Governance Matters: Improving Pension Plan Board Effectiveness

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Research indicates there is a strong relationship between pension plan governance and plan performance. The author identifies six key drivers of effective governance.

by | **Christopher K. Merker, Ph.D.**

As one public pension plan after another has faced financial stress in recent years, industry experts have observed that good governance can mitigate these issues and is an important determinant of long-term success. Just this past year, Willis Towers Watson asserted that "organizations with effective retirement plan governance are better equipped to manage potential retirement plan risks, protect against fiduciary liabilities and capture opportunities to improve structures, strategies and metrics."[1]

It sounds very compelling, but what does that term mean, *effective plan governance*? How do we know it when we see it and, if we don't have it, how do we get it? How can the pursuit of good governance become a practical exercise within the reach of any organization, no matter how large or small?

The challenges for organizations when it comes to governance are to understand what comprises good governance, come up with a way of evaluating the organization's governance and, finally, apply best practices for improvement through that process.

So, what is *governance*, exactly? A longer definition would describe the establishment and implementation of policies by a board that oversees the overall organization for the purposes of enhancing the viability and prosperity of it for a certain group of people (e.g., beneficiaries, shareholders, etc.). In the context of managing pensions or other pools of assets (e.g., foundations), governance is simply codified and structured group investor behavior that drives ongoing organizational performance.

Research

Ask any industry observer what matters on the topic of corporate governance, and you will get a different answer each time. For example, many surveys erroneously assign importance to control of investment expense. While investment expense is a governance consideration, it turns out that the relative performance of pension plans is so highly variable that modest cost savings don't generate significant impact on improving performance outcomes relative to peers.[2]

Based on corporate governance literature in our academic research, we had a general idea of what matters. But we didn't know exactly what mattered most in the context of governing pension organizations. So we started collecting data and, in 2014, created the first-ever governance database of public pension plans. For more than two years, we collected data on 54 governance variables from dozens and dozens of public pension plans.

In addition, we collected data on what pension plans actually did, rather than what those who chose to respond to a survey said or thought they did. The list of governance variables was then further narrowed down to 17 core variables. After an in-depth examination of these core variables, we ascertained six key drivers, comprising a final index measure of governance, the Fiduciary Effectiveness Quotient™ (FEQ™).[3]

Findings

The research showed that governance matters. When constructing a model of corporate governance of public pension plans, it demonstrated robust statistical relationships among the governance variables and performance outcomes (i.e., investment returns, funding ratios and other financial variables).

With respect to investment returns, the pattern was clear, as shown in Figure 1.

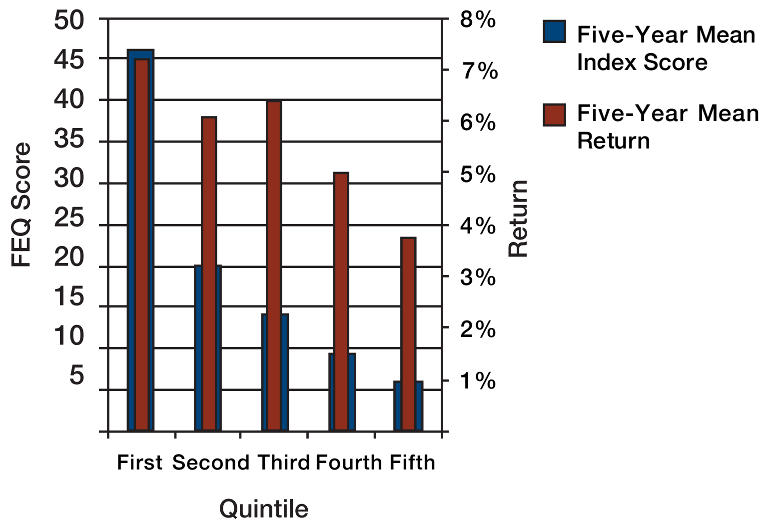
All public pensions in the sample are sorted by the FEQ. They are then broken into quintiles, with the top quintile being the top 20% and the bottom quintile representing the bottom 20%. When five-year investment returns are overlaid, research shows that the mean investment returns for plans that scored in the top quintile of the index outperformed the bottom quintile by an average of nearly two to one, with a difference of approximately 3.5% in investment return per year. In the world of pension investing, a performance gap that large is enormous and has all kinds of implications for future funding and viability.

Not only was the model useful in understanding impacts on investment performance but also, in the case of funding ratios, the model was 93% accurate in distinguishing winners from losers as defined by organizations that had reasonably adequate funding ratios as compared with those at highly distressed funding levels. While public pension plans were used in the research, the same concepts apply for single and multiemployer pension plans.

Specifically, from the 17 core variables, we identified six main drivers of effective governance.

FIGURE 1

Public Pension Fund Performance by Fiduciary Effectiveness Quotient (FEQ) Quintile



1. Professionalism

This driver is a measure of the level of professionalism within the organization. Examples of factors that comprise it are: To what extent is the consultant involved in guiding and informing the process? How often does the board meet and for how long? To what extent is the board documenting and disclosing its activities and decisions? How much board representation do the investment and audit committees have? What are the substantive matters being discussed at the board level?

2. Board Composition

What is the mix of the board? Whose interests are most represented: those of the sponsor (e.g., company or municipal government), those of the beneficiaries (e.g., union members) or those with more independent points of view? What are the backgrounds of the individuals? Do they have the proper training and experience for what they are charged with overseeing?

3. Engagement

Another important driver is the degree of engagement by the board members, staff and consultant. Is everyone participating and engaged in the process? How much turnover is happening at the leadership level? At the consultant level? Strong leadership is critical to keeping the other board members engaged in the governance process. Also, do the individuals on the board have time for engagement, or are they busy with multiple demands and unable to devote enough time to the issues at hand?

4. Staff

Is there sufficient staff or employee representation? Having professional

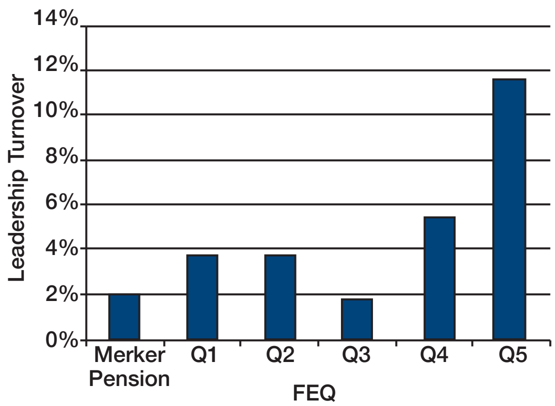
takeaways

- A governance database of public pension plans developed by researchers collected data on 54 governance variables to measure the impact of governance on plan performance.
- Researchers found a strong relationship between governance variables and performance outcomes such as investment returns, funding ratios and other financial variables.
- Researchers identified six key drivers of effective governance: professionalism, board composition, engagement, staff, institutional knowledge and diligence.
- Boards of public, corporate and multiemployer pension plans can conduct a baseline evaluation of these drivers and follow up with a more detailed self-assessment using available tools.
- Governance assessment should be a standing item for annual review to help plans identify areas for training and development, track improvement and set future goals.

FIGURE 2

Fiduciary Effectiveness Quotient (FEQ) Factors—Leadership Turnover by Quintile

Strong and consistent leadership is important for top organizations and is a key factor in institutional knowledge and continuity of the organization. Higher performing groups demonstrate lower turnover rates among the board chairperson, on average no more than once every two years.



staff serving on the board, or at least attending the meetings, is important because it allows people closest to the operation to inform the board of ongoing activity and remain connected to oversight and decision making.

5. Institutional Knowledge

This driver represents the continuity within the organization itself. How much professional experience do board members have? To what extent are board members and the consultant turning over each year? High rates of turnover can erode knowledge and continuity. Too little turnover can indicate a lack of fresh ideas coming into the process.

6. Diligence

The final driver is defined by the extent of diligence and thoroughness of the organization in exercising its governance process and making decisions. Underlying factors include consultant participation, extent of meeting documentation, involvement and direction by staff, and key discussion points.

Other Factors

As part of best practices, other aspects should be considered in addition to these drivers, including use of investment policies, board diversity, compensation and management of conflicts of interests, among others. Once a board goes through a baseline evaluation, it then can engage with board members and senior staff in a deeper self-assessment that reviews additional topics that, using board self-assessment tools such as the Governance Self-Assessment Checklist (GSAC) module, can include further analysis of board structure, board and organizational culture, board responsibilities and board process.[4] Making board governance assessment a standing item for annual review helps the organization identify areas for training and development, tracks improvements over time and allows the setting of new goals for the coming year.

Putting Knowledge Into Practice

The next step is to apply this research in a way that can be useful for organizations. This can be accomplished with two steps. The organization (1) finds a way to efficiently and accurately collect information to help it evaluate its practices and (2) compares results with its peers. There are a number of board assessment instruments in the market to help the board undertake a self-assessment. However, peer benchmarking is more difficult to find.

One example of the assessment reporting shown in Figure 2 is leadership turnover of the board, or the rate at which leadership changes within the organization. As noted, at

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higher levels this can impact overall continuity and engagement. In this hypothetical example, the board of Merker Pension learns how turnover in the chair position can impact organizational performance and how the organization stacks up against its peers. Lower levels of turnover is a feature of upper quintile organizations, with the highest level of turnover found in the bottom quintile.

Conclusion

In closing, consider the words of researchers Gordon L. Clark and Roger Urwin, who have written extensively on the topic of governance over the years: "Good governance by institutional fund asset owners (pensions) makes a significant incremental difference to value creation as measured by their long-term risk-adjusted rate of return . . . [F]unds can create more value if they correctly assess their governance and determine an investment strategy commensurate with their capabilities."[5]

Endnotes

1. See www.willistowerswatson.com/en/insights/2016/05/strategies-in-retirement-plan-governance.

2. See "Investment Expense a Proxy for Good Governance," by Christopher K. Merker, CFA Enterprising Investor, October 9, 2017, https://blogs.cfainstitute.org/investor/2017/10/09/investment-expense-as-a-proxy-for-good-governance/.

3. Christopher K. Merker, A*sset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Funds,* Marquette University, ©2017. The FEQ is a trademark of FGA-Diagnostics, LLC, patent pending, http://epublications.marquette.edu/dissertations_mu/713/.

4. Copyright ©2000 Mel Gill. All Rights Reserved. Used by FGA-Diagnostics, LLC, with permission.

5. Gordon L. Clark and Roger Urwin, *Best-Practice Investment Management: Lessons for Asset Owners from the Oxford–Watson Wyatt Project on Governance,* Oxford University, 2007.