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Trustee GAAPS is a trading name of GAAPS Ltd - Registered in England No 315450
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TRUSTEEGAAPS
PROFESSIONAL RECRUITMENT OF INDEPENDENT TRUSTEES

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Deteriorating financial position of UK companies will exacerbate conflicts of interest on trustee boards

- **Any pension surpluses may encourage companies to reduce funding**
- **Inflation adds £56 billion to pension liabilities**

Conflicts of interest on trustee boards could be strained even further as companies look to reduce funding levels of pension schemes even as their financial positions deteriorate in the wake of the global downturn, warns Trustee GAAPS, the trustee search and selection firm.

According to Trustee GAAPS, trustees will need to guard against directors taking a short-term view and cutting funding levels because, although many schemes are currently in surplus, the risks to funding levels is growing.

The Pension Protection Fund (PPF) June index of the 7,800 largest schemes shows that scheme assets have fallen by 2% over the last year to £851.8 billion. Meanwhile, rising inflation is calculated to have added £56bn onto company pension liabilities in the last year (the amount pension funds must pay to retired members goes up as prices rise).[1]

David Johnson, Consulting Director, Trustee GAAPS, comments: "As the financial strength of UK companies weakens with the downturn the temptation to cut funding for pension schemes as part of wider cost-cutting measures will increase. The existence of surpluses built up over the last few years in some schemes, will make that temptation even harder to resist."

"The conflicts of interest of being a trustee and a director of a sponsoring company are hugely amplified in these difficult financial circumstances. Trustees in this position must struggle to secure the long term funding of schemes with one hand, while ensuring short term financial returns for shareholders with the other."

He adds: "Further market turmoil could easily undermine the financial position of schemes, piling even more pressure on trustees to maintain funding levels. If inflation breaks the 4% barrier, it will heap billions more on the liability of schemes."

Trustee GAAPS points out that trustees are already becoming jittery about the precarious financial position of sponsoring companies and the potential threat to payments into schemes.

Bradford & Bingley, for example, has pension liabilities of £589.8 million, but a market value of just £289 million.

[1] Figures by Redington Partners

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According to research by Mercer, the number of pension fund trustees commissioning independent covenant reviews has jumped by 55% in the past year, to 28% of all trustees.

Trustees of Trinity Mirror's pension funds recently appointed advisers to test the financial strength of the company as its market value fell below £500 million.

David Johnson says: "This is something we are going to see much more of in the current climate. Independent covenant reviews will become an increasingly useful tool for trustees as the business plans of companies get into debt."

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32% of pension schemes admit finance directors serving as trustees could lead to conflicts of interest

- **36% of surveyed schemes admit selecting trustees 'at the golf club'**

An astonishing 32% of pension schemes now admit that conflicts of interest could arise from finance directors of sponsoring companies acting as trustees, reveals new research from Trustee GAAPS, the trustee search and selection firm. There is mounting regulatory pressure to tackle conflicts of interest, which recently culminated in a consultation launched by the Pension Regulator[2].

The research also showed that the most popular method of selecting trustees is by personal recommendation from friends and acquaintances. 36% of schemes admit they restrict their recruitment of trustees to this ad hoc method.

According to Trustee GAAPS, these figures raise serious questions about good corporate governance on trustee boards and highlight how much more work needs to be done in order to achieve levels of corporate governance comparable to the standards on executive boards.

Corporate governance is the principle whereby the management of an organisation is ruled by values such as transparency, integrity and effectiveness. This includes the avoidance of potential conflicts of interest and, when this is not possible, ensuring that they are formally identified and addressed.

David Johnson, Consulting Director, Trustee GAAPS, comments: "It's astonishing that a third of schemes now recognise potential conflicts of interest may arise from finance directors sitting on trustee boards. It is an issue which has, up till now, been easy for them to sidestep."

"It's worrying that the most popular method of selecting trustees is personal recommendation. There are parallels here with how non-executive directors were selected ten years ago over a round of golf[3], which today would be seen by many shareholders as completely inappropriate. Why should scheme members settle for less?"

He adds: "While the Pension Regulator is increasingly encouraging schemes to become more proactive in preventing conflicts of interest from arising, there is clearly still a long way to go."

47% of schemes surveyed employ independent trustees. According to Trustee GAAPs, five years ago less than 25% of schemes would have used independent trustees.

2 Conflicts of Interest Consultation Document
3 Until the publication in 2003 of the Higgs Review on the role and effectiveness of non-executive directors in light of corporate governance

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David Johnson says that with schemes that do not have any independent trustees soon to be in a minority, pressure will intensify to remove conflicts of interest from trustee boards.

He says: "Five years ago employing an independent trustee made you a trendsetter. It is now rapidly becoming the norm. In another five years, schemes that don't will really be under the spotlight."

The survey also reveals that 52% of independent trustees remain on trustee boards for five years or more. According to Trustee GAAPS, serving too long on the trustee board can affect trustees' independence from the sponsoring company.

Explains David Johnson: "Just as with non-executives independent trustees need to be rotated on a fairly regular basis. If you stay on a trustee board for too long you are naturally going to lose your ability to challenge the status quo and bring a fresh pair of eyes to entrenched problems."

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Signs of declining governance standards in pension schemes?

- **Trustees concerned about their own skills to negotiate required funding levels and monitor service providers**

Research by the Pensions Regulator gives worrying signs that the standards of governance in employers' pension schemes may have slipped, says Trustee GAAPS, the trustee search and selection firm. According to the research, trustees are increasingly concerned about their ability to manage risk, monitor service providers and negotiate funding levels effectively.

Trustee GAAPS says that while trustees' general understanding of their role has seen an improvement, there are signs that trustees are themselves concerned that their ability to impose high standards of governance has waned over the last year.

According to the Pensions Regulator's Governance Survey, the percentage of trustee boards who "strongly agreed" they were "able to conduct effective negotiations with the employer in relation to scheme funding requirements" has declined from 66% to 61% over the last year.

Trustee GAAPS highlights that the ability to successfully negotiate funding requirements is a skill that has become essential, especially as stock market falls have put a dent in pension schemes' funding level.

Comments David Johnson, Consulting Director, Trustee GAAPS: "As corporate profits weaken, employers are more inclined to dig their heels in and prevent cash slipping off their bottom line and into their employees' pension scheme."

"Although employers' arguments can be very persuasive, trustees need to be aware that that such volatile investment markets are capable of turning healthy surpluses into deficits in a matter of months."

Difficulties to actively monitor risks and control service providers

The Pensions Regulator's Governance Survey also reveals that the number of trustee boards who "strongly agreed" that they "actively monitor service providers and professional advisers" has declined from 52% to 41% while the number who 'have appropriate internal controls to manage risk' has declined from 51% to 48%.

David Johnson, comments: "Trustees are under great pressure as their role and responsibilities are becoming more complex. It may be that, as portfolio investments continue to diversify across asset classes, trustees feel that their ability to keep a proper oversight over their advisers such as fund managers becomes challenged."

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Trustee GAAPS says that the growing complexity of the trustee role is causing part-time trustees to withdraw from the market, while the vacancies are being increasingly filled by professional independent trustees.

David Johnson concludes: "Trustees are putting great efforts into improving governance standards, but as their job description widens and as they come under ever-greater scrutiny from the Pensions Regulator, they are likely to be feeling the strain."

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Pension schemes say difficulties in recruiting member nominated trustees particularly acute

- **69% say recruitment problems centre on member nominated trustees**

Data from the Pensions Regulator shows that pension funds are finding it particularly hard to recruit "member-nominated" trustees, says Trustee GAAPS, the trustee search and selection firm.

Recent research by the Pensions Regulator found that of those pension funds that were finding it hard to recruit trustees 69% said that their problems lay in recruiting member nominated trustees.

Trustee GAAPS says that schemes are struggling to meet their legal obligation to appoint at least one-third of their trustees from among the scheme members. This is becoming more difficult as the growing complexity of the trustee role makes serving as a member-nominated trustee less and less attractive.

Comments David Johnson, Consulting Director, Trustee GAAPS: "Recruiting member nominated trustees is a growing concern for many trustee boards. There is a diminishing incentive for members of occupational pension schemes to take up what is tantamount to a second job as a trustee without any remuneration."

"The role of trustee is becoming increasingly complex, which inevitably means there are fewer people qualified to do it."

He adds: "So few employees are now willing to become member nominated trustees that there is the risk that trustee boards will be forced to accept the first person who volunteers rather than be able to pick and chose. If the reservoir of potential member nominated trustees keeps shrinking it will eventually impact on the quality of the trustee board's decision making."

Trustee GAAPS points out that employers who struggle to appoint suitable trustees among their scheme members and are concerned that the pressure to meet the 'one third' quota would compromise the quality of the trustee board can appoint an independent trustee as an alternative.

Trustee GAAPS says that the Regulator's growing focus on eradicating conflicts of interest on trustee boards, culminating in the publication of fresh guidance on conflicts of interest on October 1 2008, could act as another factor to hinder the recruitment of member-nominated trustees.

David Johnson explains: "Member-nominated trustees are often members of trade unions, so there are certainly situations where conflicts of interests may arise. For example,

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member-nominated trustees might be tempted accept lower contributions from employers in exchange for other benefits, which may be in the interest of the current workforce, but not of the scheme members who are already retired and in receipt of benefits."

David Johnson concludes: "Recruiting trustees from among scheme members is only likely to become more problematic, both as the role becomes ever more demanding, and as reducing conflicts of interest assumes a greater priority for the Regulator."

16% of all pension schemes say they are reporting difficulty in recruiting trustees.

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Scramble to hire professional trustees as Regulator says independent trustees should chair pension trustee board

- **Regulator to intervene and remove conflicted trustees of pension funds**

A surge in the use of professional pension fund trustees is expected as new guidelines from the Pensions Regulator state that pension trustee boards should be chaired by independent trustees says Trustee GAAPS, the trustee search and selection firm.

According to Trustee GAAPS, only a small minority of pension schemes currently have truly independent trustees chairing the trustee board.

The Pensions Regulator's guide on conflicts of interest published on October 1 2008 follows a consultation launched earlier this year (April 2008), and is designed to help pension schemes manage conflicts of interest and raise standards of governance on trustee boards.

There has been a growing awareness of the difficulties that a pension fund trustee, who is also a director of the company that is funding the pension scheme, has in balancing their duties to the pension fund members and to the shareholders of the company they work for. For example, conflicts of interest can be created during negotiations over funding levels paid by the company to the pension scheme.

With companies facing more economic stress the temptation to try and reduce payments to pension schemes increases.

According to Trustee GAAPS, this is the first time that the Pensions Regulator has taken such a robust stance against conflicts of interest by explicitly recommending schemes appoint independent trustees to chair trustee boards. The Regulator also drew attention to its determination to intervene and remove trustees where conflicts of interest are not being managed appropriately.

The Pensions Regulator has also stated that smaller schemes that do not have sufficient resources to hire full-time independent trustee should appoint them on a contract basis, for example during a particular decision-making process.

David Johnson, Consulting Director at Trustee GAAPS comments: "This is a huge step forward and raises the standards of governance and protection for pension schemes closer to the level that pension fund holders deserve. The Regulator has clearly called for pension schemes to up their game and it will expect trustee boards to step into line."

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"The Regulator is becoming increasingly determined to clamp down on conflicts of interest. Schemes that don't have a single independent trustee are likely to come under much greater scrutiny."

"For the first time the Regulator has formally stated that the chair of trustee boards should be independent. At the moment only a small minority of schemes have truly independent chairs, so this is likely to precipitate a scramble for professional trustees. In fact a lot of schemes still have a director of the sponsoring company chairing the trustee board, which in view of the Regulator's threat to remove trustees, is bound to cause discomfort."

"One of the key responsibilities of the chair is to manage conflicts of interest. It is therefore vitally important that the person in that role is to a large degree independent and not conflicted."

Adds David Johnson: "Even small schemes, which have up until now been under the Regulator's radar to a large extent, are now firmly in its sights. By endorsing the use of independent trustees on a contract basis, the Regulator is making every effort to pre-empt the usual reasons small schemes have for not using independent trustees."

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