The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

October 2023

THE *PENSION GOVERNANCE EDUCATION PROGRAM* IS ALIVE AND WELL:

WHY IT CONTINUES TO RECEIVE HIGH 'VALUE FOR MONEY' RATINGS

"Program content and pedagogy were excellent. I appreciated the variety of speakers. The use of a group project encouraged engagement and deeper learning. Well done!"

"I think more time needs to be added to the Program. Three-and-one-half days are not enough to thoroughly engage on governance matters of such importance."

"The event confirmed the value of pension board member education. I am worried for the pension industry that only 30 board members are educated at the time. How do we increase the numbers? Not an easy problem to solve….but worth thinking about."

Feedback from the 15th offering of the *Rotman-ICPM Pension Governance Education Program* (*PGEP*)

The Quest to Improve Pension Governance

The creation of *PGEP* in 2011 resulted from a collaboration between the *International Centre for Pension Management* (*ICPM*) and the *University of Toronto's Rotman School of Management*. Improving pension governance was a high priority for *ICPM*, and *Rotman* already had the highly respected *ICD* corporate governance education program underway. The *ICPM-Rotman* partners created *PGEP*, started out offering it twice a year in 2011, postponed it because of COVID in 2020 and 2021, and reopened the Program in 2022.

Offering #15 took place this past September 25-28 at the *Rotman School of Management*. There were 30 participants from 13 different pension organizations based in 6 different countries. Pension plan designs ranged from DB to DC to various forms of hybrids. The number of employers involved ranged from 1 to 3000+. The number of plan members involved ranged from 42 thousand to 2+ million. Board size in the 13 pension organizations represented ranged from 4 to 16 members. Asked to rank the challenges facing their Boards, the top two were 'plan stability/sustainability' and 'organization design/talent retention'. Five group projects to be completed by the final day were assigned, including on addressing these top two challenges. On the 'value for money' scale, attendees gave the *Program* an average ranking of 6.4 on a scale of 7 (great) to 1 (terrible).

Setting the Stage

As soon as attendees signed up for *Offering #15*, they were sent a reading list to help them prepare for the 3.5-day 'live' event. In the opening session, *PGEP* Academic Director Prof. Rob Bauer provided key statistics about the group and their organizations, and then asked attendees to introduce themselves, and share what their expectations were for the *Program*. A lively discussion followed…..

Also waiting for them when they arrived was a copy of *ICPM* Director Emeritus Keith Ambachtsheer's book "The Future of Pension Management". Speaking to the book's messages, he suggested there are four:

1. How we design pension systems matters.

2. How we govern pensions systems matters.
3. How we invest retirement savings matters.
4. How well we integrate the design, governance, and investment dimensions also matters.

As much of the *PGEP* curriculum focuses on governance and investment issues, I set out some pension design challenges for discussion.

Where Is Pension Design Going?

The *World Bank* proposed 25 years ago that we discuss retirement income systems as having three Pillars:

1. Pillar 1: Universal base pension, pay-go funded, possibly with an anti-poverty bias, and with claw-back provisions for high-income earners.
2. Pillar 2: collective, employment-based supplementary pensions, pre-funded, could be DB or DC or some hybrid of the two.
3. Pillar 3: tax-assisted individual retirement saving plans.

In this context, what are the current pension design challenges?

1. Pillar 1: the big challenge here is demographics. Aging populations increase dependency ratios. To offset this, if benefit levels are to be maintained, moving to some combination of higher retirement ages and higher contribution rates is required. These are politically unpopular measures and hence challenging to implement.
2. Pillar 2: once again, there are three levers to generate adequate and sustainable pension income streams supplementary to Pillar 1 pensions: target benefits, contribution rates, and retirement age. In different ways, traditional DB and DC arrangements are both challenged in using these levers. Auto-enrolment and separate accumulation and lifetime decumulation pools could help overcome these challenges. More on this below.
3. Pillar 3: for most people, leaving them to design and execute their own retirement finances is problematic for two reasons: 1. *Inertia*: retirement finance requires looking decades ahead into the future, something that does not come naturally to most people, and 2. *Asymmetric Information*: many for-profit service providers take advantage of the fact that most people are not schooled in how to best invest their retirement savings. As a result, many overpay for the management of their retirement savings, and hence underachieve their retirement income goals.

How are these Pillar 2 and 3 challenges best met? Here are three measures that would go a long way:

1. Make cost-effective Pillar 2 coverage available to the entire workforce through requiring employers to enrol their workers in a qualifying pooled Pillar 2 pension plan. For example, an initiative to that end launched a decade ago has materially increased Pillar 2 pension coverage in the UK.
2. Ensure that these supplementary pension plans have fiduciary mandates, scale economies, separate unitized return generation and collective lifetime decumulation pools, as well as a default, age-based transition path from the return generation to the lifetime income pool. These designs are emerging in Australia, Canada, the UK, and the USA. Chair Gale Rubenstein and CEO Barbara Zvan shared the birth and evolution of the *University Pension Plan* as a 'live' example of these developments.
3. Choice options that could be embedded in the plan design include choice of retirement date, the asset transition rate from the return generation pool to the lifetime income pool, and asset allocation in retirement between the two pools.

These pension design issues triggered animated discussion and debate among the 30 participants. Pension design change is not easy to implement, but if there is a better way, it has to be considered.

Addressing Pension Governance Challenges

The Governance part of the *Program* unfolded in four parts: 1. Board Dynamics, 2. Lessons from Corporate Governance research and practices, 3. Applications to Pension Governance, 4. The special case of IT and Cybersecurity Risk:

1. **Board Dynamics** led by Rotman Prof. Geoffrey Leonardelli: Ideal Board size is 3-8 members. Large Boards have high co-ordination costs and foster 'social loafing' (i.e., incentive for individual members to tune out). This can be offset by having Board committees that focus on specific areas (e.g., governance, investment, audit/finance, member services, HR). Avoid employer/employee 'tribalism' and foster a 'same goals/same team' spirit. Establish 'vigilant' Board decision-making process with clear objective(s), alternative possible outcomes, multiple information sources, possible bias identification/elimination, and a clear implementation plan.
2. **Lessons from Corporate Governance Research and Practices** led by Rotman Prof. David Beatty: Boards can vary greatly depending on the purpose and ownership of the organization being governed (e.g., publicly-traded or privately-held corporations, joint-ventures, venture capital, not-for-profits, pension funds). However invariably, no matter what the context, good governance adds value. The 4 keys to board effectiveness are skills (hard and soft), structure (key committees), briefings (what, how), and agenda (huge investment decision). The 4 effectiveness activators are promulgate, evaluate, educate, and celebrate. The *Canadian Coalition for Good Governance* (*CCGG*) experience confirms all this. Founded in 2002, *CCGG* has been promoting better disclosure, ranking governance quality, supporting the *ICD* governance education program, and celebrating the rising *CCGG* corporate governance quality rankings over the course of the last 20 years.
3. **Applications to Pension Governance** led by Prof. Rob Bauer and Keith Ambachtsheer: historical pension fund CEO surveys on the governance quality of their boards have not been flattering. Problem lists have included faulty board member selection processes, lack of board effectiveness evaluation, board micro management, poor board agenda construction, and lack of support for incentive compensation structures. A special problem unique to US public sector plans is the political nature of their boards. These findings lead directly to a 'to do' list for improving pension governance: rethink board member selection processes, clarify the decisions responsibility between board and management, ensure board meeting agendas focus on strategic rather than operational issues, and construct a formal board effectiveness evaluation process.
4. **The special case of IT and Cybersecurity Risk** led by Prof. Michael Parent: for many organizations IT amounts to 1/3rd to 1/2 of total capital spending, of which 40% is approved by the board, 20% is wasted, 30-40% have major cost overruns, and 30-40% end up having no strategic benefit. The four IT watchwords for board members are select, deploy, exploit, protect. If Cybercrime was a country, it would be the 3rd largest in the world. As part of their responsibilities, board members must pose four questions: 1. What is our data breach/cyber incident response plan? 2. What validation procedures do we have in place? 3. What assets and data are most valuable? Most at risk? 4. Do we have, and regularly rehearse, a Cyberbreach Playbook?

As with pension plan design, these pension governance 'to do' lists are easier to say than to do. However, such lists are a good start.

Investing Retirement Savings

The investment segment of *PGEP* covered two topics: investment beliefs and sustainable investing.

1. **Investment Beliefs** led by Prof. Alexander Dyck: investment beliefs constitute the foundation on which a pension organization's investment program should be built. They must address four questions: 1. How do financial markets work (e.g., market efficiency, asset pricing and risk premia, diversification, relevant time horizons)? 2. What investment processes are best suited to help us achieve our goals (e.g., return projection models, engagement strategies, costs control)? 3. What is the best organization design for us (e.g., outsourcing vs. insourcing, team structures, incentives, skill/experience sets)? 4. What roles should corporate governance and sustainability play (e.g., corporate engagement, social considerations, climate-related considerations)? Addressing these four questions will bring clarity, discipline, and result measurement focus to the pension organizations. Is the board capable of leaning in on these four dimensions? They should be. *CPP Investments'* Annie Harlow spoke to her organization's investment beliefs and how they guide its investment program.
2. **Sustainable Investing** led by Prof. Rob Bauer: sustainable investing has three dimensions: 1. Excluding certain investments for non-financial reasons, 2. Including certain investments for non-financial reasons, 3. Engaging with investee corporations on issues relating to their long-term sustainability (e.g., could be environmental, social, or governance-related). Pension organizations must carefully think through their motivations for taking actions in these spheres. Are they fiduciary duty-related? Regulations-related? Or related to the expressed preferences of their plan members? An important related question here is the potential trade-offs involved in the sustainable investing space. For example, are achieving Net-Zero goals compatible with achieving pension affordability? Even experts cannot reach agreement on this question. Nevertheless, the sustainable investing topic can no longer be ignored by the boards of pension organizations. In an *ICPM* discussion forum in 2010, attendees were asked if the topic was a worthy agenda item on pension board agendas. Out of 52 responses, there were only 16 'yesses' and 36 'nos'. Today, it would be surprising if there any 'nos' in such a survey.

PGEP Offering #15 ended with the presentation of the five Group Projects assigned on Day 1. Each project described a pension design, governance, or investing challenge to be addressed. Each project team did so with energy, creativity, and humour, making great use of the course material accumulated over the course of the prior three days.

What's Next?

We will share the governance education plans for 2024 as soon as they are formalized. We will also ponder the question posed by one of the attendees of *PGEP Offering #15*: "*The event confirmed the value of pension board member education. I am worried for the pension industry that only 30 board members are educated at the time. How do we increase the numbers?*" How would you answer that question?

Keith Ambachtsheer

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