Newsletter

# Investment Insights

## Governance

Very simply, governance refers to the way in which an organisation is run and decisions are made. It is often felt to be a "soft" issue, less important than discussing which asset class to invest in or whether to fire your underperforming fund manager and, as a result it often doesn't get the attention it deserves.

The purpose of this paper is to demonstrate the importance of governance and explain how taking the time to ensure you have strong governance in place will bring real benefits.

## What are the benefits of good governance?

It is a common misconception that the benefits of good governance are less visible than the outcome of other tasks undertaken by trustees. We believe that a good governance structure is the lynchpin of a successful, well-run scheme.

We set out below some of the most notable benefits of good governance:

### 1. Confidence

Strong governance of a strategy promotes understanding, clarity of purpose, confidence, efficiency of implementation and greater unity of purpose from all parties involved. It is borne out of having an objective all parties understand and support and a clear link between the strategy and how the objective is expected to be met. Simply put, it will help trustees sleep at night.

## 2. Efficiency

Another very visible output of a well governed scheme is the speed with which decisions are made and implemented and the efficiency with which meetings are run. Both are products of having a clear objective that is based on agreed aims and beliefs and takes account of any constraints identified by the trustees. These provide a reference point when making decisions – the trustees can ask, "is this consistent with our strategy and does it move us towards our long-term objective" – and make it easier to identify the most important items for discussion at trustee meetings.

## 3. Output

The Pensions Regulator has noted "there is a clear link between good governance and good fund performance". We believe one of the reasons for this is a good governance structure encourages forward looking decision making based on a scheme's own circumstances. It helps guard against reactive, herd-like decision making. This is especially noticeable in turbulent market conditions, where decisions linked to clear objectives lead to better outcomes than more rash decisions, driven by fear or greed.

## 4. Succession

Having a well-governed scheme will mean that the decisions you make as trustees are documented and make it easier for new trustees to understand the strategy and the decisions made to date. This will also help explain decisions to other parties; such as members, the sponsor or The Pensions Regulator.

# What will we cover?

This paper first sets out some common features of well-governed organisations before briefly looking at some of the governance structures that trustees have to choose from. We conclude with some "key take-away actions". In doing this, the paper demonstrates the value of good governance and sets out some areas of focus when developing your governance policy.

Whilst we have focused on investments in the case studies throughout this paper, the principles can be applied much more widely than just to your investment decision-making process.

# What does good **governance** look like?

There are numerous parties involved in running a pension scheme and the dynamic between these parties will differ by scheme. This means what "good governance" looks like will also differ for each scheme. However, there are a number of features that are common to well-governed schemes. Key to this are seven features which we split between "People" and "Structure" below.

## People

1. One of the most important features of a well governed scheme is the establishment of **clear roles and responsibilities** that are understood by all parties. We believe it is important to clearly document the distinction between the different roles and hold each of the parties accountable against this specification. Equally important is each party has the authority to carry out their role efficiently. In our experience, this is best achieved by promoting a culture of open dialogue and challenge.

2. **Strong and stable leadership with appropriate succession planning** are not confined to Conservative Party electioneering. They are also common features of well governed schemes.

3. A note on governance would not be complete without emphasising the importance of training. Effective decision making requires the **appropriate knowledge** as well as clarity of role and authority. In our experience, well governed schemes have a clear and ongoing training schedule and record of training undertaken. In an ever changing investment market, we view it as our responsibility to ensure trustees are kept abreast of relevant market developments and the **implications for them**.

4. The efficiency of a scheme is constrained by the strength of the relationships between the various parties involved.

## Case Study 1:

### Clear roles And responsibilties

Otis is a new Trustee Director on a scheme with an investment sub-committee (ISC). Whilst the full trustee board is involved in setting the long-term objective for the Scheme's investments, they have delegated responsibility for implementing the strategy, including the asset allocation and selection of managers and funds, to the ISC.

Otis finds it hard to follow the rationale for some of the decisions made by the sub-committee and thinks that it would be more efficient for the sub-committee to be dissolved and all investment decisions to be made by the full board – especially since so much of the full board meetings are taken up by the ISC explaining their decisions to the trustee, often with the outcome the ISC is asked to review their decisions.

> This suggests that either the role of the ISC is not clear to the full board or that the board does not trust the ISC to carry out their role.

Ela, a fellow trustee has put forward an alternative solution. Ela has suggested that rather than dissolving the sub-committee, each Trustee Director should sit on the investment sub-committee for 2 years. Ela believes that this will not only make sure all Trustee Directors fully understand investments but also bring fresh ideas through new members. Combined with better reporting, this could lead to a much more effective decision making and a better investment strategy.

There is no right or wrong answer here. The trustee board should consider the shortcomings of the current structure, including whether the other trustees share Otis' concerns. The trustee could bring all decisions back within the remit of the full board, or continue to delegate some responsibility. In the latter scenario, it is imperative that all parties are clear on which decisions are delegated to the ISC and that the board has confidence in the abilities of the ISC in making those decisions. In turn, the ISC must ensure that their reporting, and therefore the rationale behind their decisions, is clear.

## Case Study 2:

### Meeting agendas

Chloe has served as a trustee on a number of pension scheme boards for over 15 years. She has recently been appointed to a scheme that typically have an agenda dominated by standing items, such as ongoing reports on funding position, investments and administration. As a result of that, at her first trustee meeting for the scheme, a discussion of the proposed de-risking schedule was rushed and a decision deferred to the next trustee meeting. This led to a de-risking opportunity being missed.

In response to this, Chloe has proposed to the Chairman that the meeting agenda is revised to use a structure that has been much more effective in her years as a trustee, which is to put key strategy items early on in the agenda. Alongside this, the Trustees have decided in future to set out in the agenda which items are "for noting", "for approval" and "for discussion" so that it is clear where time needs to be spent and what decisions are needed. This ensures important items are awarded the time they deserve and also means the Trustees' minds are fresh when making the most important decisions.

### Structure

5. **Agreeing and documenting the long-term objective** of the scheme is, in our view, the single most important step in achieving good governance. Well-governed schemes will focus their performance evaluation and decision making against these objectives, looking at assets in aggregate rather than individual managers' results.

   Setting clear, attainable and measurable objectives in advance, which reflect what both the trustees and scheme sponsor would consider a success, is vital to good governance. We find the **discipline of documenting** these aims and objectives cements their ongoing use as a reference point in the investment process, and leads to **better outcomes in the longer-term**.

6. As well as clear objectives, the best governed schemes have a **clearly defined risk tolerance**. That is, the trustees and sponsor have established in advance funding and risk metrics they are willing to accept in seeking to attain their objective. By doing so, when challenging conditions arise, they have considered in advance how they may react.

7. The final good governance feature that we will mention is the importance of **regular, structured evaluation**. This involves evaluation of all parties against the roles and responsibilities set out under (1) as well as monitoring the progress of the scheme against the objective and risk tolerances set out above.

> "If you don't know where you're going, you're liable to end up somewhere else."
>
> YOGI BERRA

## Identifying governance cracks

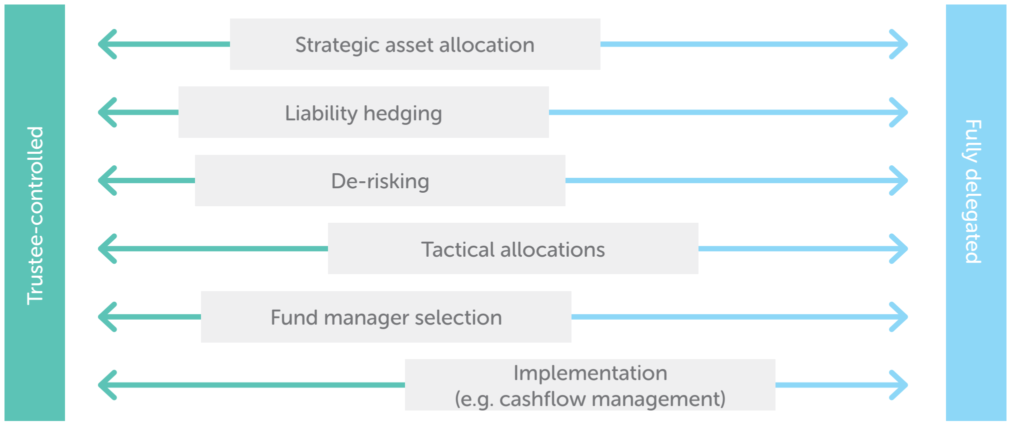
We have spoken at length of the features and benefits of having a well-governed scheme. Sometimes it is easier to assess the effectiveness of your governance policy by looking out for cracks – we have set out below some tell-tale signs to look out for:

- Are decisions regularly deferred or do changes take a long time to implement?
- Does the investment strategy objective or benchmark regularly change or do you have a number of different benchmarks in place? Are all of the trustees familiar with the long-term objective of the scheme?
- Is there a high turnover in board members – either trustees or sponsor representatives?
- Does one individual or group (e.g. a sub-committee or employer management group) dominate the agenda or decision-making?
- Is there any tension in the relationships between stakeholders? Are all parties satisfied with the level of information and input they have? It is easy for the structure to breakdown if there is a breakdown in any of the links in the diagram on page seven.

In all of the above cases, it is possible that there is a reasonable explanation and it is not because of governance fall-downs but as trustees you may wish to satisfy yourselves that this is the case and document this.

## Governance frameworks

Governance is a decision making framework for delivery of your investment objectives. It sets out how decisions are made and who is responsible for making them. A number of different structures can be used – in all cases, trustees sit at the head and retain ultimate responsibility for the scheme but the degree of their involvement in the day to day delivery differs. The key, is to ensure that, for each of the types of investment actions, the trustees have decided where responsibility and authority rests.




The variety of models that could be established is the content of a separate note, space does not permit going into the details here. For now, we note that where schemes have identified “cracks” in their governance, the trustees could consider adjusting the structure to ensure the appropriate level of delegation, and to the appropriate parties, is taking place.

## Key takeaway actions

- Agree a well-defined objective between the trustees and sponsor, with the help of your advisors. Define what this equates to in terms of investment strategy objectives.
- Work out the level of risk you are willing to take. Consider, for example, the increase in deficit that the scheme could sustain. This will provide an indication of the risk-return trade-off that is appropriate for the scheme and therefore how long it may take to reach your objective.
- Review the relationships between the trustee board, sub-committees, sponsor and advisors with the aim of creating a frank and open culture.
- Make sure the roles of each party are clearly defined and documented. Where responsibility is delegated, ensure each party has the appropriate training, resources and authority to carry out their role.
- As part of the above, consider whether you have the right governance structure for your scheme or whether more (or less) delegation would be appropriate.
- Review your meeting structure. Make sure the most important items appear first on the agenda. Remind the attendees of your core principles and long-term objective at the start of every meeting.
- In developing your governance policy, focus on the elements that the trustees can control; for example, who you chose to delegate authority to, how you run your meeting, what your long-term objective is (what would you consider to be a success?).
- Finally, take the above and document them in a formal governance policy that can be given to new trustees, sponsor representatives or advisors so that it is clear how you run the scheme.

## Case Study 3:

### Strength of the relationships

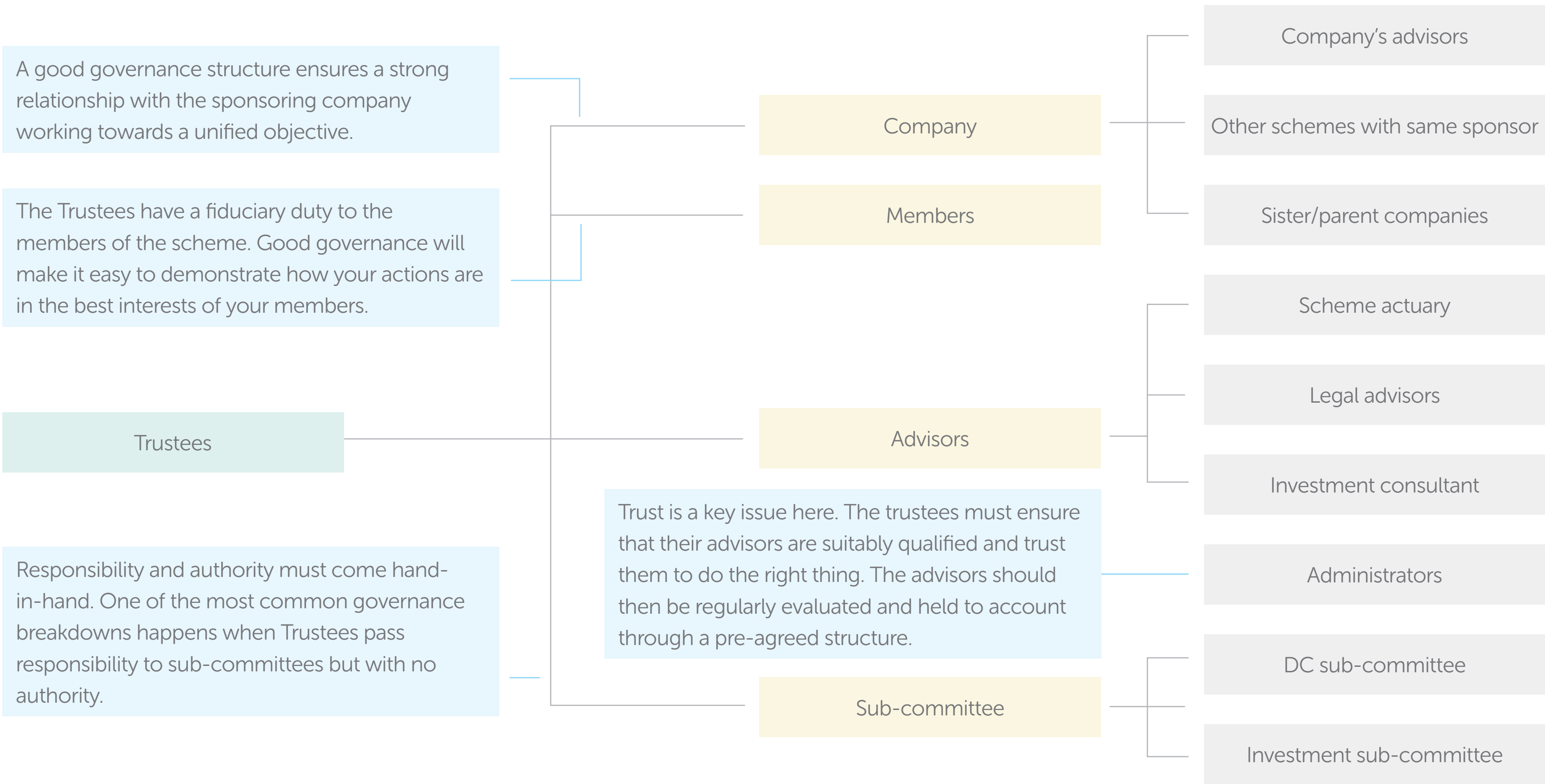
Micah and Lydia are the Investment Consultant and Scheme Actuary respectively for two schemes with similar covenants. In both cases, the size of the scheme is significant relative to the size of the sponsor and, whilst the covenants are reasonably strong, the sponsors both have limited cash available to put into the schemes over the next five years.

In the first case, the sponsor is engaged, with a good understanding of pension scheme matters and a representative attending all trustee meetings. The relationship between the trustees and the sponsor is strong – the trustees trust the sponsor's presentation of the company's financial position and the sponsor understands the trustees' concern over the lack of available cashflow. As a result, the sponsor has agreed to put in place a contingent asset, a property that will fall to the scheme in the event the sponsor's free cash falls below a certain level. This has allowed Micah to support an investment strategy with more risk over the next five years and Lydia to be comfortably with smaller prudence margins in her calculation of the liabilities (resulting in a lower funding cost).

In the second case, despite the significant size of the scheme, the sponsor continues to see the scheme as a legacy issue and is unwilling to commit time or resources to the support of the scheme. As a result, it is difficult for the trustees and their advisors to get a good grasp of the company's financial position. Micah and Lydia are concerned about the poor relationship with the parent and, moreover, the potential lack of security for the scheme. They have therefore proposed a low level of risk is adopted in this scheme's investment strategy and a higher funding cost. Despite the sponsor's objection to this, Micah, Lydia and the trustees do not feel they can adopt a higher-risk strategy without more engagement from the sponsor.

A good governance structure ensures a strong relationship with the sponsoring company; facilitating a two-way sharing of aims and strategies takes place.

The diagram below illustrates some of the parties involved in running a pension scheme – the openness of the relationships between all of these stakeholders is key in developing and establishing the culture above and in deriving value from it.



# Closing comments

Governance is about how decisions are made. Making sure that the scheme has appropriate people, structures and processes in place will help you to work efficiently, together with the employer and your advisors, toward an agreed long-term goal. It will make you more likely to achieve it. Along the way it will provide a framework for meetings, meaning decision-making will be more effective, help to manage risks to the scheme and members and provide a reference against which you can measure performance.

It has been said that investment strategy may be the most valuable contribution trustees can make to a scheme. Whilst a clear governance structure has many other benefits, one of the most valuable may be that it helps improve the likelihood that your strategy is moving you efficiently towards your long-term goal.

> There will always be bad investment experience at some stage. Good governance gives the trustees the confidence that this is not the result of something that could have been easily prevented

**Speak to your Barnett Waddingham contact about tools available to help assess your scheme's governance, including questionnaires that look at governance and investment strategy together.**

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

matt.tickle@barnett-waddingham.co.uk

0333 11 11 222

**www.barnett-waddingham.co.uk/investment-strategy**