PENSIONS IN TRUSTY HANDS

JOHN ASHWORTH HIGHLIGHTS THE VALUABLE CONTRIBUTION TREASURERS CAN MAKE AS TRUSTEES OF DEFINED BENEFIT PENSION SCHEMES.

Falling equity markets and the introduction of accounting standard FRS 17 have highlighted the risks inherent in running a pension fund. When a pension fund is of a significant size relative to that of the company, serious problems in the fund might cause the firm to collapse. So this growing awareness of the risks involved is welcome, especially in the way pension funds invest their assets. It also demonstrates that the company needs to appreciate what risks are being taken and managed by the trustees of the pension fund.

Of the many risks to consider, asset allocation is foremost in the minds of many analysts, the pension press and the national press – especially following the move by Boots to switch 100% of its assets into AAA-rated Supranational bonds (see article on page 38). The reason asset allocation is foremost is because something can be done about it. Asset allocation has always been important as it is the main process in managing a fund's overall risk and return profile. However, for the past 20 years, financial markets that were friendly concealed this importance. Now markets have turned, though, and, while still under transitional arrangements, FRS 17 has highlighted the risks that the wrong asset allocation can bring.

RISK ASSESSMENT. Asset allocation is only one of the many risks inherent within pension funds. Treasurers, corporate financiers and finance directors are well placed to appreciate the significance of the risks that need monitoring and managing. These risks, however, need to be managed by the trustees, not the company. Exley, Mehta and Smith, in their 1997 paper on *The Financial Theory of Defined Benefit Pension Schemes* argue that pension fund assets and liabilities are economic assets and liabilities of the company. Company pension contributions are on a 'balance of cost' basis, so the firm is obliged to make up any shortfall after member contributions and investment returns. If investment returns are good in relation to the liabilities, the company benefits through lower contributions, while poor investment returns result in increased contributions.

The value of pension fund assets and liabilities therefore increases or decreases the value of the sponsoring company. Because the fund assets and liabilities are economic assets and liabilities of the company, any risk associated with those assets and liabilities, especially an asset and liability mismatch, is a risk for the company. For example, increasing longevity (that is, higher liabilities) is not just a risk to the pension fund, but also a risk to the company.

The debate in the press so far has concentrated on the risks of an asset and liability mismatch, primarily the most important risk, but this article discusses the role of the treasurer as an experienced finance expert and a risk manager in a wider context and also as someone who adds value throughout the organisation by critical focus on broader, strategic business risks and opportunities. First, we need to understand the trustee's duties.

TRUSTEE DUTIES. Trustees are governed by the trust deed and by trust, pensions, tax, employment and European law. Duties include:

- complying with the trust terms (trust deed);
- acting in the best interests of beneficiaries;
- acting impartially between beneficiaries;
- acting prudently and use special skills;
- taking professional advice where necessary;
- not profiting from the trust;
- collecting member contributions and invest assets; and
- complying with all statutory duties.

As investment issues are one of the most significant risks within a pension fund, trustees' duties in relation to investment matters will be key. Paul Myners, in his review of institutional investment, recommends that trustees ensure they have sufficient in-house support staff. The level of support that passes as sufficient will depend on the scheme and the strategies it is pursuing. For small schemes it may be sufficient to have a responsible person (perhaps a pensions manager) who organises the relations with consultants and managers and ensures the appropriate information is made available to the trustees. In larger schemes, in-house investment staff, the treasurer, or equivalent, may be employed.

In all schemes, trustees will have to decide whether they feel the information being provided by their colleagues is sufficient to enable them to make informed decisions. Large schemes should ensure that adequate support for trustee decision-making exists. Small schemes, where outsourcing investment support is the only cost-effective and practical option, may not find it appropriate to try and obtain this support for trustee decision-making.

'THE TREASURER WILL BE WELL PLACED TO HELP TRUSTEES IN THIS DECISION-MAKING PROCESS, AS WELL AS TO MANAGE THE RISKS INHERENT IN THE PENSION FUND'

MEMBERSHIP OF PENSION TRUSTS. Trustee Boards operate in a very different way from Company Boards. This is partly because of the consensus approach taken to decision-making and the role of member-nominated trustees, but also because all trustees have joint and several liability and therefore need to be comfortable they understand and are in agreement with decisions. The decision-making process is key to this approach and trustees need the right behavioural skills, such as knowing how to challenge, whether to accept or reject recommendations from experts, and understand when decisions need to be taken and when it is important to be decisive.

The treasurer will be well placed to help trustees in this decision making process, as well as to manage the risks inherent in the pension fund. The treasurer can help in three ways, as a:

- company appointed trustee;
- member nominated trustee; or
- co-opted (non-trustee) member.

The treasurer is likely to make the most significant contribution by participating in investment decision making on the Investment Standing Committee (ISC), if it exists, or the Trustee Board if not.

A more 'specialist' trustee body would serve to provide greater confidence from trustees and less reliance on the professional advisers. Improved knowledge among trustees will benefit the entire chain of the investment process, which in turn will increase the use of more sophisticated strategies and products. Growing confidence will mean that trustees should become far more effective at prioritising issues, allowing time for the discussion to focus on the more important strategic investment issues.

▪ The treasurer as a company or member-nominated trustee.
There is no difference in the duties of a company-appointed trustee from a member-nominated one. The overriding duties are to act in the best interest of the beneficiaries and to act impartially between beneficiaries. This responsibility prevents a trustee from specifically representing a particular group's interest at the expense of another. Trustees must therefore disregard their own personal interest and opinions. This observation is critical.

One of the trustee's duties is to act prudently and employ any special skills. If a trustee has a expertise, for example, in investment matters, then he or she must use it. There is also a requirement for trustees to act in a way a 'prudent businessman' would when dealing with their own affairs, for example by:

- considering the risks involved;
- getting and acting upon appropriate professional advice; and
- diversifying the scheme's investments.

Is it important therefore that a treasurer uses specialist skills but recognises that there will be a limitation to his or her expertise and specialist advice will need to be taken. Myners states that those making investment decisions don't just need some of the skills, but also the information and resources to make those decisions effectively. Any advice taken must be evaluated critically by trustees with sufficient expertise and training.

There is a government drive to increase the standard of care expected from trustees, raising the standard from "the worthy amateur". The 'investment experts' (although I would argue that most treasurers are not investment experts at all) who sit on the Investment Standing Committee (ISC) will be under a greater duty of care on investment matters, than the 'lay' trustee. However, the nature of decision-making and joint and several liability will help to ensure, however, that legal liability is shared by all trustees.

The treasurer may be well placed to understand the key principles affecting pension matters but is unlikely to be an investment expert. The focus of many treasurers on debt financing/hedging/cash management will not enable them to be sufficiently equipped, or have the time to deal with investment management matters in sufficient detail without relying on expert advice.

On the subject as to whether the trustee should be paid, case law suggests that company appointed trustees who are paid for their services (that is, in addition to their company salary) could be holding themselves up as having greater expertise than the lay amateur. In practice, it is uncommon for company employees to receive any additional remuneration on becoming a trustee.

▪ The treasurer as co-opted member to the ISC.
Representing company. If the treasurer is a co-opted member of the ISC (in theory, it is possible to be a co-opted member of the Board, but this is rare) then there is a clear understanding that that individual is likely to act in the best interests of the company. When the treasurer acts in this role conflicts will arise if the relationship with the trustees is not managed with some care. Trustees have a paramount duty to act in the best interests of beneficiaries and must balance the interests of different classes of beneficiaries.

Company influence/consultation. The company, however, is a beneficiary of the scheme, to the extent that it may be entitled to any surplus assets which remain on a winding-up. Also, the company is the sponsoring employer and needs to be consulted on decisions that could increase costs. The company also influences the design of the scheme and the benefits being offered. Trustees need to be mindful of the risk that the company could exercise its right to restrict future benefits to members, or even take the ultimate step of closing the scheme to future accrual. Exercising this right may not be in the best interests of all beneficiaries.

Trustee control. While the issues outlined above allow the co-opted treasurer to have some influence, the trustees, by law, do not have to agree with the employer or carry out any of their wishes. If the trustees choose to disregard the employer's wishes then they need to be satisfied that this will not be to the detriment of the beneficiaries. The co-opted treasurer therefore needs to understand his or her relationship with the trustees and handle it with care.

POTENTIAL CONFLICTS OF INTEREST. Conflicts could arise when a treasurer is also a trustee, partly because of the role in company risk management, but also, to a lesser degree, by being a beneficiary of the scheme (the Pension Act allows this conflict to exist – that is, a trustee can exercise their powers, even though they may be a beneficiary). The more serious potential conflict caused by being a company employee needs to be recognised and managed to ensure

trustee duties are not compromised. The advisers to the scheme, or fellow trustees, will be quick to point out any obvious conflicts emerging in discussions, helping to ensure company appointed trustees are reminded of their duties.

There is, of course, also the usual conflict of interest requirement for trustees to ensure that neither they, nor family nor associates should buy or sell assets to the fund (in exceptional circumstances this can be arranged, however, provided all aspects of the transaction are on an arm's length basis).

- **Opportunities for alignment.** A trustee's duty to protect the interests of all beneficiaries is one of the greatest opportunities for the interests of the treasurer as a co-opted member, as a risk manager for the company, to align interests with those of the trustees. An example of this alignment could be supporting a move by the trustees to have a greater bond holding, driven by a desire to protect beneficiaries' interests because of a deterioration in the sponsoring employer's covenant. This move would help reduce the company's balance sheet volatility and protects against a potential gearing covenant breach if FRS 17 had been fully adopted (if covenants are not written in frozen, pre FRS 17, GAAP). The cost of this protection may however be an increased contribution rate.

- **Potential for mis-alignment.** Although it is difficult to generalise, this natural alignment of interests is unlikely, in the main, to promote significant risk-taking to enhance returns. Fund managers take controlled risks within their investment portfolios, with the risk being consistent with the mandate set by the trustees. Investment consultants play a key role in risk control, from helping advise on investment strategy through to selecting fund managers and quarterly monitoring of performance. The treasurer needs to understand how the fund manager and investment consultant operate in balancing risks versus potential rewards. The management of this relationship is perhaps where there is the greatest potential for conflict between treasurer, trustee and adviser. For example, trustees may wish to pursue a higher risk equity strategy, whereas the company may want reduced balance sheet and profit and loss volatility (or vice versa). The treasurer can play a crucial role in explaining the company's position, while also appreciating the motives and responsibilities of the trustees. Over time, given a receptive trustee and a reasonable approach taken by the company, the key principles within the risk management policy of the company should be consistent with that of the trustee.

TRUSTEES' LIABILITY AND PROTECTION. Trustees can either be a collection of individuals or a trustee company. In terms of duties and liabilities, there is little difference. Although the company is a legal entity, the directors of a corporate trustee are in a similar position to individual trustees. The main advantage of the company approach is the relative ease of appointment and removal of individual directors, rather than the relative difficulty of dealing with individual trustees. Company directors do not owe a direct duty to the beneficiaries, it is the trustee company itself that owes this duty. Individual trustees have a direct duty to the beneficiaries.

- **Liability.** Trustees have unlimited personal liability under trust law. In addition, there is now a regime of fines under the Pensions Act 1995. These range from £200 for an individual trustee (or £1,000 for a corporate trustee) up to £5,000 and £50,000, respectively. Treasurers need to appreciate that trustees are jointly and severally liable for their actions. A trustee can be held responsible for a breach of trust by another trustee if they fail to stop them committing a breach. Trustees are still liable, even when they cease to be a trustee, if a breach of trust took place while they were a trustee. These concerns usually means that some trustees may have difficulty in delegating powers to an ISC by passing responsibility to a small group of 'investment experts' to take decisions. The delegation of this type of responsibility is commonplace among company directors but is still a difficult concept to accept for trustees, especially those who have never been company directors themselves. The infrequency of trustee meetings (often, once a quarter) can slow decision making on investment matters considerably. It is likely that over time trustees Boards will become more comfortable with the principle of delegating investment matters to a ISC. At present, few Boards give delegated authority to their ISC.

- **Protection.**

Statute. Trustees enjoy a number of statutory protections (as outlined in Figure 1).

FIGURE 1: STATUTORY PROVISIONS ON TRUSTEE PROTECTION

(a) section 61, Trustee Act 1925: this gives the court power to relieve a trustee from personal liability if it appears to the court that the trustee had acted honestly and reasonably and ought fairly to be excused;

(b) Section 30, Trustee Act 1925. This exempts a trustee from liability for losses arising from the actions of a co-trustee or of a third party in certain limited circumstances;

(c) Section 34, Pensions Act 1995. This exempts the trustees for liability for the acts or defaults of an authorised fund manager provided they have satisfied themselves that the fund manager has the appropriate knowledge and experience and has taken steps to ensure that he or she is carrying out their work competently.

Exoneration clauses. Many pension scheme deeds will contain a clause known as an 'exoneration clause', which specifies that the trustees will not be liable unless they act fraudulently or in deliberate breach of trust. Although there is little case law on the effect of exoneration clauses, the case law that does exist indicates that the courts do not shy away from giving full effect to these clauses. In some cases, the exoneration will be accompanied by an indemnity that provides for the trustees to be indemnified either by the employer or out of the pension scheme. The Pensions Act 1995 prohibits an indemnity being given from scheme assets to the extent that the indemnity protects against Pensions Act penalties and fines.

Trustee insurance. It is possible to obtain trustee liability insurance. The premiums will be paid for by the employer or from scheme assets. It is preferable to have a policy specifically designed to respond to the needs of trustees, co-opted members and other individuals involved in the management of pensions. This is especially so for company appointed trustees, who have this potential conflict of interest between their duties as a trustee, and their duties to the company and its shareholder. The Pensions Act 1995 prohibits scheme assets from being used to pay insurance premiums to the extent that the insurance protects against Pensions Act penalties and fines.

Trustees can protect themselves in a number of ways, which I will not go into detail in this paper, other than they need to focus on taking professional advice. They can protect themselves by ensuring they take proper professional advice and have good documented reasons should there be circumstances in which they have not followed this advice. In general, trustees will not be acting prudently or in the best interests of their members if they fail to do this.

CORPORATE COMMUNICATIONS. Good communications on pension matters to employees is vital, as most employees underrate their benefits. Many employers are not getting the full business benefit from the amount of money they spend on benefits, especially pensions (which is usually the most costly benefit) since these benefits are undervalued, therefore under-used and under-appreciated by employees.

Pension trustees have minimum standards of communication as these are covered by statute, but members increasingly need advice, perhaps through an independent financial adviser (IFA), and explanations on pension issues, not just the trustee report and accounts, or the scheme member booklet.

The treasurer, as a trustee, may also have a valuable role in facilitating the communication process between scheme members and the employer. It is a responsibility that correctly sits somewhere between the human resources and pensions departments.

The company may be losing out if the value of this costly benefit is being undervalued and under-used. Company representatives responsible for communication need to get the right message across to the right people at the right time. Only 1% of employees retire on the maximum pension allowed by the Inland Revenue. Employees increasingly need mid-career and pre-retirement advice to ensure they make informed decisions.

Company closure of defined benefit schemes to new starters and the move to defined contribution (DC) schemes can transfer investment responsibility and therefore the risks to the individuals (assuming the DC scheme is not run as a trust). Companies may wish to consider their responsibilities to ensure their employees are equipped to make those investment and pension planning decisions. The treasurer can help in getting the right message across, mindful of the risk of falling foul of the Financial Services Authority (FSA) in providing advice, mindful of the need to take professional advice and communicate to employees in a clear, concise way.

Case law in the UK suggests, however, that employers are not legally required to ensure employees/members of a pension scheme have advice. They just need to ensure that information is made available to enable employees/members to make a decision.

The risk of the company falling foul of the law of mis-statement or misrepresentation, and the courts seeming to favour the company position of statutory minimum disclosure, does not help the position. The complexity of pension planning to the individual has been widely reported on, and so it is no wonder employees are feeling even more 'exposed' to uncertainty as to their financial circumstances in the run-up to and following retirement. It does not look like companies are going to help on this issue.

BRINGING BENEFITS TO THE BOARD. Treasurers can bring many benefits to the pension scheme's board. They are well placed to understand and challenge the advice received from investment consultants, or fund managers. They can appreciate the workings of SSAP 24, FRS 17 and, imminently, IAS 19 and can understand how asset allocation can help to hedge the company's reported results. The treasurer also has the relevant skills and understanding to consider actuarial valuations and the implications of those valuations for the scheme's finances.

'COMMUNICATION ON PENSION MATTERS SHOULD BEST BE LEFT TO HUMAN RESOURCES AND THE PENSION MANAGER, AS THERE IS A LIMITED ROLE FOR THE TREASURER IN THIS CONTEXT'

More important, however, are the treasurer's skills as a risk manager who also appreciates how the economic assets within the pension scheme affect the value of the company. For example, asset allocation is not purely a function of matching (or deliberately choosing not to) assets and liabilities, but is also a function of the risk appetite of the trustee and the company, the strength of the corporate covenant and the company's sensitivity to increases in contributions, or volatility of the pension asset or liability. These are all matters that are critical to both trustee and company and can be well understood by a treasurer.

This article suggests that conflict of interests as a trustee can exist but that a trustee's duty should prevent them becoming an issue. The treasurer must, however, follow those duties and responsibilities to the letter to avoid losing the confidence and trust of his or her fellow trustees.

Where the treasurer is a co-opted member of the ISC, he or she represents the interests of the company, but clearly will also need to be sensitive to the duties and responsibilities of the trustees towards their beneficiaries, of which the company is only one. The pros and cons of trustee versus co-opted member depends very much on the individual and the relationship between the trustee board and the company. Different approaches may be more appropriate depending on each set of circumstances and the individual himself.

The treasurer will have a greater duty of care than a lay trustee, but should not be seen (or treated) as an 'investment expert'. Professional advice on investment matters (as well as other matters) must be taken where appropriate and it is important the treasurer understands his limitations as to experience, knowledge and time.

Communication on pension matters is best left to human resources and the pension manager. There is a limited role for the treasurer in this context, which may only be to act as a facilitator to ensure the company is getting the right message across to employees as to the financial significance of the pension benefit they enjoy.

In conclusion, it is our contention that trustees would benefit more by the involvement of the treasurer than not. What is all the more evident is that there is a clear need for the treasurer, whether or not appointed as a pensions trustee, to be aware of how movements in the value of the assets and liabilities of the pension scheme might affect the value of a company, and how this volatility affects loan covenants and financial performance ratios in general.

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