The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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PENSION FUND GOVERNANCE:

FIVE TOP CHALLENGES….AND HOW TO ADDRESS THEM

"Challenges are what we live for."
Travis White

Boot Camp for Trustees

Last month saw the launch of the Rotman-ICPM Board Effectiveness Program for Pension Funds and Other Long-Horizon Investment Institutions.* Thirty-five delegates from twenty-one organizations and nine countries attended the week-long program. Program faculty pushed the attendees to the limit through a series of interactive learning modules starting Monday morning and finishing Friday afternoon. One of the Program highlights was the identification of the top challenges facing the Boards of the twenty-one organizations represented, and the collective discovery of how these challenges might best be addressed.

The following five Challenges were identified: 1. Good Governance, 2. Sensible Investment Beliefs and Organization Design, 3. Robust Risk Management, 4. Effective Stakeholder Communications, and 5. Financial Sustainability.

The Challenge identification process actually started weeks before the commencement of the Program. Via a survey, attendees were asked to rank the top challenges facing their Boards, and comment on how they saw the specifics of these challenges in the context of their own organization. These responses were kept top-of-mind as the Program modules unfolded over the course of the week. Then, in the final Program module, attendees were organized into five Challenge Teams, assigned one of the five top Board challenges identified, and asked to advise their fellow-attendees on how to best address it. This *Letter* summarizes the five sets of recommendations and the subsequent discussions that resulted.

Advice from Board members on addressing Board challenges. It doesn't get any better than that!

Good Governance

Perhaps not surprisingly, raising the effectiveness of organization governance was an oft-mentioned challenge, as reflected by comments such as:

- "When Board members feel they represent a specific group, conflict at the Board level can result."
- "Building Boards that are both representative and competent has been difficult."
- "Not everyone on our Board is on the same page; there is a lack of focus and of understanding of the 'oversight' role."
- "Our Board is struggling with the rising complexities of pension design and pension investments."
- "Acquiring Board oversight competency in the Risk and IT areas has been especially difficult."
- "Outside pressures can sway a Board's perspective from strategic to very short-term."
- "Adoption of the fiduciary management model can lead to the creation of multiple Boards with potentially conflicting roles."

These issues were discussed and debated over the course of the week.

At the end of the week, the Good Governance Advisory Team decided to take a pragmatic approach to dealing with the Board effectiveness issue. If they could wave a magic wand, they would wish for a complete 'make-over' that makes all of the listed Board shortcomings disappear. Without that magic wand, they settled for designing and launching a practical 3-step 'Governance Improvement Program':

1. Assess & Understand the Situation by creating a current Board skills/experience matrix and by documenting Board member roles and behaviours.
2. Design & Develop the Roadmap by revisiting/ crystallizing the organization's mandate and mission, by formalizing Board processes (including the creation of an ideal Board skills/ experience matrix and mapping it against the current reality), and agreeing on constructive Board norms and behaviours.
3. Implement the Roadmap through updating the relevant Board policy documents, through internal Board bonding sessions, and through external Board training programs.

These practical, implementable recommendations received a positive reception from the group. Indeed, the recommendations flowed logically from the Program modules and the 'real life' experiences shared by participants over the course of the week. Full marks to the Good Governance Advisory Team!

Sensible Investment Beliefs and Organization Design

Arguably, strategic organizational oversight is a Board's most fundamental responsibility, and the integration of investment beliefs and organization design its most important manifestation in a pension fund context. Here are some examples of the challenges Program attendees saw in this area:

- "There is a Board-Staff disconnect here."
- "No Board consensus on these issues."
- "Current markets are seriously challenging our traditional investment beliefs."
- "We are struggling with how to tie performance and compensation together."
- "Compensation limits prevent us from in-sourcing significant parts of our investment program."

By the end of the week, the Sensible IB&OD Advisory Team had the following recommendations for the group:

1. Investment Beliefs Should Be Explicit, for example, the following three are simple, but very powerful: 1. Good governance matters, 2. Costs matter, and 3. True skill is rare. Behind these beliefs lies the understanding that retirement savings and payment obligations cross-generations and that 'short-termism' is the enemy.
2. If You Have Scale: In-source! …to the degree practically possible. This follows logically from the 'costs matter' belief, and from the further belief that 'true skills are rare' applies equally in out-sourcing and in-sourcing contexts.
3. In-source in Stages: 1. Start with publicly-traded investments and the active/passive decisions, 2. Stage private markets investments (e.g., from funds investing, to co-investing, to collaboration strategies, to going direct), 3. Expand as network-building and due-diligence capabilities allow.
4. Prepare Ground for Required Compensation Plan: 1. Demonstrate cost savings, 2. Find comparable organizations to benchmark against, 3. Generate support/neutralize opposition.
5. Build Capacity for Internal Management: 1. Improve risk management, 2. Install adequate IT systems and controls.

These arguments found fertile ground. However, many of the twenty-one organizations represented in the room don't have the necessary scale to in-source. This became an important topic of discussion. In the end, the group agreed that the same three basic investment beliefs apply. Now the strategic question becomes: how can you acquire cost-effective scale and a long-horizon mindset indirectly? Possibly through the right fiduciary management channel? A good alternative might be a simple low-cost passive management strategy.

Clearly, the Sensible IB&OD Advisory Team got to the heart of strategic oversight matters.

Robust Risk Management

Risk management was another named Board top-challenge. Survey comments:

- "Our transition to a total Enterprise Risk Management framework has been a challenge."
- "Whose financial risks are we managing? And what are their risk appetites? These are difficult questions for us."

A Robust Risk Management Advisory Team was assembled to address these questions. They started by constructing a Robust Risk Management Framework based on a common risk language:

1. Risk: a future uncertainty that influences the achievement of objectives (positively or negatively).
2. Risk Appetite: the level of risk a Board is prepared to accept, acting in the best interests of a pension plan's beneficiaries.
3. Risk Framework: the combined systems, structures, policies, processes, and people within a pension plan's operations that identify, assess, manage, and monitor all internal and external sources of risk.

With this common language in place, they laid out the design and implementation of the Robust Risk Management Framework in three phases:

1. Understanding our Risks: lay out the logic process from risk identification/categorization -> risk measurement -> risk assessment -> risk prioritization.
2. Risk-bearer Identification: assess how financial risks are currently being borne between current plan beneficiaries, employer(s), tax payers, and future generations. Make a clear distinction between this set of risk bearers, and the risks borne by the pension plan organization, its Board, and its staff.
3. Managing within Risk Appetite: what are the risk appetites of these risk-bearers? How to match risk assessments with appetites? Implications for organizational structure of risk management function? How does the Board most effectively discharge its fiduciary obligations within this structure?

Clearly, the Robust Risk Management Advisory Team left many important questions unresolved. However, there was broad agreement in the group that the Team had raised the right questions! And through reflecting on these questions, there was also broad agreement that many Boards should not be satisfied with current risk management practices in their organizations.

Effective Stakeholder Communications

Every pension fund organization is connected to a complex web of principal and agent stakeholder groups. A key Board responsibility is to understand that web. But understanding is not enough. Boards also have to ensure that these stakeholder groups are kept 'in the information loop', especially during the kind of challenging financial environments we have been experiencing since 2008.

Survey comments:

- "Getting stakeholders to the point where they accept changes to the pension deal are necessary is not an easy thing."
- "While the stability and sustainability of a social security or pension arrangement are clearly important goals, the accountability for monitoring and achieving them is not always clear."
- "We don't spend enough time staying in touch with our stakeholders."

An Effective Stakeholder Communications Advisory Team was assembled to address these Board challenges.

The Team recommended establishing 'open line' connections with all key stakeholder groups to ensure the pension organizations stays in touch, and stays on top of emerging stakeholder concerns. From there, the Team recommended a 3-step approach to acknowledging and addressing stakeholder concerns:

1. Determine Reasons for Concerns: generally related to the potential impact of external developments (e.g., financial markets-related, demographics-related, financial disclosure-related) in social security/pension plan benefits, costs, and sustainability. Important to listen and acknowledge concerns.
2. Explore Solution Options: assess stakeholder appetites for (including trade-offs between) raising contribution rates, reducing benefits (e.g., conditional indexation), eliminating early retirement options, raising retirement age. Assess feasibility/acceptability/appropriateness of changing investment policy (e.g., more risk? less risk?). Assess feasibility/acceptability/appropriateness of changing target return/valuation assumptions.
3. Consult with Stakeholders: develop a pro-active approach to communicating and consulting with key stakeholder groups including not just plan members, but also with employers, union representatives, plan sponsors, regulators and elected officials. Getting broad 'buy-in' to the need for change and the best change option(s) is key.

Recognizing that humour can sometimes be an effective communications ingredient, the Team ended with a rousing video performance of the classic Monty Python song "Always Look On the Bright

Side of Life" ("….some things in life are bad… they can really make you mad…but….always look on the bright side of life…"). The entire Program assembly of delegates and faculty joined in full voice…and felt better for it.

Financial Sustainability

Sustainable pension arrangements result from achieving a fine balance between benefit adequacy, risk measurement and allocation, property rights clarity, and cost. This reality led to survey comments such as:

- "When demographics and financial markets change, plan design may also have to change."
- "Plan stability and sustainability are not just issues in DB plans, but in DC plans as well."
- "Redesigning pension plans is especially tough in periods of financial distress and instability such as now."

In light of these comments, the Financial Sustainability Advisory Team was given the green light to design a pension arrangement they deemed to best achieve the 'fine balance' elements set out above. They decided such a plan required three key features:

1. Affordable: the target contribution rate must pass a very transparent 'affordability' test. Scale economies are achieved by covering a large participant group and using a dedicated, high-performance, low-cost pension delivery organization. There are no external risk-underwriters to the pension plan.
2. Adequate Pensions: the target contribution rate, combined with realistic assumptions about social security/age pension payments, work life length, and investment returns, produces an adequate target pension. The availability of longevity insurance mitigates the risk of people outliving their money. A self-adjusting default accumulation-decumulation path guides participants towards their target pension.
3. Intergenerational Fairness: individual pension accounts are 100%-owned by plan participants. The purchase of longevity insurance through deferred annuities takes place at 'fair value' (i.e., market) prices. The annuity balance sheet is expertly managed (e.g., kept solvent) by the dedicated pension delivery organization.

The Team was not asked to address the 'how do we get there?' question, but to focus on the destination. As a result, they sketched the outlines of a sustainable 21st Century 'fit for purpose' pension arrangement. The group agreed that each of the twenty-one organizations represented in the room would have to chart their own path to this new destination. For many organizations and their Boards, this will be a challenging journey.

Feedback

The quality of the five Advisory Team presentations set out above speaks for itself. Feedback from Program participants confirms that the problem-solving experience was a great way to end the Program. It reflected the collective wisdom and experiences of the group, and pulled together all of the topics covered over the course of the week.

In short, it would seem that the first offering of the Board Effectiveness Program hit close to the mark….with the thirty-five Program participants the stars of the show. The second offering of the Program runs next month…and is already fully subscribed. It looks like enhancing the effectiveness of pension fund governance is an idea whose time has come. By identifying the top five Board challenges and how to best address them, the Program is already paying dividends.

** The Board Effectiveness Program is a collaboration between Rotman Executive Programs and the Rotman International Centre for Pension Management, both based at the Rotman School of Management, University of Toronto. Keith Ambachtsheer is the Program's Academic Director.*

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