No Snoozing: eradicate conflicts of interest on trustee boards

By David Johnson, Consulting Director, Trustee GAAPS

In a recent survey of 310 schemes carried out by the National Association of Pension Funds (NAPF), it appears that nearly two thirds of the pension schemes (64%) still have directors from sponsoring companies on their trustee boards. This may have left some schemes feeling somewhat exposed! But when the Pension Regulator published draft guidance on eliminating conflicts of interest last month, it became clear that the vast bulk of schemes would have had no other choice than to wake up and address this issue.

Together with figures from the Pension Protection Fund (PPF), this would suggest there are over 4,900 defined benefit schemes that still have company directors acting as trustees - a surprisingly high and rather disconcerting number.

Despite the growing recognition of the scope of the problem, the majority of schemes have been slow in removing potential conflicts of interest from trustee boards. This is a potentially dangerous approach in view of the growing risk of lawsuits against trustees with obligations to both the sponsoring organisation and scheme members.

The Pensions Act of 2004 introduced the requirement that trustees identify and manage **potential** and actual conflicts of interest, but the recent figures clearly demonstrate that schemes are not being proactive enough in upholding that requirement, and that significant work still needs to be done to eliminate conflicts of interest from trustee boards.

The figures from the NAPF also reveal that Finance Directors (FDs) are the single category of director most likely still to sit on trustee boards (30% of all FDs are sitting on a trustee board). Conflicts of interest are potentially more acute for Finance Directors, as they are likely to be more conscious of how decisions to invest extra money into pension schemes may adversely affect shareholder value.

A Finance Director who is also a pension fund trustee might, for example, favour a large corporate takeover or to increase the company's debt level, because it is in the interest of shareholders, even though this could run contrary to the interest of the pension fund members. A common conflict might also be created by negotiations over funding levels paid by the company to the pension scheme.

It is concerning that Finance Directors are still seen as the natural choice for the trustee board, despite the mounting evidence that their fiduciary duty to shareholders and corporate finance activity has the potential to put them into such direct conflict with scheme members. One reason often put forward by pension funds for their reliance on Finance Directors as trustees is that their knowledge of financial and accounting issues are indispensable expertise that schemes cannot do without. However, this justification increasingly lacks real credibility when you consider the growing pool of professional, independent trustees, and how well placed they are to fill the skills gap left by departing Finance Directors.

To compound matters, fresh conflicts of interest are coming to light on a regular basis – often as a consequence of regulation. A new conflict of interest has recently arisen with the International Accounting Standards' (IAS) new guidelines regarding the treatment of

pension scheme surpluses. The new IAS guidance, IFRIC 14, which took effect in January 2008, could mean that, in many cases, surplus funds in a pension scheme will no longer count as assets on the company balance sheet. Companies could seek to reduce payments into schemes or change scheme rules so that repayments are not contingent on the approval of trustees. This could create new conflicts of interest for trustees with responsibilities towards scheme members and sponsoring companies.

Current market volatility is also bringing the issue of conflicts of interest into sharp relief. In the wake of the subprime meltdown, pension schemes are increasingly coming under pressure to undertake much more rigorous contingency planning to protect their funding plans. The seizing up of the credit markets over the summer illustrates how quickly a sensibly thought-out plan can become redundant by a change in asset values. For contingency plans to be effective they should cover a wide range of scenarios from uninvited takeover or merger approaches to financial difficulties faced by the sponsoring employer and changes in the investment markets. Here again, trustees could find themselves in a difficult position.

Pressure to resolve the issue has been building for some time, forcing the Pension Regulator to step in with draft proposals on how pension schemes should put together formal policies on managing conflicts of interest. The Regulator, which lists conflicts of interest as one of the seven governance priority areas fundamental to the successful running of pension schemes, is clearly signalling that it wants to see a faster shift towards a more proactive approach to managing conflicts of interests.

In its "Conflicts of Interest Consultation Document" the Regulator notably encourages the appointment of independent trustees stating that they would inherently have no conflicts of interest and yet will still bring the knowledge and expertise needed to replace those directors stepping down from trustee boards.

Most part-time trustees are not pension experts and they usually have a day job to occupy their time and energy. With the role of the traditional fund trustee becoming increasingly complex, a large number of trustees do not have time to gain the necessary financial knowledge to deal with issues that can be crucial to the pension fund, such as, for example, assessing the investments risks of the pension scheme. Here, the knowledge and experience that independent, professional trustees can offer, would be invaluable in strengthening the trustee board and, at the same time, would give key executives more time to concentrate on running the business.

It makes sound business sense: many senior executives would rather spend more time focusing on corporate matters and consider their duty to the pension fund trustee board as bothersome. Independent trustees are a cost-effective solution to this problem.

In some ways independent trustees are an equivalent to companies' non-executive directors (NEDs) in the sense that they both play an important role in good governance. Just as the role of NED involves resolving conflicts of interest issues and ensuring board decisions reflect shareholders' interests rather than managements'; similarly, independent trustees can help ensure that decisions are made in the best interests of scheme members. In the last five years, the role of the NED has become a more high-profile job involving more significant responsibilities. In the same way, the role of trustee has grown in complexity and we are expecting independent trustees to take up more seats on trustee boards.

So now the momentum is clearly behind the belief that greater use of independent professional trustees is the best way of addressing conflicts of interest. Many larger schemes have already seen the benefit of appointing an independent trustee to their trustee board. The Regulator will publish its final proposals later on in the year. Schemes should consider taking action now, or risk finding themselves in a position where they have to put in place a comprehensive conflicts of interest management policy within a very short time frame. The Regulator has rung the alarm bell. Schemes can no longer afford to snooze and sidestep this crucial governance issue.

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