

Pension Scheme Governance – fit for the 21st Century?

NAPF Discussion Paper

A response by

UK Society of Investment Professionals

About UKSIP

The UK Society of Investment Professionals (“UKSIP”) is a professional organisation whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. UKSIP currently has some 5,500 members who work or have an interest in the UK financial services industry. Most members hold either the ASIP, CFA or recently introduced IMC designation. The ASIP designation is held primarily by those who successfully completed UKSIP’s former Associate examination, which was similar to the CFA. UKSIP is the UK-based member society of the CFA Institute, the organisation that develops and administers the Chartered Financial Analyst (CFA®) Program.

UKSIP also develops and administers the Investment Management Certificate (IMC), the benchmark qualification for those working in investment management in the UK. Over 15,000 investment professionals have passed the IMC.

About this response

Given the rapid changes taking place in the funding of UK pension schemes, in particular with the significant on-going decline in the number of defined benefit schemes - and the transfer of risk from the employer to the employee - UKSIP recognises that existing governance structures may no longer be appropriate. It is timely, therefore, that all those concerned with the well being of pensions should consider how best their future governance should be secured. For these reasons, UKSIP welcomes the current review by the National Association of Pension Funds (NAPF) and is in favour of pension funds moving towards corporate governance best practices and considers it appropriate for trustee boards to adopt a code comparable to the Combined Code for listed companies. Whilst it is timely to review the governance structures of pension schemes – particularly for contract based governance schemes – UKSIP appreciates that major issues other than governance have led to these changes. Foremost amongst these have been the relatively poor performance of

international stock markets, the Government's decision to change the basis of pension fund taxation and changes in accounting standards.

By adopting a governance code, pension fund trustees would, in some respects, be regarded in a similar way as the non-executive directors of companies. All company board members are expected to be fit and proper but many will have expertise in just one particular field. This diversity of expertise and skills should strengthen the Board as members' skills complement one another. The Combined Code takes advantage of this diversity encouraging all Board members to participate and have a decision making role in all issues discussed by the Board regardless of whether they are the expert on the issue under discussion. UKSIP is, therefore, concerned that the current legislative framework for pension fund trustees is forcing trustee boards to move away from this position. Under the Pensions Act 2004, trustees will be required to "have appropriate 'knowledge and understanding' of trusts and pensions law and of the principle of funding and investment." The extent of the knowledge and understanding required will be dependent upon the role of the trustee and it follows that the Board's expert in one area should be able to demonstrate a higher level of competence in that particular field than other members. Under the terms of the pension legislation, however, trustees are not eligible to participate in the decision making process on issues for which they are not suitably qualified, thereby potentially reducing the quality of decisions made.

UKSIP shares the Pension Regulator's view that trustees should be suitably qualified and that they should continue to update their knowledge. However, the Society is not in favour of a mandatory qualification for all trustees, due to concerns that one examination may well be – by necessity – too general in content. Instead, the Society recommends a modular approach to the knowledge build of trustees with individuals sitting examinations and undertaking continuous professional development that are of an appropriate standard for their field of expertise. For example, it may be unnecessary for investment experts to have a detailed knowledge of all the legal aspects governing a pension fund but they should have a far greater knowledge than other board members of investment issues.

In the Society's view, a code of governance for pension schemes proposed by the NAPF should not be restricted to trust based schemes – increasingly pension provision is not covered by such arrangements. However, UKSIP does recognise that there is not a "one size fits all" solution; for example, many of the issues that affect large pension funds do not affect the very small ones, so whilst the latter should be aware of the governance themes and issues affecting pensions, it may not be practical to apply them all in particular circumstances. In such a situation a fund should be required to explain why it has not complied with the code. For this to be effective, there also needs to be a mechanism for explaining and objecting to the non-compliance.

Response to questions

- Q1 *What other governance models exist? Are there other examples of collective governance models for contract-based DC schemes? What are the pros and cons, and likely cost implications, of the three options described above?*

UKSIP is not aware of any other governance models than those mentioned.

- Q2 *Should there be a single governance model or a selection to suit differing organisations. If a selection, should there be certain minimum standards and, if so, what should these be?*

UKSIP is of the view that there would need to be a selection of governance models as the needs of schemes are different and one size will not fit all. However there should be certain key areas periodically reviewed (i.e. fund performance, range of fund investments, contract/fee terms and administration service). In the case of trust based schemes, recent pensions' legislation has clarified the responsibilities of trustees. The core essentials of these could be extracted to apply more generally whilst ensuring that there is a minimum standard of best practice. The required transparency can be provided if a practice of "comply or explain" is adhered to.

- Q3 *What other benefits are there of this (or other such models) to the employees?*

Monitoring of (and action upon) fund performance, contract terms (relative to what is available in the market) and need for improved service are the three critical benefits to members.

- Q4 *Would such an arrangement add significantly to the costs of running contract-based arrangements? How would these balance against benefits of improved governance arrangements?*

UKSIP does not believe that the introduction of a basic governance structure would have significant cost impacts - it only tends to be once legislative restrictions are in place that costs escalate. This does however depend on whether those with trustee responsibilities are paid and if these costs rise due to required skill sets, which may not be plentiful. There may be training costs but these should be there anyway under any structure.

- Q5 *What other risks would the employer be taking on? How could these be managed or mitigated?*

This is an important area of consideration for DC type schemes. Will employers want any 'risks' for ex-employees? Evidence is already that they want rid of ex-employees in DB. With DC scheme member turnover likely to be higher, some employers will not want to take on responsibility for them or devote any time to them. Others, however, will be concerned about the moral hazard of impoverished ex-employees and so may adopt hybrid schemes to overcome this risk.

- Q6 *Would these risks outweigh the benefits gained by extending good governance to contract-based DC pension schemes?*

Arguably where an employer is contributing to a staff member's pension where the employer is "sponsoring" or promoting the scheme, some element of good governance should be encouraged by the employer. Ex-employees with contract based pension should not expect former employers to continue to exercise governance on their behalf. When the pensionholder is working for the contributing employer the benefits gained by improved governance could probably be justified in

other circumstances the risks would be likely to outweigh the benefits.

Q7 *How can small schemes be helped to federate on a multi-employer basis, e.g., on a sectoral, regional or other affinity basis?*

As mentioned in the introduction to this response, a paradigm shift has taken place such that the skill requirements for good governance and management of pension schemes have increased. The long tail of very small pension schemes already has difficulty with finding proper resources on trustee boards, for example, sufficient trustees with the right mix of skills. The large number of small schemes hinders the control of operating costs and the ability to take advantage of the best investment opportunities. Hence, UKSIP agrees that small schemes should be encouraged to “federate” into larger multi-employer schemes.

There are many examples of multi-employer schemes. The Dutch model probably being the most developed with 86 industry-wide pension funds representing more than 75% of the Netherlands’ employees participating in pension schemes. In the UK small schemes could be encouraged to “federate” along industry, professional or regional basis.

Q8 *What could the governance arrangements in such schemes look like?*

The Dutch system warrants investigation.

Q9 *What kinds of cost savings on scheme governance matters could be generated if small schemes were able to pass responsibility for governance to a multi-employer scheme?*

As stated previously, there will be cost implications for improving the governance of contract based schemes in particular. Grouping large numbers together on a multi-employer basis should mitigate against this inevitability. The types of cost savings concerned would be economies of scale.

Q10 *What changes would be needed to existing legislation and incentives?*

This is not UKSIP’s area of expertise.

Q11 *What is an appropriate nomination process for filling trustee vacancies? Is the current representative model appropriate?*

UKSIP supports the current structure.

Q12 *Should trustees be remunerated?*

The established governance arrangements involving boards of “lay” trustees have been widely criticized and the case for remunerating professionalism is very strong. Furthermore, if Parliament will require trustees to be really professional, be fully conversant with all their duties and – as per Myners – able to challenge and control their investment managers properly; and if the courts are going to impose high level culpability on trustees (increasingly the case), then the argument for remuneration is most difficult to challenge. If, however, the current essential role of the workforce trustee is to be retained, Parliament may need to enact a lower responsibility level on such unremunerated individuals. Basically, Parliament will need to be more specific in its objectives and consequences. It is by no means certain future governance arrangements should consist of trustee boards, particularly in the case of contract based schemes.

Q13 *Are there benefits in moving away from a unitary board to a two-tier board?*

The quality of the individuals responsible for the effective management of pensions is the key requirement in terms of governance. Whatever Board structure is adopted the individuals involved need high levels of expertise and ethics and their decisions need to be well informed and subject to effective scrutiny. All involved in the good stewardship of pensions should be appropriately qualified for their area of responsibility. For example, those with investment responsibilities need to be able demonstrate their investment knowledge and ability. The holding of an appropriate professional qualification would provide evidence of this.

UKSIP believes there may well be merit in further investigating the option of two tier boards, not the continental company type, but ones where the senior board consists of individuals with particular and relevant expertise.

Q14 *What are the key qualities for a Chairman of Trustees (and trustees themselves) and what guidance should be given on who should become a trustee and chair of trustees?*

The chairman should ideally have reasonable knowledge and understanding of the key areas for running a scheme (investments, legal, administration, finance and liabilities), although he does not have to be an expert. Particularly critical is the ability to run meetings, to manage and guide the board and be effective in leveraging off the strengths of the individual board members.

The Chairman should play a leading role in selecting other trustees with the aim of securing those with the necessary skills. The holding of appropriate qualifications in the actuarial, accounting, administration or investment fields could be a criterion for selection. UKSIP suggests that the IMC, ASIP, and CFA are all excellent qualifications for trustees with responsibility for investment.

One of the most important issues is that prospective trustees and the chairman should have the time available to devote to the role.

Q15 *Do you agree there is scope for a Governance Code for trustees and others? What would be the benefits of a Code?*

Yes there is scope for a Code as it would provide clarity of purpose. One approach could be to adapt the Combined Code for companies and moulding it to suit pension funds. Indeed, some aspects of the Combined Code are directly transferable

Q16 *If not, why not?*

N/A

Q17 *If yes, what should it cover? Are the OECD principles adequate as a basis for pension scheme governance in the UK? If not, what other factors should be included (or omitted)?*

Any code should not dilute the expertise/skill requirements of the individuals but as mentioned before, a board made up of varying skill sets would be beneficial.

Q18 *Should a Code operate on a voluntary 'comply or explain' basis?*

Yes.

Q19 *If a voluntary Code was introduced, what would the trade-offs be for schemes that adopted the Code? For example, would it be possible (or desirable) to ease some of the Trustee Knowledge and Understanding (TKU) requirements?*

A code should not dilute the expertise/skill requirements of the individuals but as mentioned before, a board made up of varying skill sets would be beneficial.

Q20 *Are the issues covered in the draft Code at Annex 1 the right ones? If not, what else should be included or omitted? How would the draft Code at Annex 1 interface with current legal requirements on trustees / scheme managers or administrators?*

In many instances board members, of course, will not be trustees as such as there will be no trust deed under which they have been appointed.

Section 2 Independent trustees and the question of when an independent trustee is no longer regarded as independent. As the independent trustee is frequently the only element of continuity on boards, arguably they could be considered as akin to a company's auditors; they should be reviewed regularly, should perhaps change the designated partner/executive but not necessarily the firm.

Section 3 Collective skills and individual skill sets and competence - The board needs to ensure that its members are competent not only at the time of appointment but remain competent and undertake the necessary professional development training to ensure that their knowledge and skills remain up to date. This is presumably what is meant by the last bullet point.

Under section 4 on risk management, no explicit mention is made of investment risk. The board should agree an investment risk policy with the fund managers and ensure that it is adhered to. In the case of individual contracts, of course, this would be a matter to be determined between the pension provider and the individual entering into the contract.

Section 6 Internal controls - Proper records should be kept of decisions and meetings.

Section 7 The scheme's dialogue with the sponsoring employer - Trustees should liaise not only with the sponsoring employer but also administrators, consultants, investment advisers, fund managers, members of the scheme and one another.

Q21 *Would a governance Code, such as that set out at Annex 1, impose significant cost and administration burdens on schemes? If so, can you provide an estimate of the additional costs it would place on your scheme?*

UKSIP is not in a position to judge at this stage.

Q22 *Are there any other general points you would like to raise on:*

- *the issues raised in this report; or*
- *pension scheme governance for today's pensions environment*

that are not covered elsewhere in this Discussion Paper?

In the case of professional trustees, in particular, success at a relevant examination would provide evidence of a level of competence and thereby offer reassurance in respect of governance.

In addition to the qualification requirements, the membership of appropriate professional bodies amongst trustee board members – which provide opportunities

for learning and networking with other trustees or investment professionals within a strong ethical framework - should be strongly encouraged. This would be helpful to ensure trustees can understand and evaluate new developments relating to pension funds, investment funding, and so forth.

The development of new investment techniques and instruments pose a challenge to trustees, even those who may feel well qualified. For example, pension fund management in the UK has shifted from balanced to specialist mandates and is now moving to "new balanced" mandates. It is crucial that trustees maintain their expertise in those circumstances and the implications of such changes and how to evaluate them is best understood in an environment of debate and discussion that organisations such as UKSIP provide through its professional development programme. Such expertise should exist within the trustee board as a whole; not every individual trustee need have it.

In some respects a trustee's role must, inevitably, move closer to that of an investment professional, as trustees have responsibility for the effective management of scheme assets in an increasingly complex environment. For example, trustees will need to assess the strength of the employer's covenant to the pension fund, particularly where there is a need to cope with volatile contributions. This is because a pension fund in deficit is an unsecured creditor of the employer, with a long-term repayment or funding plan in place; the parallels between trustees and investment professionals are clear.

August 2005