Between the Tides

THE 2012 PENSION LAWYERS ASSOCIATION CONFERENCE

Disappointing Pensions

The plight of Trustees in fund governance

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PENSION LAWYERS ASSOCIATION

Trustees have entered a tough period

- Golden returns of 80s & 90s are behind
- So why do we have trustees (Board of Management)?
- What problems do they face – in DB & DC ?
- What are the ways forward – with a focus on the end game
- In a global and, at a very high level, local context (brief acquaintance with PF130 & Reg28).

Why trustees (Board of Management) ?

Pensions can only be provided By:

- Either a promise – an iou
- Or a fund – assets of sufficient value

An iou from the taxman may be sufficient, but not an iou from an employer – it may not be around in 80 years' time, so you need a fund, and you need it separate from the employer's creditors – so who controls it and how ?

Or why not let the State provide ?

The State can give an iou backed by the taxpayer

- But if the promise is too big, and we all live longer, will our grandchildren change the rules ? If the UK experience is an example, yes – many times over – both Conservative/Labour
- So there is an important place for occupational funds – particularly in SA
- On the macro question whether a 'fund' truly relieves the grandchildren, I believe "yes" but

Key problems for Governance

- DB: when the employer collapses the regulatory buffer may not be enough – so what are the trustee's duties to (a) consider the contribution rate (b) run the fund after insolvency – in a global rather than SA sense ?
- DC: pensions may be small – so what are the trustee's duties to (a) manage members' expectations (b) invest the default fund ?
- Is the private trustee as responsible as the professional ?

DB: Will the fund meet the promise ?

- A function of contributions and investment performance
- Future performance is unknowable – but trustees have to be aware of the central assumptions – and have professional advice that (with today's spectacles) reasonable
- Trustees need to be able to assess and challenge – interact with experts (PF130, pple 6)
- As a team, know-how areas can be split, but all need high level ability to discuss

DB Contributions – trustees' concern ?

- Yes – the plan cannot be operated if benefit payments are predicted to exhaust it early
- The key to the trustee's role is to deliver the plan – the umpire is the Court or Regulator
- If in doubt, negotiate for more – even if back-end loaded
- Understand the cashflow discount rates and ask if not uniform

DB – negotiating the contribution rate

- This is a modern development
- Is it a legal duty ? The world does not stand still – I believe it is.
- What are the levers ?
  - The ability to inform members
  - The ability to resign and make a statement
  - In some jurisdictions, application to the Regulator

DB – when the employer collapses

- The trustees are on their own
- A whole new ball game – to deliver specified promises without further contributions
- In some countries, an underpin from a State fund – but not 100% to avoid the moral hazard of "we need not worry"

DB – closed fund – 3 examples

1. History of <u>discretionary</u> inflation-proofing: trustees purchased accrued rights plus a one-off 10% increase – nothing in future years
2. <u>Inadequate</u> fund: trustees bought only 80% of accrued rights – but sufficient to meet transfer obligations (one for question time !)
3. Large fund – adequate on historical annuity rates, but not today. Counsel's advice to target higher investment return – a very high responsibility with detailed governance.

Example 1: 10% but no future increases

- The trustees had an easy time – they had delivered the plan (NB: I’ve simplified – under UK law, post-1995 accrual is inflation-linked)
- Some members comlained – but no <u>entitlement</u>
  - Lesson 1: you need wiggle room to wind up
  - Lesson 2: get agreement to fund discretionary increases, or you won’t have the wiggle room
  - Lesson 3: think Netherlands re ongoing increases when times are tough

Example 2 – inadequate fund – transfer values bought (80% accrued rights)

- Interesting – before UK's current laws
- Trustees bought what they could
- 80% isn't bad – DB horror stories of 30% (where were those trustees as contributions fell into arrears and longevity increased ?)
- Transfer values are a UK thing – helpful – a continuing reminder of funding level

Example 3 – large fund – unlike 1/2 above, not winding up

- Fund had been sufficient
- Contracting employer (contracting industry)
- Need for safer investments (lower returns)
- Need to target annuities over time
- Heroic governance required (& obtained !)
- What lessons from that governance ? See next slide

Governance in Example 3

- Expert advice needed – employer paid
- Trustees needed more know-how – professional trustee added – employer agreed
- 80% moved to bonds to match cashflows (albeit reinvestment risk remains)
- 20% return-seeking (higher risk)
- Employer/Trustee agreement on capex/divis
- Under UK law, winding up plan could crater employer

DB Governance – Lessons for Trustees - 1

- Monitor the funding – with enough advice
- Shout early to employer
- Keep in mind the members
  - It helps in discussion with the employer
  - It may manage expectations (at risk of anxiety)
  - Where relevant, communicate winding up effect to members (easier in UK than SA)

NB: this looks adversarial, but against a regulatory backdrop it is now co-operative

DB Governance – Lessons for Trustees - 2

- Mature funds are risky
- Fewer return-seeking assets mean more contributions
- If in deficit, can accrual cease/reduce ?
- What can the employer afford ? (A big governance issue in UK – hence back-end loading agreements as a last resort)

DB Governance – Lessons for Trustees - 3

- How did DB get to this state in UK & USA ?
- Remember: DB was originally unfunded
- Tax laws incentified funding; equities kept cost reasonable
- Insurers played the same game by offering managed funds – not insurance
- EU wants to treat plans like insurers
- UK has Pension Protection Fund; USA PBGC

DB Governance – Lessons for Trustees - 4

- Be aware of membership age profile
- Be aware of employer - business contracting?
- Be aware of annuity costs - longevity
- Be aware whether plan has wiggle room – eg benefit reduction on future accrual or wind up
- Be aware that on 6 January 2012 Royal Dutch Shell became the last FTSE 100 company to announce DB closure to new UK members (next year)

DC saviour - but will the pension be worth enough ?

- DC avoids all the above DB problems – but no-one knows what pension it will produce
- So it fails the historical pension purpose of specified replacement income in retirement
- But it meets the 21st Century objectives of:
  - Known and budgeted cost
  - Personal control
  - Variable contributions in fat and lean years
  - Coping well with job mobility

DC – what will it be worth ?

- If a DB plan costs 15% of pay, a DC plan receiving 5% of pay can only expect one-third the pension (and often less)
- Fund management charges are usually higher in unitised pooled funds – look for the hidden charges
- There is no substitute for a projection !

DC - projections

Projections depend on several variables. Key are:

- Contributions (if %pay, is pay static ?)
- Investment return (net of fees & tax, if any)
- Projected retirement date
- Projected annuity rates (think longevity, think interest rates)

Governance includes communicating the above to members – quite a challenge !

NB: if annuities are not bought at retirement, but pensions paid from fund, security may become a DB-like factor

DC governance - member information

- All experience shows that pension leaflets are discarded at the factory gates
- At a minimum the member must know:
  - That there is a fund - & annually his part’s value
  - Whether he can pay additional voluntary conributions
  - His rights (if any) when he leaves the job
- More sophisticated members will want to know about investment targets, security, choice – consider what is relevant (PF130, pple 9)

DC governance - employer information

- This is where the going gets tough !
- Does governance extend to the contribution rate – or is that meddling ? Is design part of governance ? (Angles re duty to sponsor – PF130, para 6)
- Regarding member expectations, emphatically "yes" – although the UK is weak in this area
- Employers brought to their knees by DB costs are not going to contribute DC 15% of pay – but they need to know what 5% does – try sharing information

DC Investments

- Once DC was a managed fund
- Now many (all in UK) offer a member’s choice
- Inevitably a default fund (in UK a Regulatory principle)
- Governance essential for managed and default funds (suitability for workforce) – and for objective descriptions of all funds
- Young workforce is easier (risks are long term)

NB: Keep objectives & managers under review – but remember that switches cost money

DC Investments – management fees

- Management fees are notoriously opaque
- For a new plan, pre-launch insist on:
  - Independent advice on fees
  - Power to change managers (perhaps after consulting employer)
- Review the manager, with advisers present, at least every 3 years, and require annual performance reports

DC – the role of the State

- Remember the lessons from Australia and Chile
- We are not here today to craft a new State system, but awareness of global trends is no bad thing
- In SA, the occupational pension may be the only benefit above the means-test – will it be enough to give value or will it simply reduce the State support (the poverty trap) ?

DC – more re member information

- Put a date on all documents
- Illustrate the effect of any tax incentives – with a suitable warning re change
- Include other warnings eg:
  - Investments can go down as well as up
  - Illustrations depend on assumptions eg assumed rate of investment return
  - Annuity rates at retirement are a complete unknown

Security – key governance area

- Ensure a padlock on assets – advice on bank and investment mandates
- React promptly to delayed employer contributions
- Insist on Trustee agendas/papers days ahead of meetings
- Insist on Minutes within a week after meetings, with Action points

What is the purpose of all this Governance ?

- To “look after” the members – you are investing their money – that makes you a fiduciary (PF 130, paras 6 & 19 re accountability and fiduciary obligations)
- To ensure the minimum of surprises – for you, the members, and the employer
- To do what the member cannot do for himself – manage a fund that receives employer’s contributions

How is the private trustee different from the professional ?

- Very different – but he cannot just be passive
- He must understand enough high level answers to challenge input received
- He should look to the professional co-trustees (if any) to identify and explain the high level questions – otherwise he must look elsewhere – training, Registrar's website or wherever
- Without that understanding, his role will be ineffective

Indemnities

- Every jurisdiction is different
- A trustee who is acting honestly and reasonably should not be put in a position of personal risk – but will need protection
- Before taking up the post, ask for advice from the fund lawyers on indemnities and insurance, and on how the particular plan handles these.