For a picture of bac’s approach to DB governance, imagine a flourishing tree. The root system is not usually visible but it’s crucial to the health of the whole tree. So too is the environment in which the tree lives, particularly the rain and sunlight that it needs to thrive.

In terms of good governance for a DB scheme, Risk management and, in particular, the risk register can be seen as the roots of the tree. The main trunk of the tree represents the trustees’ key objectives for the scheme over the short and longer term – or in other words the high-level direction of travel for the scheme. Together the root system and the trunk support two main branches of governance:

- **Organisational**, by which we mean the strategic decisions which trustees need to take about the scheme’s funding and investment strategy, based on their view of the strength of the sponsor’s covenant (these decisions very much depend upon on the sponsor and scheme, i.e. the “organisation”, concerned)

- **Operational**, which is focused on ensuring the smooth running of the scheme, including administration of benefits and the scheme’s finances, communication with members and the appointment of advisers (so decisions which are usually similar for all schemes).

In our model, Technology reflects the environment in which the governance tree grows. Technology helps ensure that the recording and monitoring of risks can happen in real-time, so that trustee decisions, whether organisational or operational, are taken with a full understanding of the impact they will have on the scheme’s risk management.

**What does ROOT and branch governance involve?**

For a start, there is no ‘one-size fits all’ when it comes to governance. In fact, the opposite is true, with each scheme and trustee board needing to develop an approach which works best for them.

Figure 1 overleaf illustrates how the amount of resource spent on governance should reflect:

- the size of the scheme’s DB liabilities relative to that of the sponsoring employer
the stability of key metrics, particularly the volatility of the scheme's funding position and the speed with which the strength of the sponsor's covenant might change.

However, the level of governance should also depend upon the complexity of the solutions which are being used to secure the scheme's liabilities. This will influence the two boxes labelled '?' in figure 1, pushing them towards high or low governance accordingly.

“Our starting point is to make sure the scheme’s risk register is fit for purpose”

Although good governance looks different from scheme to scheme, it still resembles a tree with the common features described above. We will take a look at each of these features in more detail.

Healthy roots

Our starting point is to make sure the scheme’s risk register is fit for purpose. For many schemes, this will mean moving away from a large ‘tick box’ risk register to a more focused and streamlined approach, under which the register only deals with a small number of key risks (we suggest 10 at most). This re-design process is critical if the register is to become the main roots of a scheme’s governance. However, this does not stop the pensions team or trustee sub-committees maintaining more detailed risk registers for their specific areas of responsibility.

The process of re-designing the register, if done well, will create a healthy debate amongst key stakeholders and an honest appraisal of any newly identified risks. In our experience, trustees are always surprised by how many areas for improvement are identified, and subsequently actioned, as part of this process.

By having a smaller number of main risks which the trustees have debated and ‘bought into’, the risk register will much more easily form part of regular trustee meetings. However, to make this real, trustee meetings need to be arranged so that agenda items are directly linked to the relevant risks from the new, streamlined risk register. This means that, whatever the topic under discussion, any decision takes into account the impact on the associated risks.

Too many schemes still fall into the trap of reviewing their risk register, along with the associated actions, just once or twice a year. This means that agreed actions:

- do not progress with any sense of urgency (or simply do not happen at all)
- are often seen as being needed to ‘manage the risk register’ rather than helping improve the running of the scheme.

By integrating the risk register into regular trustee meetings, we help ensure that the progress of agreed actions is reviewed much more frequently, which usually means they get done quicker. A common failing is to list too many actions for a scheme to take forward in a sensible time frame. To prevent this happening, we suggest that trustees score the proposed actions to assess which ones would have a material impact on reducing risk. This leads to the right prioritisation and focus.

Strong trunk

Next, we consider the trunk of the tree and the question of what the trustees see as the key objectives for the scheme over the short and longer term?

These can look quite different depending upon where the scheme has reached in its journey towards the eventual settlement of liabilities. At one extreme, you have a mature scheme (a fully-grown tree) which is well-funded and therefore close to being able to secure its liabilities with a bulk annuity. At the other end of the spectrum, there is an immature scheme (a sapling) with a sizeable deficit, and a sponsoring employer which is trying to invest as much cash as possible within its business.

Sometimes trustees feel that they have objectives but they are implicit rather than explicit. bac’s role as governance adviser is to help the trustees articulate the high-level direction of travel...

Some common examples of key objectives are to:

- achieve certain funding and investment targets, for example to be fully funded on a low risk gilts-based target and to have de-risked the scheme’s assets, both within 10-15 years
- improve covenant monitoring and related discussions with the sponsor, including consideration of contingency options for strengthening the covenant underlying the scheme's funding position
- ensure the right advisers are in place and they have the correct remits.
After a thorough review of the risk register and confirmation of their key objectives, the trustees will be in a good place to develop their business plan. This should be kept at a fairly high level and used to identify actions for the short term (within one year), medium term (1 to 5 years) and long term (beyond 5 years). These planned actions form the basis of the two main branches of the governance tree.

**Organisational branch**

The inter-relationship between covenant, investment and funding has been the focus of the Pensions Regulator’s extensive guidance on developing an integrated risk management (IRM) framework – see figure 2. The point we want to make here is a practical one - IRM does not have to be complicated. The fact that it often seems to become so is not a weakness of IRM but of the way in which the framework has been developed.

bac’s role as governance adviser is to work with the Trustees and their covenant, investment and actuarial advisers to design an IRM framework that is appropriate for the circumstances of the scheme in question. We do not seek to supplant any of the incumbent advisers but rather, using our broad experience of trustee governance, we act as honest broker in bringing the advisers together to develop a practical and cost-effective IRM framework.

In terms of the prevailing regulatory environment, the Regulator’s 2019 annual funding statement has sharpened its previous messages on investment de-risking, long term funding targets and the relationship between deficit contributions and dividends paid to shareholders. We expect more prescription along these lines to be included within the new DB funding code, although the latest from the Regulator suggests we may not see this until 2020.

With that backdrop, a key focus for trustees is to make sure that their investment strategy is not too optimistic, relative to the strength of the employer’s covenant. That may mean de-risking assets sooner and paying deficit contributions for longer than had been expected, but with the advantage of a much less bumpy funding ride.

Most DB schemes already have some form of long-term funding target, as this has advantages for both the trustees and the sponsor. However, the trustees would be wise to review their plans for both long term funding and investment de-risking in the light of the changing regulatory environment.

“...we act as honest broker in bringing the advisers together to develop a practical and cost-effective IRM framework”

To facilitate just such a process, we have worked with a number of trustee boards to run detailed ‘what if’ scenarios to support robust trustee discussions on how they would respond to various economic and covenant-related outcomes. The purpose of these discussions is precisely to test the appropriateness of the trustees’ long-term objectives and monitoring framework.

**Operational branch**

Here the trustees’ natural focus is on areas like:

- quality and security of data
- accuracy and timeliness of benefits administration
- sound management of scheme finances
- effective communications with members.

These are all important areas but, in our experience, they need careful summarising within the risk register so that they do not generate too many operational risks and take up too much trustee time.

One operational area where schemes have, arguably, been slow to improve their governance is their choice of advisers. That has begun to change, with more trustees realising how vital it is to get the best possible advice as their scheme approaches the DB end-game. bac has carried out twelve scheme actuary and/or investment consultant market tenders for £1billion+ schemes over the past 3 years. Over half these reviews have led to a new advisory firm being chosen, reflecting the fact that trustees are often genuinely surprised by both the ideas and by the quality of advice and service they discover when they carry out a market tender process. Of those where the incumbent was retained, in all but one case there was a fundamental redesign of the services and team provided by the adviser, reflecting what the trustees had now learnt was available to them in the market.

Training should also be included here. It is crucial to good governance, but some trustee boards have chosen to pay it lip service. The best form of training is well-timed and up-to-date, just before the trustees need it; for example training on the choice of valuation assumptions in the run-up to a triennial valuation. However, training is increasingly being used in a much broader context to allow trustee boards to role play how they would respond to a particular, currently hypothetical, scenario, such as a takeover of the sponsor.

**Protect the environment**

bac does not believe that technology should be used for its own sake. However, in certain situations technology can make a real difference to how well a scheme’s governance works. For example, if a scheme is maintaining its risk register...
using bac’s online technology, the trustees are able to update the risk register after each agenda item, so that by the end of the meeting they are able to see how their decisions have affected the scheme’s risk profile.

Whilst technology cannot replace good governance by trustees, it can make it much easier to implement good governance effectively. For an IRM framework, the inter-relationship between the key factors underlying covenant, investment and funding can most easily be captured using formulae. With that backdrop, technology is extremely helpful if trustees are to see and understand in a very immediate way the impact of changes in those factors. It can also be used to role play the impact of potential changes, so that trustees can appreciate first-hand how an event like a no-deal Brexit might affect their risk measures. bac has helped develop bespoke IRM frameworks for several large defined benefit schemes and provided the online dashboard that brings those frameworks to life.

Adviser reviews are another area where our technology brings real benefits. The use of a dedicated website, which hosts all the relevant scheme documentation, the RFQ and an FAQ tab which shares the answers to all questions raised as part of the tender process, makes it possible to maintain a true level playing field between the candidate firms. That level playing field is key in terms of achieving the best outcome for the trustees, measured both in terms of the quality of people/advice and the level/nature of the fees of the chosen firm.

“Whilst technology cannot replace good governance by trustees, it can make it much easier to implement good governance effectively”

Real-time evaluation of how effective trustees have found meetings, briefing papers and advisers can also be achieved via technology. This makes it possible to address any emerging issues immediately and to provide an audit trail of performance over time.

Finally, there are a wide range of member website and modeller solutions which can help support the trustees’ wider governance objectives for effective member communication.

The last word

Pensions governance should be a root and branch process. It does not have to be painful or tedious, but it does require careful planning and a willingness to revisit how the trustees currently operate.

bac starts by helping trustees to identify the fundamental nature of their governance ‘tree’ and to set key objectives for the high-level direction of travel for the scheme. We have developed a tool to help you triage your governance needs and quickly identify areas of weakness.

From here, we help trustees establish:

- Risk management via a risk register to provide a strong basis for governance
- Organisational focus where scheme-specific, strategic issues are addressed
- Operational focus to ensure scheme administration is robust and effective
- Technology that simplifies and streamlines governance in all areas.

Finally, it is worth pointing out that the benefits of getting governance right can be huge – both in terms of the shortened timescale over which members’ benefits are secured and the smooth running of the scheme in the meantime. Some very large DB schemes, which have focused on getting their governance right, are now within 5 years of being able to secure all their members’ benefits in the insurance market and wind-up. Even if your scheme is unlikely to achieve that endpoint so quickly, good governance will, at the very least, mean you sleep better at night under the canopy of your governance tree.

If you would like to know more about how bac can help you improve your scheme’s governance, please contact us at governance@bathactuarial.com.

Andrew Udale-Smith | June 2019

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