Good governance can impact the success of a pension scheme

Can the learnings from the largest schemes in the UK benefit schemes of all sizes?

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“Governance is the most important aspect but the hardest to get right”

Interviewee
Overview

Most UK defined benefit (DB) schemes were set up in the 1970s. Since then the economy and investments have all changed, and we have seen increasing globalisation. The one thing that has not changed is the way pension schemes are managed (their governance). Does that matter?

What is ‘good investment governance’ in today’s environment? To find out, we interviewed some of the most influential UK investors. We spent time with key individuals from 25 of the largest DB pension schemes in the UK, representing over £280bn of assets. In our first paper we highlighted some common themes identified from our research. These included governance structures, investment beliefs and pension scheme business plans.

In this second paper, we delve more deeply into the theme around good governance actually impacting the success of pension schemes. What does this success look like? How might it be achieved?

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Research background
In the second half of 2015 we carried out one to one interviews with key individuals from 25 different UK DB pension schemes. Organisations included local authority and private sector pension schemes. The aim was to understand how some of the largest and most influential UK investors have addressed their investment governance.

The discussions were deliberately free format. That way we were able to capture the most important aspects to each individual, rather than imposing a particular agenda. This was different from other research because it is qualitative — based on listening to participants’ views.
Governance impacts the success of a pension scheme

Interviewees told us one thing: that governance is really important. Not only is it important but they also said it was a key driver of returns. There was a strong view that good governance had a direct link to the success of the pension scheme — the definition of success being an individual decision.

So what does this mean? If the largest schemes are placing this level of value on governance, then schemes of all sizes should consider if (and how) they can get this benefit.

Traditional governance models may be flawed

Most UK DB pension schemes have the same governance model and approach that they have had for many years. With this traditional approach, trustees typically own all of the decision making with the exception of day to day stock and security selection (which is either delegated in-house or to an external asset manager). This means that trustees decide what to invest in, how much to invest in each asset class, and which managers to invest with etc.

The consensus from our interviewees was that this approach leads to a number of inefficiencies and, therefore, if not carefully run/managed, it can be seen as flawed. For example, some interviewees felt trustees dedicate a disproportionate amount of energy and time to relatively low importance/impact items such as reviewing cashflow projections and rebalancing decisions. One of our interviewees described their old approach where they’d see trustees being in the office many days a week to carry out day to day tasks. As a result of this, the trustees then found it difficult to spend time on the high impact, key decisions such as strategy and planning.

“Meetings would take 10-12 hours with no prioritisation resulting in poor decision-making”

Interviewee

Many of those we interviewed described what they would say were cumbersome governance structures. For example, where the trustee boards were made up of more than 20 trustees! Coming to a consensus decision is not easy in the best of conditions, let alone with such a large number of individuals. In some cases this was a feature of the regulatory framework, in others it was simply historical precedent that had not ever been changed.

Of course, if trustees’ time and energy can be focused on the key strategic decisions, and not on the lower impact items, this overcomes some of the potential flaws of the traditional approach. This might involve getting some outside help or changing internal structures and training.

The issues we’ve discussed above are challenges facing all trustees, no matter their size. There is a limited amount of time available and so good governance needs to take this into account and consider how best to use that time. There are many other considerations when it comes to governance models and approaches. For example, how many trustees is the optimal number and how are they appointed? How is the trustee board structured? How are decisions made?
Separate committees can make things worse...

Putting in place separate specialist or focused committees is often used to help decision making and governance within a pension scheme. When we spoke to our interviewees it was therefore interesting to hear some of them say that separate committees actually sometimes made things worse.

In some cases decisions within the committees were still referred back to the full trustee board and so there was no distinct improvement by having the committee in place. Several interviewees described very long decision-making processes where the trustee boards and committees went to and fro with papers and decisions between themselves. Effectively prolonging the process rather than improving it.

So what’s the solution? Schemes of all sizes need to make sure they have the right processes in place to make decisions as quickly and efficiently as possible. A key part of this is accountability...

“"The Board and in-house team tended to blame each other for slow or poor decisions"”

Interviewee

Poor accountability and poor outcomes are linked

Our largest pension scheme interviewees also talked to us about accountability for decisions and decision making. Where this is unclear it was felt it led to unhelpful behaviours. For example, one person told us about a culture where the trustees and in-house team would tend to blame each other for slow or poor decisions.

This may or may not surprise you that even the largest schemes haven’t always been clear who is responsible for decision making. What is clear, is that when looking at ‘good governance’ it is important to ensure there are clear roles, responsibilities and accountabilities at each level and that everyone is aware of this.

“Governance is often perceived as getting in the way of doing things. Actually it is a framework for getting things done”

Interviewee

What is the reward for getting governance right?

All our interviewees overwhelmingly agreed that getting the governance structure and decision making ‘right’ within a pension scheme impacted the success of a pension scheme. What did they mean by this? Well, many felt that it added significant value and were able to give examples of some of the benefits of getting it right.

One of the examples highlighted was cost savings. Our interviewees felt that by having a clear structure and decision making process, they were better able to negotiate with underlying investment managers. This was in terms of fee negotiations but also better investment terms such as securing access and capacity to funds that are otherwise closed to new investors.

The other cost angle was that they felt able to use consultants and advisers in a more targeted way, thereby reducing costs incurred. It is also important to note a word of caution on the use of advisers as this would very much depend on the expertise on the trustee board and committees in place.

Those interviewees that had expertise and time (deemed good governance), said one of the benefits of that approach was the ability to monitor markets and asset classes. They felt better placed to then capture opportunities as they arose. This was both in terms of new ideas and in terms of when an investment became better priced and they should invest (as opposed to investing at an ‘expensive’ price point). One interviewee also described how the revamped governance structure they had put in place enabled them to identify a wider range of opportunities including longevity hedging.

Having a good governance structure with clear decision making allowed all our interviewees to make focused and timely decisions. They felt they were in a better place to analyse past and future decisions, assess the opportunities and then make an informed decision without delay. Clearly, in volatile markets like we have seen in 2016 and the uncertainty of Brexit, this is more important than ever.
Can all schemes achieve these rewards?

It is clear that not all of these benefits could be achieved by every single scheme, all at the same time. The size of the scheme’s assets does clearly play a role in some of the benefits our interviewees described, in particular the ability to negotiate with managers.

However, many of the other benefits can be achieved with the right governance structure. Time and expertise were key elements of good governance that came up with all of our interviewees, and in different contexts. This is something that can either be developed or enhanced internally, for example through training or recruiting an investment expert as an independent trustee. For the large schemes the solution in some instances has been to build an in-house investment team and CIO. Alternatively, we are increasingly seeing trustees and sponsors bring in outside help. This can involve delegating the day to day management of some or all of the portfolio to investment professionals. This gives the time and expertise needed to monitor the portfolio and markets, and be able to react quickly to capture opportunities. Something that may not be possible to do through in-house options.

Another key element is the decision making process itself. To reap the benefits of good governance decision making must be efficient and not cumbersome. If separate committees are used, then they must be set up in a way that improves this and creates a more streamline process, rather than further delaying. Any delay could mean missing an opportunity which might have a direct impact on returns.

What our research has shown us is that good governance isn’t just a term. It’s also an ongoing and evolving element to a pension scheme that is critical to the overall success. We’d encourage all schemes to view this as integral to successfully running their pension scheme. The benefits are not just about saving time and clearer roles, but also there can be real cost savings and/or improvements in scheme performance itself.

“Fundamental to success is how decisions are made”

Interviewee

What actions can schemes take?

As you can imagine, some of the examples that were shared with us made running the pension scheme even more difficult and time consuming. Nearly all the large schemes we interviewed have proactively gone through a process of change over the last decade.

We’d therefore encourage all schemes to review their current governance structure and decision making. Even small improvements can have a big impact.

Key actions:
1. Review your current governance structure and decision making
2. Identify where improvements can be made (using our series of papers and advice to help you)
3. Assess all your costs/charges and look at if it is possible to get more value from the services being offered or able to negotiate these
4. Review this every two to three years to ensure you don’t get left behind

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To talk to us about any of the points we have raised in this paper or to find out more information about our delegated offering, please do not hesitate to contact your Aon Hewitt Consultant or Sion Cole, Senior Partner and Head of European Distribution, Delegated Consulting Services, on +44 (0)207 086 9432 or at sion.cole.2@aonhewitt.com.

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