Good Pension Governance: There Is An ROI

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We all know that good governance is critical to the effective operation of a pension plan. A sound governance structure can mitigate risks, avoid costly litigation, and enhance time efficiencies. But too few realize that the benefits of an effective pension governance structure can actually be measured and expressed in dollar terms.

This article discusses what good pension governance is and how it can be measured to quantify a return on investment (ROI). It also shows how to determine what differentiates effective governance from mediocre governance. Finally, it discusses the benefits of good pension governance and concludes with an example of a company that went wrong—to show that the costs of inadequate governance can be considerable.

What is pension governance?

There is a basic difference between *corporate* governance—where the focus is on shareholders—and *retirement* or *pension* governance—where the focus is on participants and their beneficiaries.

Pension governance is the system of oversight and control that creates value derived from the skills, resources, and processes employed by a plan or fund. The basic goals of pension governance are:

- Secure the pension savings and promises
- Manage the legal and financial risks associated with a pension plan
- Minimize the possibility of the agency problems, or conflicts of interest, that can arise between a fund's members and those responsible for its management.

Although good governance means having the right people in the right roles following the right processes to make the right decisions, for a pension plan, good governance also aims at delivering high pension fund performance while also keeping costs low for all stakeholders.

What are the "success factors" for pension governance?

In an attempt to gain an understanding of the factors at play, The OECD (Organization for Economic Co-operation and Development) in 2009 conducted a global study that identified six components of sound pension governance:

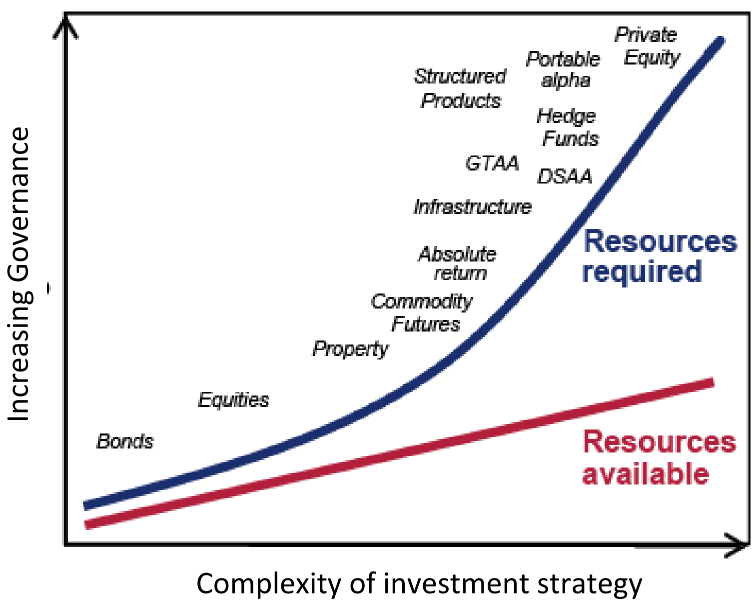
- *Risk management*. Procedures should be established for the identification, assessment, and management of risk.
- *Effective committees/decision-making bodies.* Board or committee members should be appropriately qualified, roles and responsibilities should be clearly allocated and defined, and members should demonstrate their ongoing commitment to training.
- *Policies.* Written policies should be in place, supported by procedures for monitoring to ensure compliance.

- *Accountabilities.* Proactive strategies for managing real or perceived conflicts of interest should be followed; asset managers should receive closer oversight, both during selection and in the ongoing scrutiny of performance.
- *Supervision and monitoring.* Regular and ongoing oversight practices require attention to selection criteria, service standards and performance monitoring practices for all advisors, both internal and external.
- *Information flows.* Effective reporting should include disclosure of the information needed by plan members and beneficiaries, the sponsor, and other stakeholders. (1)

Distilling the various studies cited, it is clear that good governance requires competency and expertise, accountability, internal controls, and rules, procedures, and documentation. Let's look at each of these.

Competency and expertise

Fiduciaries today must function in a highly complex environment—the investment process is more difficult to understand, as are the risks relating to the execution of the investment policy. In addition, the required reports have increased in both frequency and complexity. Recognizing this, many institutions tightened their requirements in regard to fiduciary knowledge and training. So a governance budget—the capacity to create value from the skills, resources, and processes employed by the fund—must be established and maximized to ensure success at the investing game, as illustrated by the chart below.



Now more than ever, competent, experienced people are critical to effective governance. Clark and Urwin state that a best practice is to select chairpersons and trustees on the basis of their commitment, training, and proven ability to deal with the complexities of the current investment environment. They acknowledge that competencies are not easy to instill, so expertise is a critical factor. They designate three criteria as key: demonstrable numeric skills, capacity for logical thinking, and ability to think about risk. In addition, they cite collegiality as important to the board's collective decision-making ability. (2)

Also, several studies indicate that there is an inverse relationship between the "busy-ness" of board/committee members and their governance ability. An executive's time is not infinite. The academic studies show that directors/members who are overextended do a poor job of monitoring, resulting in less effective governance. (5) This is especially true with respect to pension and retirement plan committees, which are usually composed of the busiest corporate officials, including the CFO, the CEO, the treasurer, and the top HR executives. If committee members are too busy to make—and monitor—investment decisions (and in many cases even to show up for committee meetings), governance suffers.

One viable remedy to the problem of the busy executive is to streamline meetings. This can entail circulating minutes before the meeting and using a consent agenda to cover issues that do not require further discussion. Minutes would cover such things as confirmation of previous decisions, informational materials, committee reports, and routine correspondence. A consent agenda can free up meeting time for important investment matters.

Accountability

The matter of accountability really centers on the fiduciary role of the committee members, a clear understanding of their responsibilities, and reputational risks. The OCED guidelines for pension fund governance state that in addition to the standards for competence and expertise, the trustees and fiduciaries must meet certain minimum standards to ensure a high level of integrity and professionalism, e.g., no civil or criminal offenses, especially ones involving fraud or dishonesty. (3)

Accountability by a governance committee is best ensured through the use of written processes and documentation. Well-documented processes help the committee to clearly establish the particular roles and responsibilities of the various parties performing plan-related functions. They also help to ensure adequate documentation of why decisions were made and how they were implemented.

Internal controls

If a committee is practicing good governance, it is taking preemptive action to identify problems before they escalate into lawsuits or penalties. Two examples are "alive" audits and fiduciary liability insurance.

Alive audits. An alive audit is a compliance audit that reviews the mortality and current addresses of employees and beneficiaries. It usually covers all participants, surviving spouses, and beneficiaries who are receiving a monthly retirement benefit or are due a monthly retirement benefit. It can also include all terminated vested participants. Because trustees often perform death searches only on retirees in payment status, they often overlook terminated vested participants until payment starts, and deceased spouses as well.

Results of an alive audit also can include the following:

- Reduction in funding liability
- Improvement in plan financial status
- Reduction in Pension Benefit Guaranty Corporation (PBGC) premiums
    - Refunds of excess premiums can be captured up to six years back (to 2005)
- Prevention of fraud and overpayment by avoiding sending checks to retirees and beneficiaries who are deceased

- Termination of payment of medical premiums for deceased retirees and/or spouses.

It is our experience that all of these results are quantifiable, as illustrated in the chart below.

	Liability Savings	PPA Savings	P&L Expense Savings	PBGC Premium Savings
Energy Company	$6 million to $15 million	$1 million to $3 million per year	$1 million to $2 million per year	Up to $135,000 per year
Manufacturer	$4 million to $8 million	$1 million to $2 million per year	$500,000 to $1 million per year	Up to $80,000 per year
Fast Food Giant	$6 million to $12 million	$1 million to $3 million per year	$800,000 to $1.7 million per year	Up to $90,000 per year
Transportation Company	$2 million to $3 million	$400,000 per year	$100,000 per year	Up to $30,000 per year

Fiduciary liability insurance. Another way in which effective governance translates into dollars is in the area of fiduciary liability insurance. Fiduciary insurance is not required by ERISA, but the majority of plan sponsors purchase it for their fiduciaries, and it is highly recommended because personal assets are at stake.

A fiduciary liability policy covers:

- Breach of fiduciary duties
- Negligent errors and omissions
- Improper disclosures to plan participants
- Remiss investment advice
- Imprudent choice of outside service provider (OSP)
- Faulty advice of counsel
- Improper amendments to plan documents.

In pricing the premiums for fiduciary insurance, underwriters ask specific questions about documentation and past violations or reviews by regulatory agencies. They also want to know if the plan has an effective governance structure to safeguard against imprudence, negligence, and conflicts of interest. According to several underwriting authorities, poor governance can affect premiums by a factor of six. More important, the average claim under a fiduciary policy is $800,000, and 90% of the claims are filed by plan participants.

Rules, procedures, and documentation

Considering their importance, the rules and procedures governing pension fund decision-making and their relationships with external service providers have a deliberate or an explicit quality to them such that their design and implementation is (or should be) continuously monitored.

If we assume that economic agents in general and pension plan trustees in particular have limited knowledge, time, and resources, then rules enable these trustees to take shortcuts—to economize on the costs of decision-making by providing a reference point for issues as they arise. Because they are generally used as automatic 'filters' for identifying the most significant issues, these decisions can be less than optimal. This suggests that the social value of rules and procedures lies not in their precise utility on a case-by-case basis, but rather in their generality. Being 80% right may be sufficient for trustees to hold to a set of rules recognizing that evaluating exceptions is a time-consuming process.

Only when exceptions occur would trustees contemplate revising the rules themselves. The challenge, then, is to design rules and procedures that require pension plan officers to weigh the efficacy of their decision-making practices while, at the same time, are sufficiently flexible to accommodate innovations that go beyond common practice. Rules and procedures establish minimum standards of competence; however, those rules and procedures must also be able to accommodate changing circumstances that demand expert qualities and attributes. Too often, public rules and procedures only penalize noncompliance when they also should reward innovation outside the inherited framework of rules and procedures.

At the very least, good pension governance calls for:

- An investment policy statement that includes investment guidelines and performance metrics
- Specification of the roles and responsibilities of fiduciaries, including reference to the scope of their discretion and control
- Procedures for the selection and appointment to the governance committee of fiduciaries
- Processes for selecting and monitoring investment managers, trustees, and vendors
- Procedures for approving plan expenses
- Processes for interpreting plan provisions
- Procedures for preparing periodic oversight reports on the plan
- Written documentation of all fiduciary meetings (usually meeting minutes, with all reports attached)
- Best practice procedures for plan administration and operation, such as nondiscrimination and compliance testing, plan document reviews, contributions, notifications, and claims.

Can a link between governance and performance be established?

A study of large global pension funds by Ambachtsheer et al. (2006) attempted to determine if good governance and good performance are linked. The study used pension fund executives' own opinions of the effectiveness of their governance structure and processes as a proxy for good governance, and pension fund returns over a passive asset benchmark as a proxy for performance. The study concluded that “good” governance, as assessed by pension fund CEOs, is worth as much as 1% to 2% of additional return per annum. (5)

Further affirmation of the link between performance and governance is found in several studies conducted by Clark and Urwin. One study (Clark and Urwin, 2007) reviewed a group of large pension funds (more than $5B in assets) in six countries across North America, Europe, and Asia-Pacific. The study found a link between superior performance and strong governance, and identified various areas in which the funds excelled, such as clarity of mission and effective risk management and performance monitoring.

On the basis of their findings, the authors deem the presence of a CIO critical to success and recommend linking the investment strategy of the fund to the governance capability of the board. For example, boards should decide whether they are capable of monitoring alternative investments effectively before deciding whether to include such instruments in their investment strategy.(6)

Clark and Urwin identified 12 “governance best practices” for pension plans and demonstrated that a strong governance structure is the distinguishing factor in the ability of pension plans to maximize investment proceeds. (7). These 12 best practices (see sidebar) might not be attainable by every fund, but they can be ’translated’ into a simple equation:

Time + Expertise + Organizational Effectiveness = Improved Performance. (1, 4)

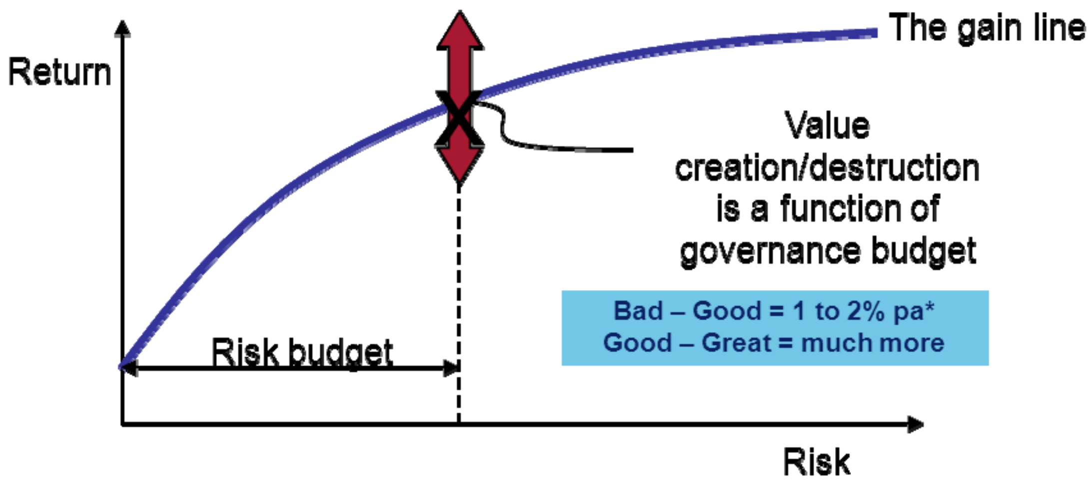
Want to use as a sidebar in the article

The 12 Attributes of Good Governance

Coherence	Mission clarity
	Investment executive
	Effective focusing of time
People	High level Board competencies
	Leadership
	Supportive compensation
Process	Strong beliefs
	Competitive positioning
	Risk budget framework
	Real-time decision making
	Fit for purpose manager line-up
	Learning organization

How great is the impact of governance on performance?

The implication of both the Ambachtsheer research and the Clark and Urwin studies is that effective governance may result in as much as 100 to 300 basis points of value-added performance per year, as illustrated in the chart below. (8) So, in essence, an effective governance system can be quantified in terms of fund performance.



How much can poor governance cost a company?

The following example gives an idea of how much money poor governance can cost a corporation. Although it is highly unlikely that any one corporation ever would face all of these consequences, the costs of ineffective governance can be extremely high.

Company ABC has 7,500 employees and sponsors both a defined benefit and a 401(k) plan. The DB plan is frozen but has assets of more than $200 million. The 401(k) plan is newer and has assets of about $150 million, including 30% in employer stock.

Plan fiduciaries include the members of the investment committee and the plan administrator, who has just given notice. This is the plan's sixth administrator. The investment committee has three members: the CEO, the CFO, and the HR director. The committee has not met for almost 18 months as the company has struggled through a possible merger and a write-down of bad loans.

Problem 1: The HR director just discovered that since its inception the retirement plans had not been administered in compliance with the definition of compensation and had excluded all overtime and bonus payments from plan eligible earnings. This error was uncovered in an IRS audit and the violation extends over five years.

Dollar Impact: The IRS assesses a penalty under its Audit Closing Assistance Program (Audit CAP) of $100,000 for each plan.

Problem 2: There are two underperforming funds in the 401(k) plan, one due to recent turnover in the portfolio management team and one that never recovered from the market downturn in 2008. Participants in these funds experienced a loss of more than 150 bp on assets of $10 million.

Dollar Impact: Loss of 150 bp for three years, totaling $450,000.

Problem 3: Participants filed suit against the fiduciaries for breaching their duty to monitor the funds.

Dollar Impact: Litigation costs of $50,000 to $1 million.

Problem 3: In the DB plan the investment committee invested in a sub-fund of the Madoff hedge funds, in the amount of $5 million, because Madoff's son was a good friend of the CEO. There is no documentation on how or why the sub-fund was selected. The DOL finds this to be imprudent and seeks recovery of losses from the plan sponsor.

Dollar Impact: Recovery of $5 million to the plan, plus 20% penalty of $1 million.

Problem 4: There has never been a compliance or alive audit of the participant base in all the years the DB plan has been in existence. The outside auditors request one and it is discovered that more than 50 participants have been deceased for the last three years but continued to receive benefit checks in the amount of $150,000 for each of the three years.

Dollar Impact: $450,000 in restitution is due the fund.

Problem 5: Fiduciary insurance has lapsed and the HR director would like to get a new policy. However, there is no written investment policy, minutes from past committee meetings are very sketchy, and there is a significant investment in employer stock.

Dollar Impact: The premium, which is typically based on assets, will increase by a factor of up to six if there is no solid governance structure in place or there are impending actions by regulatory agencies. On $1 million of coverage, this results in a six-fold increase in premium cost, from $10,000 to $60,000—a "premium penalty" of $50,000.

Problem 6: Several busy executives fail to attend a committee meeting, and so there is no quorum for an important decision about replacing an underperforming investment fund.

Dollar Impact: Underperformance caused a decrease of 10 bp on the $10 million fund. If no action is taken owing to lack of a quorum, the annual cost to the plan is $100,000, with the possibility of future additional losses. A committee's ability to reach a decision expeditiously could limit these kinds of losses.

Conclusion

Companies can face serious consequences for their failure to ensure adequate governance, as the chart below shows.

Financial	Tax
• Costly correction of noncompliance • High IRS/DOL penalties for noncompliance • Reporting/disclosure risks	• Plan disqualification - Loss of deductions - Immediate taxation of benefits - Loss of tax deferral of future benefits • Possible unavailability of IRS voluntary correction program • Excise taxes
ERISA	**Other**
• Fiduciary liability • Noncompliance fines and penalties • Personal liability	• Negative brand/employer perceptions • Litigation • Employee relationships

By taking certain specific steps, though, companies can promote good pension governance:

- Establish a clear mission for the plan and the governance committee
- Develop the committee infrastructure and establish an appointment process that includes standards and criteria for the fiduciaries who will serve on the governance committee
- Appoint qualified people to the committee and offer education and training to all members
- Provide for periodic review and assessment of all committee members
- Clearly delineate roles/responsibilities among committee members
- Hold regularly scheduled committee meetings with pre-set agendas, at least quarterly, and fully document all actions and decisions
- Task the governance committee with conducting periodic investment (and fee) reviews and periodic reporting on plan operations (administration, regulatory compliance) and financial transactions.

These actions will go a long way to ensure good governance, thereby avoiding costly penalties and generating a quantifiable return on the governance dollars spent.

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