5. MONITOR THE PLAN'S EFFECTIVENESS

Given that the risks involved in 401(k) plans are different from those involved in defined benefit plans, it is important that plan sponsors design tailored reporting processes to continually monitor the effectiveness of the plan. These processes should ensure that:

- ❖ Duties and responsibilities are carried out as per policy;
- ❖ Investment managers have complied with their mandates;
- ❖ The investment program continues to be appropriate;
- ❖ Member education initiatives are effective;
- ❖ Member communications are appropriate;
- ❖ Committee operations are effective;
- ❖ Legislation is complied with;
- ❖ Plan members are satisfied; and
- ❖ Fiduciaries are satisfied.

To accomplish these objectives requires concentrated effort in designing the reporting process and performing data collection and analysis, including, if necessary, member focus groups and survey research.

6. FOCUS ON EDUCATION AND COMMUNICATIONS

The most obvious difference between defined benefit and 401(k) plans is that members of 401(k) plans require a much higher degree of retirement and investment education and communication due to the fact that they are now expected to make difficult investment decisions for their own retirement. Failure to provide adequate support in these areas may expose sponsors to considerable risk should plan members' decisions result in unsatisfactory pension benefit levels. However, plan fiduciaries often underestimate the importance of these issues and thus do not devote sufficient attention to member education and communications.

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While it is true that there may be other factors more potentially injurious to corporate health, fiduciary risk is nonetheless an area that, if unmanaged, could prove as damaging as many of the more conventional forms of business risk today. For the prudent plan sponsor who wisely looks ahead to the future state of retirement plans in America, implementing a well-thought-out and balanced approach for the 401(k) plan will enhance sponsor and plan member satisfaction for years to come.

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