

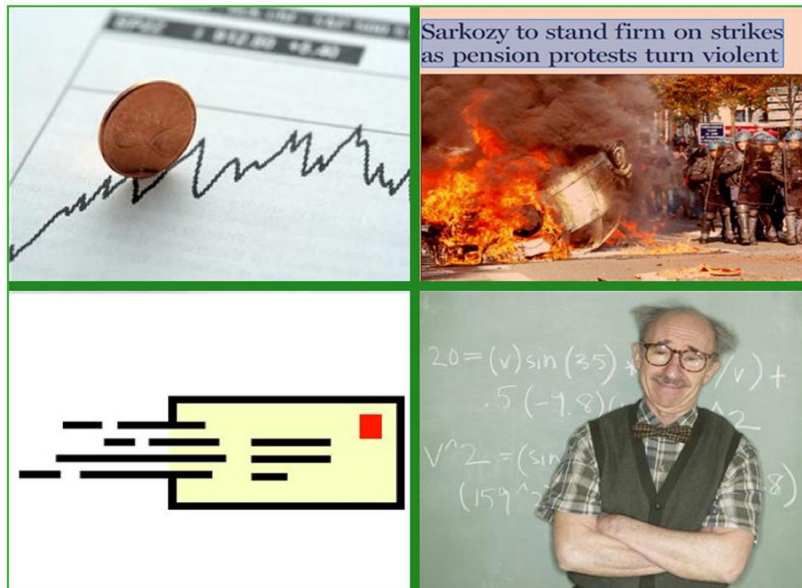
**PENSION FUND GOVERNANCE: boards of trustees under pressure**

For many people pension benefits are the financial pinnacle of an industrious life. Not so long ago nobody seemed to worry about his or her pension, as this was guaranteed and pension funds were well funded. However, times have changed. Since the financial crisis in 2008 many pension funds are in dire straits. In one fell swoop the 'gilt-edged' pension funds lost billions of Euros of accumulated pension reserves. Almost forgotten words like 'writing down' were reintroduced in the Netherlands. As well as the question of whether pensions will still be affordable in twenty years' time.

*Why so much pressure? What has changed?*

**Market volatility**

**Public opinion**



**Short term-ism**

**Longevity**

For the general public the 'pension crisis' may have come as a shock. Governments, supervisory institutions, sponsors, pension fund boards, asset managers, participants and pensioners have known for quite some time that the pension structure needs to be revised. This against the background of an ageing population and increasing life expectancy. The most obvious reaction is to increase the pensionable age. A number of European countries have already started this process. Furthermore, the discussion has focused on revising the pension contract. For example, within Europe there is a trend towards funded defined contribution (DC) schemes. Some parties also plead for more hybrid structures in the form of combined DC and defined benefit (DB) schemes. Multinational organisations have appealed for cross-border pension schemes in preference to different schemes per country. Indeed, national legislation has already been adapted to facilitate cross-border provision. The Netherlands, for example, has created the Premium Pension Institution (PPI) to act as a new cross-border defined contribution pensions vehicle to operate defined contribution schemes across Europe. The Dutch government is also exploring the defined ambition scheme set-up.

## OECD recommendations

In its report from 2009 the OECD makes six recommendations to improve pension fund 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 and able to show their ongoing commitment to training.
- **Policies:** Written policies should be in place, supported by monitoring procedures to ensure compliance.
- **Accountabilities:** Pro-active strategies for managing real or perceived conflicts of interest should be followed; asset managers should receive closer oversight, both during selection stage and in 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 necessary information to plan members and beneficiaries, the sponsor and other stakeholders.

## Regulatory change

Increasingly strict regulations should also contribute to preserving national pension schemes, with focus falling on pension governance. In the words of the Organisation for Economic Co-operation and Development (OECD), what do pension funds and supervisory institutions do “to protect individual’s pensions from mismanagement and fraud”? Are there sufficient “checks and balances” to protect the interests of those entitled to a pension? Is risk management adequate?

Pension governance has been an overlooked issue for a long time. The trust in the expertise and supervision of pension funds was generally high. However, the environment in which pension funds operate has changed significantly. Increased supervision, greater product differentiation and the need for effective investment strategies are making heightened demands on pension fund governance. Pension fund managers are increasingly pressured by governments, regulators and other stakeholders to set up their fund as transparently and efficiently as possible. An increasing number of pension funds have realised that an optimum set-up of their governance is of strategic importance when maximising the fund’s investment proceeds. The expectations are that governance will increasingly become a distinguishing factor between pension funds.

## Reports

In March 2001 Paul Myners, author of the famous Myners Report<sup>1</sup>, wondered “whether institutional investors were acting in the best interests of their beneficiaries”. Myners particularly targeted the lack of insight into investments in non-listed stocks. He recommended that pension fund trustees voluntarily adopt, on a “comply or explain” basis, a series of principles codifying best practice for investment decision-making, which placed pension governance clearly on the radar of governments and supervisory institutions.

On 7 July 2009, the OECD<sup>2</sup> published an updated version of its Guidelines for Pension Fund Governance from 2005 in which optimum risk management was the main priority. However, the guidelines also pointed out the necessity of paying greater attention to possible conflicts of interest. Furthermore, the OECD deems it necessary for pension fund managers to be better trained. Competence and experience are mentioned as significant qualifications next to integrity and professionalism. In addition, the OECD pleads for increased participant influence in pension fund governance. To conclude, the OECD points out the necessity of advising all stakeholders correctly via effective and transparent reports.

In the Netherlands, pension governance received a significant boost with the implementation of the Financial Assessment Framework (FTK) in January 2007. The FTK is built around the principles of market valuation, risk-based financial requirements and transparency. The latter relates to a clear and objective way of defining and publishing the fund’s financial position.

In past years, the European Commission (EC) has interfered in the regulations and guidelines for good pension governance. According to the EU Pensions Directive<sup>3</sup> a pension fund must be managed by “persons of good repute who must themselves have appropriate professional qualifications and experience or

employ advisers with appropriate professional qualifications and experience”.

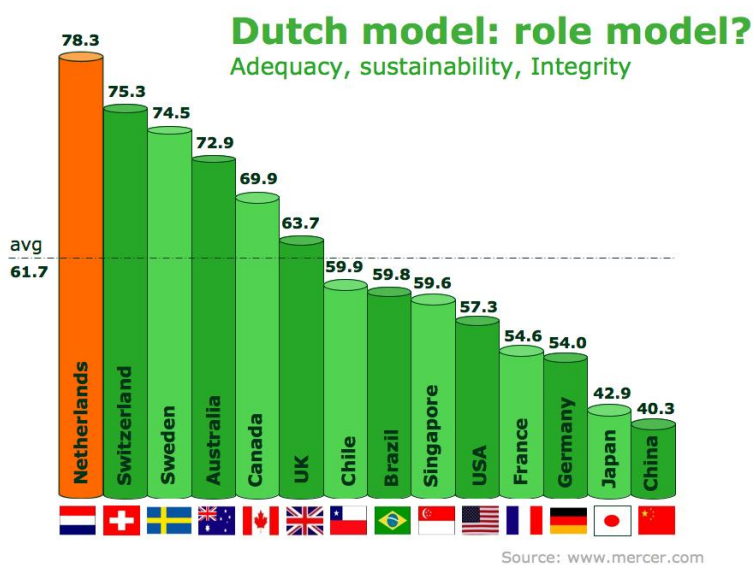
The EC recently published its Green Paper ‘Towards adequate, sustainable and safe European pension systems’.<sup>4</sup> In addition to considering the consequences of the Solvency II guidelines for pension funds, the Green Paper also discusses how Europe can enable adequate and future-proof pensions that will fulfil a significant role in the future economic growth in Europe. Hybrid pension schemes will probably become a considerable part of the European pension landscape.

## Pension fund governance revisited: the need for greater control

### What system would we value most?

In October 2009 Mercer published a study that compares eleven different retirement income systems around the world. The graphic shows the overall index value for each country. The overall index value represents the weighted average of the three sub-indices: adequacy, sustainability and integrity. The sustainability sub-index has a focus on the future and measures various indicators which will influence the likelihood that the current system will be able to be maintained in the future. The integrity sub-index has a focus on the private sector and therefore has a more restricted scope than the other two sub-indices.

Source: Mercer Melbourne Center for Financial Studies, Melbourne Mercer Global Pensions Index, October 2009



Since the financial crisis began in October 2008 the financial position of pension funds has been subjected to great pressure. As is common in the Netherlands, several committees were immediately appointed to investigate the consequences of the credit crisis for pension funds and to make suitable recommendations. Most attention was paid to the Investment Policy and Risk Management Committee (the ‘Frijns’ committee).<sup>5</sup> This committee investigated how the investment policy, risk management, execution and governance of pension funds had developed since 1990, in relation to the objectives and the risk framework of pension funds.

A significant focus area of the Frijns committee is to achieve ongoing control of pension funds by drastically improving risk management. The committee believes that pension fund boards are not always best equipped to perform their duties adequately. Pension fund managers must possess more explicit expertise and experience in the risk arena, which will enable them to provide effective balance to, and oversight of, commercial asset management providers. Professional support may give solace. Furthermore, the committee believes that the current structure of the pension system is paternalistic; decisions are made on behalf of the participants. According to the committee, many boards still have a long way to go in the area of (policy) transparency.

### **Recommendations of the 'Frijns' Committee**

- The board should develop, apply and monitor a framework that shows to what extent the board functions adequately with regards to the definition, substantiation and execution of:
  - Risk policy
  - Corporate social responsibility
  - Investment policy.
- The board must be effectively in control regarding risk management during all stages of the investment process. This applies to the execution of the strategic, tactical and operational investment policy, which is laid down by the board in an 'in control statement'.

The board should account annually for the performance and sustainability of the investments.

The report of the Frijns Committee has proved to be an incentive for many pension fund boards to put their governance in order. An investigation by CPI Governance<sup>6</sup> shows, for example, that three-quarters of banks, insurers and pension funds believe that risk appetite should be the basic principle underpinning all strategic decisions. This does not only concern the implementation of strict control measures but also the adaptation of internal governance structures. The risk willingness must also be embedded in the decision-making process via specified risk tolerances and risk limits and the control thereof.

Even more important is a behavioural and cultural change and knowledge development. An average of 45 percent of the respondents believe, for example, that there is insufficient knowledge available to their organisation and matters such as risk profile, asset allocation and liquidity requirements remain issues. The Frijns Committee also reached a similar conclusion in its report: in the majority of cases pension fund managers have insufficient relevant knowledge and experience in the area of risk management and investments.

Still more recently (April 2011) the Dutch regulator De Nederlandsche Bank (DNB) published a report<sup>7</sup> of their findings related to risk monitoring of pension scheme investments in which it advocates a professional independent risk monitor function.

### **Trustees under pressure**

It seems fair to say that trustees have one ultimate professional goal: delivering your pension benefits. In other words: ensuring that what was promised is also delivered to you at your retirement! Therefore, it is safe to conclude that pensions management is mostly a matter of expectation management. Having said that, some questions arise such as: What was promised to you? What pension pay out are you expecting? These, and more, are all expectations to be managed by pension fund trustees. And apart from that, all must be in the interest of the beneficiaries, whereby trustees must protect the rights of participants (current and future pensioners) and the rights of the sponsor as well.

As you can imagine, the trustees' role is a delicate balancing act. Especially when one knows that this is often combined with a busy full time day job within the sponsor company. Time itself is therefore an essential part of delivering the pension promise.

Furthermore, the fund needs to produce a healthy return, in order to payout the pension money as promised. The fund therefore needs to maintain a high coverage ratio. It must generate pension wealth but at the same time stay within the guidelines, regulations and other requirements. And on top of this already challenging task comes the need to communicate updates on how the pension promise is proceeding and what progress the fund is making in delivering upon this.

### **How can trustees handle this expectation management?**

By organising the investment and information process as efficiently as possible.

### **DNB investment research letter 2011**

In April 2011 the Dutch regulator DNB published a letter that among other things focuses on the establishment of an independent risk management function for pension funds. DNB notes that pension funds that invest in complex products "need more than a simple risk measure". An ex-ante proactive risk management function enables fund trustees to recognise and steer the exposure to risks at an early stage.

Equally important is that "the risk management function is involved in all

phases of the investment process". That way pension fund trustees can assess whether risks are sufficiently clear and acceptable before investing in complex products.

DNB also emphasises the importance of counterbalance in outsourcing the risk management function. That way trustees can keep a better grip on the entire investment process including the operational investment process.

Finally DNB stressed that the limits of investment mandates for asset managers should be carefully monitored and set down in clear agreements.

With products such as ex-ante risk analysis, institutional risk management, performance measurement and an independent role as risk manager, administrators must play an important role in implementing the recommendations of DNB.

Compared to approximately ten years ago the duties of the pension fund board have become increasingly complex. Supervisory institutions have set stricter requirements for levels of knowledge and training. The investment process is increasingly complex and more difficult to understand, as are the risks relating to the execution of the investment policy. The number of obligatory reports continues to increase, both in frequency and complexity.

Another major impact on today's pension debate has been the changes in IFRS and the way we have adapted the pension fund accounting rules. Pension funds' long term investments are now marked to today's market values, as if they were short-term stock investments.

In the meantime, pension fund managers are expected to understand these issues. They remain responsible for the execution of the investment policy, even when it is outsourced to external asset managers, for example in the form of fiduciary management or an executive body.

### **Starting over?**

It all seems a bit daunting; is there still hope for trustees? Is there still hope for us? Will we still get our pensions, once we retire? Let's assume an ideal world. Let's assume all these challenges that trustees face are no longer relevant. Suppose we start designing our own pension fund, what would we decide?

Of most importance is to design a solid and effective working governance structure separating decisions from execution and independent reporting and controls. Any such structure would enable trustees to gain greater control and would satisfy regulators and hopefully help beneficiaries.

Unfortunately, at the present time these structures are lacking. In practice pension funds deal with a wide variety of contractual partners. They receive much advice from many different sources. A lot of information is exchanged, but it is not always clear what sources are used. Trustees should therefore be 'empowered' to be in greater control.

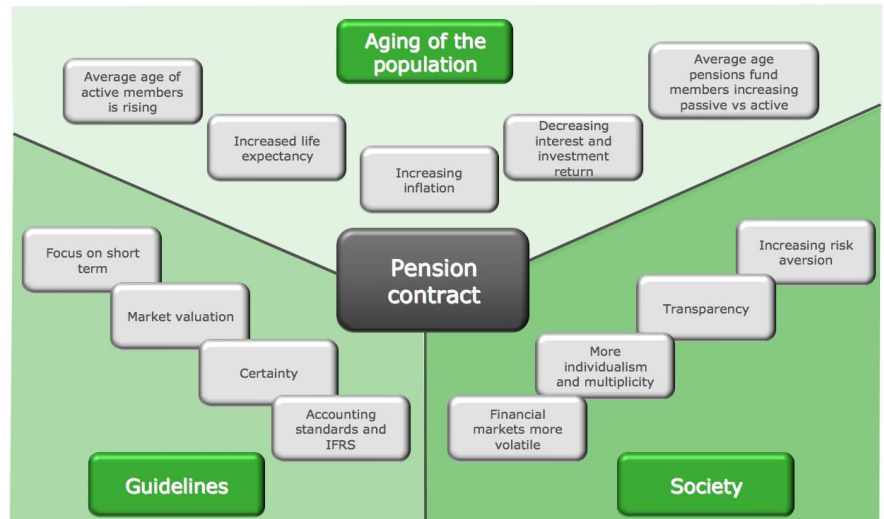
As stated above, trustees deal with a range of different parties. All these perform parts of the overall pension fund management process, and it sometimes seems that there is no one who monitors whether they stay within their guidelines. As a matter of fact, this is often undertaken by these parties themselves. And how often do we see that the asset manager measures his own performance? Here lies a role for (independent) third parties: for example, neutrally determining which returns have been achieved by the asset managers.

### **Counterbalance**

Custodians, for example, are pre-eminently positioned to provide independent and neutral analysis in the area of fund accounting, compliance, performance measurement and risk identification. Why? Because they comply with a fundamental principle of effective administration: the segregation between custody and administration on the one hand and fund management on the other.

Another important factor is timing. Nowadays trustees need information on a daily basis. In the past auditors would validate the numbers at quarter end, but this is no longer good enough. Collecting data should take place in a timely fashion and from a neutral source. And creating information through independent checks facilitates a better position for trustees. An independent source of information will provide the board of trustees with a single point of reference. It will also allow for independent monitoring of all decisions, guidelines and other parameters.

**Pension board trustees:  
Today's challenges**



Accurate data from a neutral source provides trustees with a solid foundation for decision making and control. It is also critical that trustees fulfil their fiduciary role with the support of an interactive tool and that compliance monitoring is actively pursued by an independent party.

Based on the guidelines and parameters as agreed with the board of trustees, this process allows trustees to monitor the pension fund's management process actively. It also enables them to take immediate action when guidelines are breached or parameters not met. In short, it affords them direct managerial oversight and the ability to deliver crucial counterbalance.

What else can we do to help the trustees under pressure? What else would enable them to operate from a stronger position and provide them with greater control?

A pension fund's most active decision making function is the investment board. Again, many parties are involved. Advice is important, but implementing decisions is often overlooked. In addition, the financial markets and instruments used are often complex and hard to understand. Discussions and explanations therefore take time. A decision is often perceived as a relief. And as many others need to follow, with limited time available, you can guess what happens.

Creating an independent implementation function, with a focus on process, instructions and control will therefore support trustees, and result in an audit trail that will help them to establish a counterbalance to the many parties with whom they must deal.

### **Implementation of this independent function**

How does this work? The investment board takes decisions. Once agreed, the decisions must be executed. In order to facilitate a more professional implementation process, it is suggested that an experienced and independent implementation manager translate these decisions into a set of instructions. The board then reviews these before indicating their approval. Once approved, the implementation manager initiates the execution of the instructions. He or she also monitors the process of execution and provides the board with a summary of the process. This also allows the quality and transparency of the execution process to be monitored.

The investment committee often makes decisions related to the management of a pension fund. Implementing these instructions is not an easy task and is often poorly documented (if at all). Implementing the new role will allow for decisions to be translated into clear instructions, which will be confirmed by the trustees and then actively and independently executed and monitored.

### **Organising the governance structure**

- Regular fund accounting: daily/monthly/quarterly/yearly valuations of the assets invested
- Independent compliance checks on investment guidelines and the asset managers
- Performance measurement of the portfolios and the asset managers
- Identifying risks associated with investing the assets, allowing trustees to create a robust risk management/monitoring framework.

This way all participants in the decision making process receive more professional support, to ensure appropriate execution. Trustees benefit from a clear audit trail that supports their fiduciary responsibilities. And all parties are provided with greater transparency, thus enabling trustees to remain in complete control.

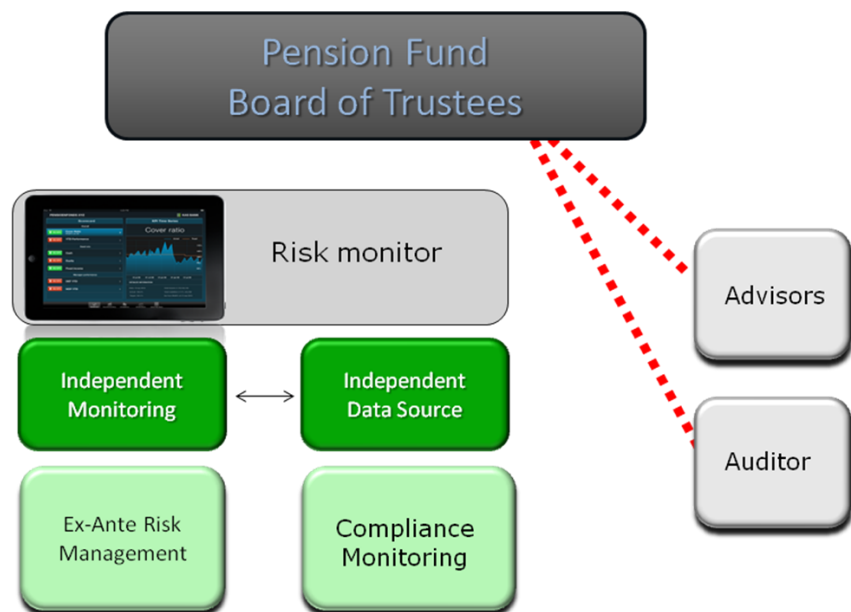
So the trustees' role is not impossible, there is still hope! It is, however, important for trustees to take ownership of their information management and also appoint independent parties that can facilitate and ensure appropriate and professional pension fund governance.

### **The search for an independent party**

The role of independent party or 'controller' could be fulfilled by, for example, a custodian. But what kind of custodian best fits the needs of trustees under pressure? And how can they have input in organising the governance structure?

Custodians (or custodian banks) come in all shapes and sizes. There are global custodians, local custodians (also known as sub-custodians or agent banks), self-directed retirement account custodians and mutual fund custodians. Pension funds are likely to use a global custodian, as they are able to safeguard assets in multiple jurisdictions around the world, using their own local branches or other local custodian banks in each market to hold accounts for their respective clients.

The typical role of a custodian, or more accurately a securities services provider, would be the safekeeping of assets and securities (such as stocks, bonds and commodities, both domestic and foreign) and the execution of corporate actions and all other relevant events. Their added value derives from the ability to perform additional services for individual clients, such as pension funds and mutual funds; examples include fund accounting, administration and legal and compliance services. Furthermore custodians provide regular, bespoke reporting on any or all of their activities, to their clients or authorised third parties.



As securities services transaction providers are responsible for safeguarding a firm's or individual's financial assets, they are not likely to engage in 'traditional' commercial or consumer/retail banking. Most providers, however, are part of a larger financial institution. To ensure that there are no conflicts of interest with other clients or the activities of the institution itself (such as proprietary trading or 'house funds'), internal Chinese walls are required. This, however, is not the case with 'pure play' providers.

'Pure play' encompasses neutrality, no active asset management, no active trading for one's own account, no conflict of interest with clients and no internal Chinese walls. This allows them to take over the investment guideline monitoring function required by the regulator on behalf of many pension fund boards and pension departments. This function will continue to grow in importance for pension funds operating under increasing regulatory pressure. The shift towards more extensive outsourcing (in response to pressure exerted by regulators) also necessitates further professionalisation of the monitoring framework.

#### **How can securities services providers help trustees?**

Securities services providers do not solely provide basic information for the financial administration but also relevant management information enabling pension fund boards to remain in control. They can also play an explicit role in monitoring the execution of the investment policy within the risk and policy framework determined by the board. In this way, the board is able to provide appropriate compensation to commercial asset management providers. Furthermore, on the basis of the reports provided, they will be able to keep the fund's participants and pensioners up to date concerning the performance and risk management of the fund in a fully transparent manner.

How? By offering independent audits of the investment process as well as the performance of investments and the quality of valuations, and providing the board with an overview of the operating risks inherent in the investment policy, for which it holds ultimate responsibility.

In order to provide them with timely and relevant information, 'pension dashboards' are being developed. Through such an interface trustees, scheme managers and sponsors will have online access to important information covering different aspects of governance, and independent analysis. It will also give users options on reporting style and frequency, and provide reporting on fund accounting, compliance monitoring, performance measurement and risk management.

Pension trustees can make well considered decisions and interpretations based on this monitor, as it delivers all the key metrics required for effective pension fund management. The party providing this data should, of course, be totally independent, so that trustees have access to neutral data and unbiased third-party monitoring.

Thanks to these stable checks and balances the pension fund can focus on its core business and the board will be continuously in control of the entire investment process. In this way, the fund will be prepared for the pension governance of the 21<sup>st</sup> century.

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<sup>3</sup> IORP Directive, 2003/41/EC, [www.dnb.nl](http://www.dnb.nl)

<sup>4</sup> [http://ec.europa.eu/economy\\_finance/articles/structural\\_reforms](http://ec.europa.eu/economy_finance/articles/structural_reforms)

<sup>5</sup> Commissie Beleggingsbeleid en Risicobeheer, *Pensioen: "Onzekere zekerheid". Een analyse van het beleggingsbeleid en het risicobeheer van de Nederlandse pensioenfondsen*, 19 januari 2010, [www.rijksoverheid.nl](http://www.rijksoverheid.nl)

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<sup>7</sup> De Nederlandsche Bank, *Beleggingsonderzoek 2011*, april 2011, [www.dnb.nl](http://www.dnb.nl)

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