The Link Between Governance and Sustainability in Contingent Pension Plans

by | **Barry Gros** and **Barbara Sanders**

A key development in the Canadian occupational pension sphere over the past decade was the rise of so-called *contingent pension plans*—collective pension arrangements where some or all of the pension benefit depends on the financial position of the plan. Newer examples of such plans include target benefit plans[1] and shared risk plans,[2] but older implementations are also abundant in the form of jointly sponsored pension plans[3] with conditional indexing and multi-employer pension plans where the accrued benefits can be reduced.

Sustainability of the targeted benefits is a key consideration in the management of these plans and was the focus of a research study we recently completed.[4] In that study, we conducted in-depth interviews with 30 experts involved in the management of various contingent pension plans, seeking to understand how sustainability is defined, managed and communicated. We uncovered many interesting practices and gathered important insights—one of them being the critical role that governance plays in the quest for sustainability.

Components of Good Governance

The positive link between the performance of a pension fund and good governance is well-documented.[5] Over a decade ago, Gordon Clark and Roger Urwin characterised best practices in pension fund governance in terms of three factors: organizational coherence, people and process.[6] While their research focused on the interaction between governance and the investment management function, our interviews suggest that their framework is equally useful in the context of sustainability. The table gives a quick summary of the parallels; the rest of the article provides more detail.

TABLE

	In Clark and Urwin's original work, as applies to investment management	**In the context of sustainability for contingent pension plans**
Organizational coherence means	• Clarity of the organization's investment mission • Highly competent investment function with clear responsibilities and accountability to the institution • Resources dedicated to executing the mission, both in terms of the investment process itself and the governance chain related to it	• Clarity of the plan's sustainability goals and aspirations • Highly competent sustainability management function with clear responsibilities and accountability • Operational and governance resources dedicated to monitoring and managing sustainability
People means	• Board members with key competencies (numeracy, logical reasoning, probabilistic thinking) • Leadership (highly qualified and respected board chairperson and senior management) encouraging a culture of accountability • Commitment to managing by goals and objectives	• Board members with key competencies (same) • Leadership encouraging a culture of accountability around sustainability • Commitment to managing by goals and objectives • Respect for fiduciary role
Process means	• An investment philosophy that is supported by the entire organization, agrees with operational goals and drives investment decision making • Use of a risk budget aligned to plan goals • Investment process that recognizes the institution's strengths and limitations • Effective use of external managers • Ability to act on a time frame consistent with investment opportunities	• A sustainability philosophy that is supported by all stakeholders and is reflected in the plan's integrated benefit-contribution-investment policy, which drives all decision making • Use of short- and long-term risk budgets aligned to the plan's sustainability goals • Sustainability management process that recognizes the plan's capacity • Effective use of external advisors (actuaries, investment consultants, lawyers, communication professionals) • Ability to act on a time frame consistent with stakeholders' expectation for intergenerational equity

Organizational Coherence

Clark and Urwin placed great emphasis on *organizational coherence*, which in our context could be interpreted as the clarity of—and commitment to—a plan's sustainability goals and aspirations as well as the resources dedicated to them. Based on our study, this appears to be an area of challenge for most contingent pension plans. Many of the participants in our study told us that they are using the term *sustainability* without having an official definition. When probed for their own interpretations of how this term is used, their descriptions varied a lot. Combing through the interview transcripts, we extracted about 30 different aspects of sustainability: concepts that could be packaged in different ways to construct people's understanding of this term. Some of the more prominent ones were long horizon, affordability and benefit security—the latter in the sense of being able to deliver the targeted benefits with high probability. In fact, benefit security was a key aspect of sustainability for many of our interviewees but usually needed to be balanced with some other objective. Unfortunately, the parameters of that balancing exercise were generally poorly defined.

The lack of clear definitions and objectives reflects low levels of organizational coherence. To improve, contingent pension plans ought to define what they mean by sustainability. They need to do this at a high level: describing their philosophy, clearly articulating their objectives, acknowledging any competing concerns (e.g., affordability vs. benefit security) and the need for balance, and establishing priorities. Of equal importance, they need to do this in operational terms: How will they measure progress relative to their specific objectives, and how will they consider these metrics in decision making? At a practical level, what are the circumstances that would lead to benefits needing to be adjusted, in either direction? What will be the financial signals guiding decision makers in considering and taking specific actions?[7]

Participants in our study noted that there can sometimes be a reluctance to talk about these issues or to document them in a meaningful way. Part of the reason is that stakeholders want to maintain flexibility and not tie themselves to a particular policy response, especially if unforeseen circumstances arise. We agree that the ability to respond to new situations is important: There has to be an understanding among stakeholders that new information—the "unknown unknowns"—could affect the actions to be taken. In fact, setting out policies for sustainability (even relatively detailed ones) should not stop a plan from deviating from those policies when it is warranted; however, in such cases, decision makers ought to explain and document why deviation is necessary and how they came up with their new decision. This is consistent with good governance.

Once the objectives are defined, the sustainability goals should have clear ownership within the plan's management structure and clear channels of accountability to the board. Appropriate resources should be dedicated to this function, both at the operational and board levels.

People

In Clark and Urwin's model, the second but equally important dimension is *people*. As the table indicates, many of the best practices identified by Clark and Urwin in the context of investment management are directly translatable to sustainability. Once again, our study indicates that significant challenges exist in this area.

Contingent pension plans typically have plan members directly involved in plan governance: Lay members often sit on boards of trustees and participate in making decisions. In many cases, these members are appointed or elected by virtue of their position or affiliation with the sponsoring employer, the union or some other stakeholder group. This means that not all decision makers may possess key competencies—such as high numeracy, logical reasoning and the ability to think in probabilistic terms—that are critical for understanding and managing sustainability in a contingent pension plan. Although a cooperative attitude and a willingness to learn are helpful, they are not always enough to fill the gap.

Appointment by constituency can also give rise to significant agency problems: As fiduciaries, all appointees ought to act only in the best interests of plan members, yet representative members in these situations face considerable pressure to make decisions that align with their roles outside the board. This is a well-documented challenge facing many pension plans around the world.[8] It can be particularly dangerous in contingent pension plans, where representative members may find it challenging to reduce benefits or increase contributions in a timely manner.[9] This is a serious threat to sustainability—one that deserves at least as much attention as anything related to financial management.

These agency issues were reinforced in our participants' comments (paraphrased here for conciseness):

- Education is key—for example, about what constitutes reasonable margins, about not setting the benefits too high and about making benefit cuts when you need to.
- The temptation is always there to keep the benefits level and hope that the markets will bail you out.
- Making tough decisions at the time is hard if there have not been any relevant discussions in advance. It helps to establish policies in advance of having to deal with major plan stressors.

Process

Clark and Urwin considered the first two elements of good governance—organizational coherence and people—to be most essential. When these are in place, optimizing the decision-making process can add further value. At least one participant in our study agreed with this ordering of priorities, noting that having the right people in a poor governance structure (i.e., one with less-than-ideal processes) works better than having the wrong people in a great structure.

Looking at Clark and Urwin's best practices for the decision-making process, we can also carry them over to sustainability. The first and most obvious one is the integration of the overall philosophy with (1) operational goals at the management level and (2) decision making at both the board level and the management level. Several of our interview subjects talked about having detailed benefit-contribution-investment policies to achieve this integration. Such policies were quite common among newer implementations of contingent pension plans like shared risk plans, target benefit plans and jointly sponsored pension plans (JSPPs) but less prevalent among older multi-employer pension plans. Similarly, newer style plans were more likely to have a clear understanding of their risk exposures and tolerances, both in the short and the long term.

One area of challenge we observed in our study was capacity. Between the demands of appropriate governance, communication and financial management, running a contingent pension plan takes a lot of resources, and not all plans have the time, money or expertise to do as much as they'd like to. Thankfully, economies of scale exist, not just in investment and administration[10] but also in plan management: Bigger plans tend to have better governance,[11] better risk management processes,[12] and more tools and resources. In fact, large Canadian JSPPs are known around the world for their excellence in pension management and delivery. Yet for every well-run JSPP, there are dozens of smaller plans that the international community does not know about and that will never have the opportunity to manage their plans with as much care and expertise. One possible answer to this challenge is consolidation. The idea has been floated by researchers and industry

Takeaways

- The past decade has seen the rise of contingent pension plans—collective pension arrangements where some or all of the pension benefit depends on the financial position of the plan. Examples include target benefit plans, shared risk plans and jointly sponsored pension plans, among others.
- One of the key considerations in the management of these plans is sustainability. A research study by the authors revealed important insights and practices into sustainability, including the critical role played by governance. Three key factors for good governance and sustainability are organizational coherence, people and process.
- *Organizational coherence* is the clarity of and commitment to a plan's sustainability goals and aspirations as well as the resources dedicated to them. This has been a challenge for contingent pension plans because *sustainability* has often lacked clear definitions and objectives.
- *People* form a second but equally important dimension to good governance and sustainability. Plan decision makers should possess key competencies such as high numeracy and logical reasoning. Education is very important, as is finding appointees who will act only in the best interests of plan members.
- *Process* involves the integration of the overall philosophy of the plan with operational goals and with decision making. An important aspect is the ability to make changes to the plan's benefits, contributions or investments quickly enough to maintain intergenerational equity.

observers in the past[13] and appears to be gaining traction now, with a number of different implementations developed in recent years. On the one hand, we have the model followed by CAAT[14] and OPTrust,[15] where a large, existing plan opens its door to smaller entities to join. Another possibility is to create a container for cost-effectively combining smaller contingent pension plans until sufficient scale is reached—The Ideal Canadian Pension Plan[16] is an example of this approach.

An interesting aspect of Clark and Urwin's *process* dimension is the ability to act quickly enough. In the context of investment management, this means making tactical investment decisions in real time—that is, on a time scale consistent with how quickly investment opportunities arise and vanish. Clark and Urwin suggested that pension plans whose investment function is more nimble can reap additional rewards. This too has a parallel in the area of sustainability, where the timeliness of certain decisions and actions has a direct impact on intergenerational equity. Quicker action (for example, to adjust contributions or benefit levels) reduces subsidies between different cohorts of members but results in greater volatility. Each plan should therefore decide what it considers to be an acceptable "speed" for action, balancing stability and equity. It is important that all stakeholders agree on this, because plans that are perceived by their members to be inequitable are at risk of failure. In our interviews, we found that equity in general and intergenerational equity in particular are growing concerns among contingent pension plans. Robust governance can help these plans avoid trouble by bringing the issue out into the open and ensuring that appropriate action is taken at a speed that satisfies all stakeholders.

Conclusion

As we think about sustainability, it is important to remember that governing boards cannot manage results—They can only manage the risks their plan is exposed to. Feedback we received to our study included the comment that "governance is where the rubber hits the road." It's the decisions that governing boards make that will make the difference. Ensuring that the plan has a coherent mission and beliefs, selecting the right people for key leadership positions, and putting in place the right decision-making processes can help guide current and future boards in their task of delivering the benefits that plan members deserve.

Barry Gros and Barbara Sanders are presenting "The Quest for Sustainability in Pension Plans With Contingent Benefits" on Thursday, May 28 at the Canadian Legal and Legislative Update, which runs May 27-28 in Nashville, Tennessee. For more information, visit www.ifebp.org/canupdate.

BIOS

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Endnotes

1. Target benefit plans are pension plans where members share risks among themselves, and contributions are either fixed or limited to a narrow range.
2. Shared risk plans are specific implementations of target benefit plans unique to New Brunswick.
3. According to the Financial Services Regulatory Authority of Ontario, a jointly sponsored pension plan "is a contributory defined benefit pension plan in which the employer(s) and the members share responsibility for the plan's governance and funding."
4. For a brief summary of our findings and their implications for regulatory policy, see Gros and Sanders (2019).
5. See Ambachtsheer (2007) and Ambachtsheer and McLaughlin (2015) for evidence from North America or Ammann and Ehmann (2017) for evidence from Europe, among others.
6. Clark and Urwin (2007).
7. The regulatory regime in place for shared risk plans in New Brunswick articulates some of these with considerable precision, but most other plans are left to develop their own objectives and operational definitions.
8. See Stewart and Yermo (2008) for a description and potential solutions.
9. The specific challenge facing contingent pension plans is explored in detail through a very accessible case study in Bauslaugh (2019).
10. Mitchell and Andrews (1981), Bikker and de Dreu (2009), Dyck and Pomorski (2011).
11. Ambachtsheer, Capelle and Lum (2008), Ambachtsheer and McLaughlin (2015).
12. Based on responses in our study.
13. See Stewart and Yermo (2008) for consolidation as the solution to governance challenges in an international context, Hawthorne (2018) for consolidation in the United Kingdom and Benjamin (2014) for mergers in Canada.
14. www.dbplus.ca/en.
15. www.optrustselect.com.
16. www.idealcanadianpensionplan.ca.