

The Role of Pension Funds, and the Role of Boards

Key Take Aways

- Pension funds help people with their retirement provisions. They are entities that specialize in making long-term decisions. Trustees have the overall responsibility of formulating the policy of the fund, and of ensuring the required quality of implementation of the policy.
- Trustees can have three different roles, which involve different—and sometimes conflicting—responsibilities: the role of fiduciary, the role of employer, and the role of shareholder.
- A guiding light for making informed decisions and policy is fiduciary duty: behaving responsibly with other people's money. For investments, this comes down to prudent investing. It is important to reflect on this and to become familiar with fiduciary duties.
- Trustees delegate. Delegation is a balancing act between the added value of specialization and the agency cost of lengthening the investment chain. How can a board make sure that the agency issues are minimized?
- It is important to understand the motives of stakeholders of the pension fund; they can have societal, political and/or financial motives. Ignoring the motives involved is usually detrimental for the participants' interests.

In this chapter, we focus on the pension fund and its board of trustees. The primary role of the board is defining the goals of the pension fund, setting policy, organizing the investment process, and monitoring and adjusting choices in order to adapt to any changing circumstances. Boards can be a complex and diverse combination of lay people in the field of finance, as well as people with a professional background in finance or investing. The board is the key determinant of the success of a pension fund.

In a recent review of how boards have developed over time, Ambachtsheer¹ states that “while there is some evidence of improvement of pension organizations [...], the finding is that the major concerns about how board members are selected and trained, about the effectiveness of board oversight processes, and about the ability to attract

and retain key executive and professional skills remain. Much remains to be done to materially raise the effectiveness of the governance function in pension organizations.”

A malfunctioning board can have a considerable negative impact on the pension fund. The malfunction can have many causes, from failing to understand the crucial role of the board to appointees lacking the skills needed to be effective board members. This chapter outlines the very first step a board should undertake in order to be well functioning: understanding its roles and responsibilities, thus forming the framework for all other steps and decisions required in the investment process and governance. Understanding these roles, however, requires background knowledge on what it actually is that a pension fund does. To this end, we start with a short overview of pension funds, why they exist, and what their roles are. Our view is that these roles and responsibilities—give or take a few cultural and regulatory differences—have clear commonalities around the world. Following this, we discuss the characteristics of a pension plan, which defines who pays what (premiums), who receives what (pensions), and, crucially, who holds which risk.

Zooming in on the role of the board, we consider a trustee’s responsibilities from three angles: the duties as a fiduciary, the duties as a board member and the duties as a shareholder of an investment organization. An important question is how to balance these roles. Because delegation is an important board task, we discuss delegation and agency issues that arise as a result of delegation. The chapter concludes with a section on understanding and managing different stakeholders.

THE ROLE OF PENSION FUNDS

As the baby boom generation started to retire in the first decade of the twenty-first century, the amount of capital needed to provide for future income increased. In 2017,² global wealth was \$280 trillion. This is about four times the global gross domestic product (GDP), which totaled \$75 trillion in 2015. Pension funds in the 22 most important pension countries managed \$36.4 trillion at the end of 2016, amounting on average to 62% of their local GDP.³ Thus, pension funds are significant players in the world’s economy. A pension fund is an institution set up to accumulate assets in order to pay retirement obligations. It thus provides the means for individuals to accumulate savings over their working life so as to finance their consumption needs in retirement, either by means of a lump sum or by provision of an annuity. To a large extent—often 75% or more—the benefits are paid out of investment returns. This means that pension funds are important investors and sources of potential long-term capital to parties such as corporations, governments and sometimes households.⁴

In many countries the pension system consists of three pillars: a state pension, the supplementary company pensions, and the private individual pension products that each person can arrange for themselves.

First pillar pensions are a basic pension provided to all citizens by the local government of many countries around the world. This requires (tax) payments throughout the citizen’s working life in order to qualify for the benefits upon retirement. A basic state pension is a “contribution-based” benefit, and depends on an individual’s contribution history. Examples are National Insurance in the UK, or Social Security in the US.

The second pillar consists of the company pension schemes, as well as pension schemes for occupations and industries. This book focuses on these second pillar pensions, but its insights and lessons are easily applicable for the other types of pension schemes as well. The basis for setting up a second pillar pension fund is the pension plan, i.e. a plan that determines the funding, accrual and payout of benefits; detailing the rights and obligations of members and sponsors.⁵ Pension funds then administer the pension plan.

The third pillar is formed by individual pension products, such as an annuity insurance or via a tax-efficient blocked savings account. These are mainly used by the self-employed and employees in sectors without a collective pension scheme. However, these products can be serviced or offered by pension organization, where the boards have similar fiduciary duties to second pillar pension plans.

Each pension plan has certain key elements. These include⁶:

- A pension agreement that describes the pension benefit structure and guides day-to-day operations;
- A trust fund, foundation or other form of organization, independent from the sponsor, to hold the plan's assets and the administration of pension benefits. The trust is legally and financially independent from the companies;
- A record-keeping system to track the flow of money going to and from the retirement plan;
- Documents to provide plan information both to the employees participating in the plan, and to the government;
- At times, a number of officials with discretion over the plan; these are the plan's fiduciaries.

For a trustee, the main concern is to ensure that the members' retirement obligations will be properly funded and protected. The trustee's role is to make sure that pensions are paid not only now, but also in the future. These obligations stretch out over a long period. Understanding the longevity of the obligations provides a starting point for trustees in getting to know the fund. Taking a brief look back in time, in 1889, German Chancellor Otto von Bismarck introduced the first pension for workers aged over 70, at a time when the average life expectancy of a Prussian civil servant was 45. In 1908, when the British Prime Minister Lloyd George secured a payment of 5 shillings a week for underprivileged workers who had reached 70, Britons, and especially those who were poor, were lucky to survive much beyond 50. By 1935, when the United States set up its Social Security system, the official pension age was 65, just 3 years more than the lifespan of the average American worker.⁷ Pension plans, especially state-sponsored plans, were thus set up for the few people with long lifespans. Today, retirement is for everyone. In some European countries, retirement lasts for more than a quarter of a century on average. In the United States, the official pension age is 66, but the average American retires at 64 and can then expect to live for another 16 years. This puts into perspective the responsibilities of a pension fund.

Ensuring financially sustainable retirement benefits is a global challenge. With a population that is living longer, payout periods are extended. Governments, plan sponsors and industry are constantly challenged to make informed decisions that will meet both the retired, and the working population's needs.

When workers are covered by collective bargaining agreements, pensions, insurance and health benefits are key items of negotiation between management and labor. This has been important in the United States and the United Kingdom, as well as in the Netherlands, Germany, Sweden and Switzerland. For employers, who are concerned with managing their human resources, offering participation in a pension scheme has traditionally been a means of locking in older skilled workers while stabilizing labor turnover in competitive labor markets.⁸ However, with the introduction of new technology and flexible labor contracts the traditional organization of labor markets is changing rapidly, and this is altering the view employers have of the role of pension schemes. Nevertheless, in many cases the employer still provides for, or facilitates access to, a form of pension scheme.

The pension scheme itself is an arrangement for providing employees with an income during retirement, when they are no longer earning a steady income from employment. Retirement plans often require both the employer and employee to contribute money to a fund during their employment in order to receive predefined benefits upon retirement. This is a tax-deferred savings vehicle that allows for the tax-free accumulation of a fund for later use as retirement income. Funding can be provided from external sources, such as labor unions or government agencies, or via self-funded schemes.

Pension schemes operate under a high level of scrutiny from the government, lawmakers, regulators and participants. Plans must continually balance the needs of sponsors and of members. The plan's design needs to be optimized to ensure employees are getting the most cost-effective plan with the best possible benefit package. The investment choices play a large role in defining both the cost and the expected benefits of a pension fund. With low risk investments such as high-grade government bonds, the outcome over time will be relatively low, but certain, resulting in high premiums and/or low benefits. With high-risk investments, returns over time may be expected to be higher, which lowers the premium and raises the expected benefits, but at the same time makes the outcomes more uncertain, at least in the short term. Someone in the fund must decide on this risk/return trade-off, and come to an agreement with all of the stakeholders concerned as to how the risk is allocated between the company, pensioners, pension fund and active members. Sometimes, but less and less so, this will be the employer or the sponsor, sometimes it will be the beneficiaries, sometimes the premium payers, and often a combination of these. At the same time, the fund must ensure that the plan meets tax and regulatory guidelines, as well as manage costs.

THE PENSION TRIANGLE

When setting up and managing the pension scheme, there is a triangular relationship between the employee, the employer and the pension provider. The basic principle of this relationship is that pensions are a part of the terms and conditions of employment. Within this triangle, we can observe the following relationships:

- The relationship between the employer and the employee, who have jointly entered into a pension agreement or a pension plan;

- The relationship between the employer and an external pension provider, the pension fund, to whom the administration of the pension agreement is outsourced on the basis of an administration agreement;
- The relationship between the pension fund and the employee, as a result of the outsourcing of the administration of the pension agreement. The pension fund provides the employee with the pension scheme as well as agreed-upon information and services.

The pension scheme is drafted by the pension administrator in accordance with the pension and administration agreement. The pension scheme is organized around three institutional choices,⁹ as shown by Exhibit 1.1. First, there is a formal separation between sponsors' interests and the interests of the plan's beneficiaries. Second, a legal regime of trusteeships exists to protect the interests of the beneficiaries. Third, the management and investment of fund assets is delegated to expertise, either within the fund or externally.

Pension schemes tend to be semi-autonomous financial institutions, and, as the number of assets increases, they are increasingly viewed as such by regulators. In general, the pension triangle tends to be at its most complex in the case of Defined Benefit (DB) schemes. In that case, legal regulations require current funding of the plans to meet expected future liabilities, where sponsors' interests and the plan's beneficiaries' interests might not coincide, and where there even may be significant differences between the interests of older and younger beneficiaries, for example. In a DB scheme, the focus is on collective funding and how the employer will bridge the gap in funding. The participant of the DB scheme builds up a claim in pension payouts that do not depend, or depend only in part, on the investment returns and financial health of the pension fund. The participant is a consumer; payments are more or less clear when entering the scheme, a (nominal) pension policy provides regular cash payments from the predetermined retirement age onwards. The promised payouts are liabilities of the pension fund and do not vary with the financial health of the fund.¹⁰

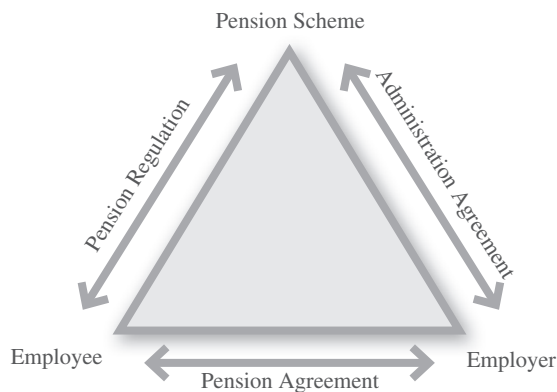


EXHIBIT 1.1 The pension triangle: relationship between employee, employer and scheme.

The majority of the risks and responsibilities in a Defined Contribution (DC) arrangement are with the participant rather than the employer. The participant is a co-investor rather than a customer. Payments to the participant are not clear when entering the scheme and fully depend on the investment return. With DC governance, trustees have to focus on individual financial planning and help participants consider areas such as when to retire, what level of benefits to retire on, what is the tolerance to risk and, if applicable for the specific pension market, what sort of annuity the participant should buy. DC schemes are by definition fully funded and are by design managed with the aim of maximizing the investment return and the accumulated value of the plan's participants' contributions within the agreed risk appetite. Here, the formal separation between sponsors, such as employers, and beneficiaries is virtually complete, simplifying the complexity of the pension triangle considerably.

With a DB scheme, the investment governance and strategy is set over a number of years to ensure full funding and realization of indexation goals. If full funding is not feasible, the valuation will show any shortfalls in funding and recovery plans can be put in place and reviewed accordingly.

DC schemes are, on the other hand, by definition fully funded and show no shortfall in funding. DC schemes rely on regularly monitoring and reassessing members' attitude to risk and appetite for engaging in the investment process; the combination of these members' choices determines the investment strategy.¹¹

DUTIES OF TRUSTEES

While many trustees understand that they are appointed trustees of the interests of the beneficiaries, they may be less aware of just what their fiduciary duties include. Until a few years ago, there was little need to scrutinize the list of fiduciary obligations of trustees. But things are changing. For one thing, in the past decade investment returns have fallen behind compared to previous decades, periods where strong investment returns were the norm and participants did not complain. Participants are increasingly asking tougher questions, as are regulators. As pension funds have grown in size in the last decade through consolidation, the number of parties involved and the complexity of strategies have increased, requiring trustees to manage these parties proactively to contain costs. Pension funds are also expected to grow further, transforming them into heavyweight financial institutions and yet further increasing the need to explicate roles and responsibilities.

A trustee is a named fiduciary to whom the administration of the pensions, the management and the investment of the fund assets in the pension scheme are delegated by the sponsors and the beneficiaries. While definitions of fiduciaries vary, a practical one is any organization named as a plan sponsor, or person named as a trustee. Investment advisors (who are paid fees) and plan administrators are so-called "deemed" fiduciaries, which include any persons who exercise any discretionary authority or control in management or administration of the plan or its assets. This comprises fiduciary managers, who can exercise considerable discretionary authority, as well as the underlying asset manager. This also includes the staff or executive office of a pension fund. Depending

on how the board of trustees organizes the support function, it either heavily influences the choices in management and/or administration in the plan through policymaking; or, alternatively, the board delegates discretionary authority or control over the implementation and monitoring of board policy to the staff or executive office.

The role of the trustee depends among others on the type of governance of the pension scheme is. In an overview study by the Organisation for Economic Co-operation and Development (OECD), two types of pension funds are identified, institutional and contractual.¹² There is an institutional type, where the fund is an independent entity with legal personality and capacity, and hence it has its own internal governing board. Examples include pension foundations and associations in countries such as Denmark, Finland, Hungary, Italy, Japan, Norway, Poland, the Netherlands, Switzerland, as well as Austria and Germany. In most of these countries pension funds have a single governing board, whose members are typically chosen by sponsoring employers and employees (or their representatives). In some countries, like Germany and the Netherlands, there is a dual-board structure. In Germany, there is a supervisory board that is responsible for selecting and monitoring the management board, which in turn is responsible for all strategic decisions.

On the other hand, a contractual-type pension fund consists of a segregated pool of assets without legal personality and capacity that is governed by a separate entity, typically a financial institution such as a bank, an insurance company, or a pension fund management company. The governing body of a fund set up in the contractual form is usually the board of directors of the management entity, although in some countries some key responsibilities are shared with a separate oversight committee. Examples of contractual-type pension funds are to be found in the Czech Republic, Mexico, Portugal, Slovakia, Turkey, and the open funds in Italy and Poland.

Trustees have characteristics of both the institutional and the contractual type. Under the trust form it is the trustees who legally own the pension fund assets. Trustees must administer the trust assets in the sole interest of the plan participants, who are the beneficiaries from the investment of those assets according to the trust deed. While this feature of trusts is similar to that of foundations, the trustees are not legally part of the trust. Indeed, in Australia or Ireland a trustee may be of the corporate type that makes the pension fund resemble a contractual arrangement.

The United States has an additional feature as the governing body may be the plan sponsor, the trustee, or/and some third party. ERISA (Employee Retirement Income Security Act of 1974) requires single company pension plans to have one or more named fiduciaries who have authority to control and manage the pension plan, including its investments. The sponsoring employer and the trustee are always named fiduciaries but it is possible for the trustee to be devoid of any major fiduciary responsibility, following instead another named fiduciary (e.g. a plan committee). In addition, asset managers, financial advisors, and other persons and entities that exercise some discretion over the fund's assets are considered functional fiduciaries, all of whom have some legal responsibility for the pension fund.

The formal documentation of the pension plan should provide answers to questions with respect to who has the responsibilities and discretion for the plan administration and investment of the assets, and specifically the role and responsibilities of the trustees.

In general, as long as they are acting in their professional capacities,¹³ accountants, attorneys, actuaries, and other consultants are not identified as fiduciaries. These individuals do not ordinarily exercise discretion and control over the plan. However, they may become fiduciaries if they are formally hired to take on any of the responsibilities identified above, and to exercise discretion and control over the plan. A situation that trustees must avoid at all times is one where these professional advisors are not formally hired, but in practice take on the responsibilities or influence the board in a decisive way.

The fiduciary role is the trustee’s most important role, but seldom the only one, as he or she combines several roles on the board. In many countries, the members of the board of trustees are also employers and board members. The board of trustees can own the executive office or staff organization, as well as the pension delivery organization(s). These forms of organization can make sense from the point of view of the fiduciary duty—they create the framework for the execution of duties in the participants’ best interests, lowering costs, and helping with the monitoring—but alongside the fiduciary duty, they also create the additional responsibilities of an employer and shareholder. Below, we discuss the following three roles of trustees: fiduciary responsibilities related to running the pension scheme; employer responsibilities for setting up a staffed office or other entity to support the trustees; and finally shareholder responsibilities when the trustees set up an investment management organization that is partly or wholly owned by the pension fund and that executes part or whole of the pension plan. These roles are visualized by Exhibit 1.2.

Responsibility as a Fiduciary

Acknowledging the role of trustees leads to the next step, that is, understanding how to comply with the fiduciary responsibilities. A good starting point is ERISA, the Employee Retirement Income Security Act of 1974, a federal law in the United States that impacts fiduciary responsibilities related to qualified retirement plans. Under ERISA, regardless

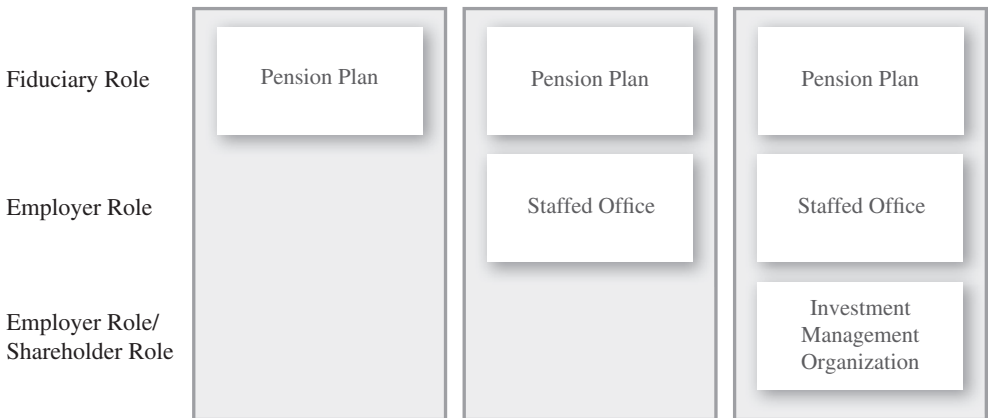


EXHIBIT 1.2 The different roles of trustees in a pension plan.

of the size of the pension scheme or pension fund assets, all fiduciaries have responsibilities and are subject to standards of conduct because they are acting on behalf of participants in a retirement plan and their beneficiaries.¹⁴ These responsibilities include:

- Acting solely in the interest of the plan's participants and their beneficiaries and with the exclusive purpose of providing benefits for them and avoiding conflicts of interest;
- Carrying out their duties prudently; thus ensuring that the plan offers a diversified investment approach that minimizes the risk of long-term losses. The investment approach is designed to cover the scheme's technical provisions to ensure funds are invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme. Diversification means avoiding excessive reliance on any particular asset, issuer or group of undertakings in order to avoid accumulations of risk in the portfolio as a whole;
- Following the plan documents;
- Paying only reasonable plan expenses. The fiduciary knows what they are paying in terms of total plan expenses and how these costs compare to the market. It is not necessary to have the lowest costs;
- Monitoring investments—implementing a continuous program for the evaluation of the pension funds' investment managers for consistency of style, performance against set goals and benchmarks, and changes in their organization;
- Avoiding prohibited transactions—a fiduciary must not engage the fund in transactions that are prohibited or represent a potential conflict of interest.

These standards are more or less generally accepted in many countries, while being adapted to suit local purposes. Depending on the jurisdiction, different issues are accentuated or raised. For example, in the UK, pension legislation focuses on liquidity. Trustees are required to exercise their investment powers in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.”¹⁵ Additionally, pension fund assets should consist predominantly of investments admitted to trading on regulated markets. Other (unregulated, illiquid) investments must be kept at a prudent level.¹⁶

Delegation and Agency Relationships An alternative approach to understanding the responsibilities of trustees is to realize that they are entrusted with managing several layers of principal–agent relationships, which are the consequence of delegation of administration and management of investment activities.¹⁷ The pension fund has the ownership (on behalf of the beneficiaries or savers) of the assets and acts as principal, but delegates the management of the assets to specialized asset managers, the agents. Therefore, the trustees are the agents of the plan's participants who have delegated their pension problem to the pension fund; and financial service providers are the trustees' agents because parts of the investment problem are delegated to them.¹⁸

The term “agent” refers to a key concept in economic theory: whenever a “principal” decides to delegate or outsource a task to somebody else (the “agent”), agency issues will arise: how can one be certain that the agent acts on behalf of the principal,

and not in its own interests? Perfect alignment between principal and agent is practically unattainable. In each decision to delegate, the pros (e.g. specialized knowledge, cost efficiency, less time consumption) should be carefully weighed against the cons (e.g. agency costs, such as monitoring costs, contract costs and intensified risk management).

Because it is impossible to recruit perfect agents, trustees need to carefully design and monitor agency relationships. Two problems that will need to be resolved¹⁹ can arise in agency relationships. The first is the agency problem that arises when (i) the desires or goals of the principal and agent conflict and (ii) it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. This is also referred to as information asymmetry. This problem is increased when the feedback loop between decision and outcome is long, which is usually the case with pensions and investments.

The second is the problem of risk sharing that arises when the principal and agent have different attitudes towards risk. The problem here is that the principal and the agent may prefer different actions because of the different risk preferences.

Such problems arise in part due to information asymmetry between the principal and the agent (the agent having superior information); this makes it difficult for the principal to monitor the agent's actions or assess the motivation of the decisions that it takes on the principal's behalf. In addition, the principal and the agent may have different interests. For example, consider a case in which the principal, the board of the pension fund, is investing to meet its liabilities in the long term, while the agent, an investment manager, is paid and retained or fired on the basis of short-term performance.

For many pension fund trustees, delegation is the predominant strategy. The most obvious way to handle potential agency issues is in the form of contracts governing the relationship between the principal and the agent. The question is then how to determine the most efficient contract governing the principal-agent relationship for the delegation of responsibilities, given basic assumptions about people (e.g. their self-interest, limits to rationality, risk aversion), organizations (e.g. conflicting goals among members), and information (e.g. information as a commodity that can be purchased).²⁰ Sometimes, not delegating or keeping activities nearby is the best possible way to minimize agency costs.

Boards should identify the main agency relationships in advance, allowing them to design and manage the relationship more proactively. Exhibit 1.3 shows five typical agency relationships that a trustee has to consider and manage:

Delegation involves layering of agency relationships. A participant in a DC plan is simultaneously involved in at least five principal-agent relationships:

1. The relationship between the beneficiary and the sponsoring company;
2. The relationship between the sponsor and the investment consultant;
3. The relationship between the consultant and the asset management company (that wins the investment mandate);
4. The relationship between the sponsor and the asset managers, whose products are part of the chosen menu;
5. The relationship between the asset manager and the individual portfolio manager, who makes the actual investment decisions.

Conflicts of interest can arise between any of the relationships in the chain outlined in Exhibit 1.3. While these issues are not new to the pensions industry, increasing

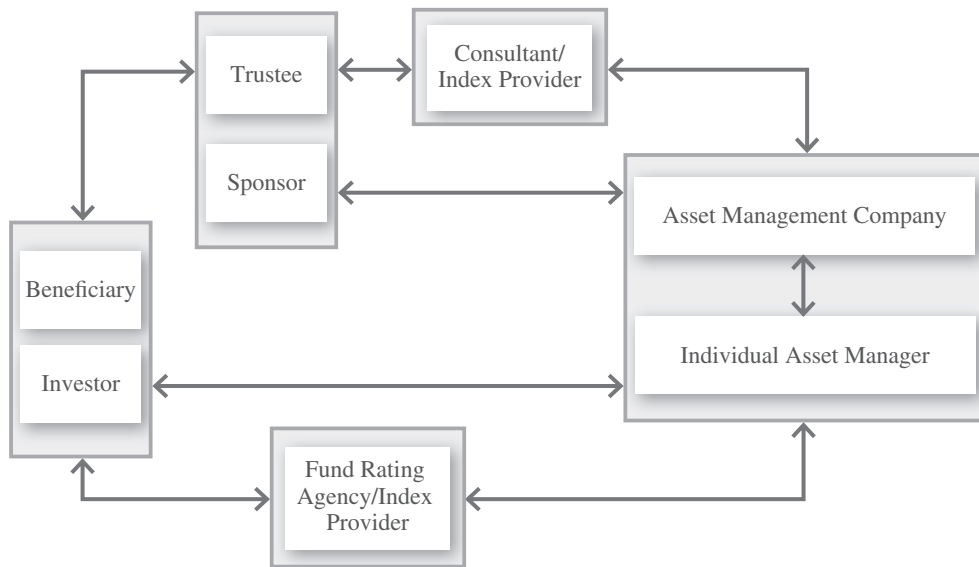


EXHIBIT 1.3 The different layers of agency relationships for a pension fund.²¹

investment complexity and the fallout from the global financial crisis have focused more attention on managing conflicts and improving the alignment between investors and the agents to whom they delegate.

As the number and complexity of agency relationships increase, so does the likelihood of conflicts of interest between investors and their agents. As a consequence, investment decisions can differ across funds, in part due to differing numbers and combinations of agency relationships. For example, investments chosen by DC pension funds can differ substantially from those in DB plans, given that the former choices are made by households investing on their own, while the latter are guided by pension fund trustees acting for the pension fund's beneficiaries as a group. In addition, investment decisions by individual customers might further be influenced by the advice of investment firms' sales networks, which may have certain incentives to sell or recommend particular products.

These differences in agency relationships may also imply differences in optimal contractual relationships. Optimal (compensation) contract design for delegated portfolio managers is a thoroughly researched topic. The results of this research have not been wholly conclusive. The basic conclusion is that contract design is highly sensitive to the specifics of individual agency problems. Various strategies have evolved over the years to manage these agency problems, usually involving some combination of the following components:²²

- A profit sharing rule (i.e. a fee structure), to align incentives in terms of returns;
- Making returns comparable by measuring relative performance against a benchmark, to monitor performance and risk;

- Checks on risk-taking, such as maximum allowable tracking error, reporting requirements and constraints on available investment choices;
- Employing consultants who regularly act as intermediaries between trustees and service providers to evaluate the value and performance of agency relationships in accordance with industry benchmarks;
- Using competing financial service providers for the same functions, thus using competition to discipline costs and achieve service quality;
- Building trust relationships between privileged service providers, thereby sharing knowledge about the supply and demand of services.

Trustees employ a combination of the above-mentioned components to deal with agency problems. The weightings differ, depending on the board's assessment of costs and benefits, and sometimes also depending on which component might be more in vogue given the political environment and societal discussions. Effective boards not only have an eye for effective mitigation of agency costs, but they are also sensitive to potential negative externalities that may arise due to such issues.

Responsibilities as a Board Member

In the line of fiduciary duty, the trustee adopts the role of a board member to fulfill the fiduciary duties he or she has undertaken on behalf of the participants. The board, or board of directors, is the body within the pension fund that directs the fund on behalf of the beneficiaries.

The board of directors, as a unified body, takes on the responsibility on behalf of the beneficiaries of collecting, managing, administering and paying out (future) pension entitlements. The board firstly has a legal remit of formulating policies to fulfill these responsibilities. The main duties of the governing board of an occupational pension plan should normally be enshrined in the relevant legislation. The pension plan or fund statutes will include these duties and make them more specific to the fund's situation.²³

The central responsibility of any pension fund board should be to set out a clear mission for the fund, including specific measurable objectives (e.g. indexation ambition, funding levels, return targets, etc.); to define a strategy for meeting those objectives (e.g. selecting a broad asset allocation, choosing between internal and external management, etc.); and to monitor the fund's success (and that of its staff and external managers) in achieving those objectives. This will be discussed in Chapter 3. The board also needs to consider suitable governance structures for implementing its long-term strategy and consider, for example, how the investment function and staffing should be designed, implemented, monitored and remunerated. The pension fund board has to manage five tasks; these will be further explained in the chapters of this book.²⁴ These tasks are:

1. Policy formulation and foresight: developing a long-term perspective; the fund's mission;
2. Strategic thinking: translation of the mission into strategy;
3. Design of governance, organization of the pension scheme: pension administration, investment advice and record-keeping;

4. Supervision of management: monitoring the execution and progress of the pension scheme;
5. Accountability: reporting on results to stakeholders, evaluating strategy and readjusting when necessary.

Responsibilities as a Shareholder

Alongside their fiduciary role, the board of trustees is often also an employer. They can own the executive office or staff organization, as well as the pension delivery organization(s). These organizations make perfect sense from the point of view of fiduciary duties; they create the framework for the execution of such duties in the best interests of beneficiaries, lowering costs, and helping with the monitoring. But they also create a separate set of responsibilities: those of a director. One option is for the board to appoint a director to manage the pension delivery organization, operating outside the board. Another approach for a number of jurisdictions would be to set up a single-tier board, where the executive directors on the board manage the pension delivery organization, and the non-executive directors monitor, review and guide the strategy of the fund. The OECD Principles of Corporate Governance provide guidance on the responsibilities of directors; these principles are presented in Appendix “OECD Principles”.

Many of these responsibilities as a shareholder overlap with the fiduciary duties that are discussed in this chapter and the key tasks of a board discussed in Chapter 10. However, new elements are ensuring a formal and transparent board nomination and election process; monitoring and managing potential conflicts of interest of management, board members and shareholders—including misuse of corporate assets and abuses in related party transactions; and ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit.

Balancing the Three Roles

The challenge is to balance the three responsibilities—fiduciary, board member, and shareholder—when they exist within one pension fund board. Much of the interaction between the three roles is sensible and supports an alignment of goals. If trustees are the employers of the staff and executive office, then developing a professional human resources role and treating employees with trust creates the right culture to help trustees to get the best support and follow-up in their decision-making. A more difficult situation, however, arises when the pension fund is the sole owner of a pension delivery organization, and also has a shareholder role to consider. What should be done when, for example, on the one hand, trustees push for cost-effective solutions in the investments carried out by their pension delivery organization, compelling it to reduce costs and/or margins, while on the other hand, they demand decent shareholder returns from the same organization? Here it becomes visible that the different hats the trustee has to wear may lead to difficult dilemmas and even conflicted interests, especially if the board has not acknowledged these different roles. A common approach is to prioritize these roles and discuss them separately. For example, the board first

decides on the investment policy. In a subsequent shareholder meeting, the board of the investment organization discusses the consequences for the organization, as well as the changes that should be made to realize the goals of the investment policy.

UNDERSTANDING AND MANAGING YOUR STAKEHOLDERS

It is important to understand the role of the stakeholders and the environment in which pension funds operate. The pension fund operates on behalf of its members or owners. It also operates in a broader environment with a number of stakeholders such as regulators, politicians, non-governmental organizations (NGOs) and the press. On the investment side, it operates in financial markets as part of a long chain that includes a large number of agents such as asset managers, investment funds and consultants.

Understanding the stakeholders and their potential roles is the key issue here. More important for a trustee is to comprehend when and how these actors are in sync with the trustee's requirements and desires, as well as when there might be a potential clash. To help the reader understand some of the possible stakeholders, we will review the following agents: the government, the regulator, the financial market and NGOs.

Government

The government has a crucial role to play. It decides on how pension provisions are organized within the country, sometimes described as the "pillar discussion." In addition, it decides on how the contributions, investment returns and pension payouts are taxed. But it also has a broader set of goals. For example, it may wish for pension funds to invest in the home country, for instance in infrastructure. Alternatively, it may want to stimulate the stream of investments towards a more sustainable future. Often, the thinking of the government reflects the thinking in broad layers of society. Because ultimately it is the government that to a large extent defines the license to operate for pension funds, it pays off to understand this stakeholder and maintain a constructive dialogue with it, either directly or through industry bodies.

Regulator

Public regulation and supervision of pension activities are the two most powerful instruments any jurisdiction has for shaping the market. Their role is to impart socially desirable qualities to the ways and means by which commercial institutions are operated. Regulation is about setting standards and is closely tied to lawmaking—and thus is also exposed to political and market pressures.

Pension regulations have a number of objectives. They seek to promote efficient administration of work-based pension schemes, and to improve confidence in such pensions by protecting the benefits of scheme members. To meet these objectives, pension regulators increasingly employ a risk-focused approach, concentrating their resources on schemes that pose the greatest risk to the security of members' benefits.

A crucial element of this risk-focused approach is that a capital sum or buffer is determined, based on the scheme's investment risks and liabilities, which pension funds are required to hold by regulation.

Supervision, in contrast to regulation, is only peripherally involved in standard-setting activities, at a very basic, pragmatic level—if at all. Its main focus is the enforcement of regulatory requirements for pension funds and the pension sector. Hence it is closer to the technical side of the business and is focused more on the micro dimension than on the macro dimension. The supervisor promotes high standards of scheme administration and works to ensure that those involved in running pension schemes have the necessary skills and knowledge.

To ensure supervisory objectivity, it is generally recommended that supervisory operations be independent of political, governmental and industry interference. Despite those fundamental differences between regulation and supervision, in practice they are similar to plants and animals; they depend on each other. Regulation without an enforcement mechanism is simply powerless. Supervision, on the other hand, requires a legal framework for its operation, which is mainly provided by regulation. Because it is at the forefront of the market and in daily contact with market institutions, supervision is well positioned to provide important alert signals and inputs for the regulatory process. The better the professional quality of supervisory institutions, the better the chances of an adequate regulatory focus and regulatory standards. At the same time, supervisory institutions set the limits of the regulatory framework, as they define the applicability and feasibility of the standards to be met both by the entities supervised, and by the supervisory system.

In the aftermath of the global financial crisis, we are faced with increased regulation of the finance and insurance industry and an expansion in the regulatory culture. One only has to think of the wave of recently introduced or debated standards on solvency, corporate governance, fit and proper internal controls, transparency, financial conglomerates, insurance groups, financial reporting, etc. to notice this. In addition, regulatory standards have been expanded to cover previously largely unregulated activities—intermediation, reinsurance and personal claims advisors. Correspondingly, self-regulation is increasingly marginalized.

Financial Markets

Pension funds operate in the realm of financial markets. If a trustee joins a board, they become part of an ecosystem of organizations and structures. Some of these might help the pension fund, but not fully understanding their motives might also give the impression that you, as a trustee, are not pulling your weight. After all, a pension fund sits on considerable sums of money, and has a large industry and many mouths to feed.

In a financial market, securities are sold and resold. The means to realize this exchange is the asset price—the valuation of a security based on supply and demand. There is no such thing as a single financial market. There are innumerable financial markets, catering for different regions and securities. Insiders sometimes describe financial markets as living organisms. They can be positive, giddy or ecstatic. In reality,

markets are no such thing, but investors trading on the markets can be. Similarly, financial markets are simply platforms that register sales and purchases. The financial markets have migrated considerably over the last decades, and continue to do so, with several implications.

Throughout the 1990s, it became increasingly difficult for even the largest plans to maintain internal fund management functions. The salaries, bonuses, options, and career prospects for internal managers have in general not kept pace with those offered by leading investment banks. Moreover, given the increasing importance of recurrent investments in computer systems, the scale economies of the largest service providers have driven many funds to outsource the provision of necessary financial services.

The market for pension-related financial services is quite distinct and varies from country to country. The Dutch, for example, have developed hybrid financial service conglomerates, intimately linked to pension fund sponsors. Boards of directors overlap with one another, with many of the largest funds acting both as consumers and suppliers of financial services. Custodial services, insurances, and investment management services can be found in Dutch pension fund related companies. Nevertheless, perhaps more than any other continental country, the Dutch have sought to purchase expert advice and advanced financial products from London and Wall Street firms. For the German and Swiss funds, by contrast, long-term relationships with banks and related actuarial firms have dominated the provision of pension fund management services. Thus, until very recently, the market for financial services in many European countries was an internal market either between directly related “firms,” or between long-term partners with substantial cross-representation on boards of management. This stands in contrast with the disintermediated market for services characterizing the Anglo-American world.^{25,26}

Non-Governmental Organizations

NGOs are typically not-for-profit organizations that focus on a limited number of societal goals. They exert influence on pension funds by way of trustee and trustee composition, as well as with publicity. Without a clear vision, purpose and strategy supported by the participants and known to the stakeholders, a pension fund can be confronted with the danger of regulatory capture to the benefit of specific interest groups within the insurance industry; or outside of it to the benefit of competitors, customers, suppliers, etc. Certain large funds will be targeted by NGOs, for example to invest tobacco-free or fossil free, as seen in recent cases. Similarly to governments, NGOs often give voice to important current issues in society. Therefore, it is important to listen to them, to be open to their message and to have an open dialogue with them. But, taking this a step further, the message of some NGOs might give the board guidance to the way the fund could or should adapt or invest in the future.

ENDNOTES

1. See Ambachtsheer (2016, p. 80).
2. See Credit Suisse Research Institute, Zurich (2017). Global Wealth Report.
3. See Willis Towers Watson (2017). Global Pension Assets Study.

4. See Davies (2000).
5. Definitions based on Davis and Steil (2004, p. 450).
6. See Department of Labor Employee Benefits Security Administration, U.S. (2017).
7. See the ‘The End of Retirement’ in *The Economist* (2009): ‘Demography means virtually all of us will have to work longer. That need not be a bad thing’.
8. See Clark (2000).
9. See also Clark (2000).
10. See Merton (1995) for a formal distinction between customer and investor.
11. See for example Clark and Urwin (2010), Stewart and Yermo (2008), or PTL (2013) “Distinguishing Features of DC Governance” for discussion on the governance of DC Schemes and the differences between DB and DC. Available at: <http://www.oecd.org/finance/private-pensions/34722818.pdf> and <http://ptluk.com/files/2013/11/DC-Grid1.pdf> respectively.
12. Discussion on contractual and institutional type taken from Stewart and Yermo (2008).
13. See for example Sych and Metzger (2014).
14. See Department of Labor Employee Benefits Security Administration, U.S. (2017).
15. See The Law Commission (2014, Response 14.29).
16. See The Law Commission (2014, p. 65).
17. See Ambachtsheer and Ezra (1998).
18. See Clark (2000).
19. See Eisenhardt (1989).
20. See also Eisenhardt (1989).
21. Committee on the Global Financial System (2003, p. 1–69).
22. See Clark (2000).
23. See Stewart and Yermo (2008).
24. Adapted from Stewart and Yermo (2008), cited in Garratt (2010).
25. See Dufey (1998).
26. See Edwards and Fischer (1996).