Governance and Corporate Governance in Pension Funds

Pension Reforms in the country have a potential to institutionalize retirement savings and help individual's meet their retirement goals. However, the issue of Corporate Governance needs to be addressed at all levels for safeguarding the interest and adding value to all stakeholders.

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Pension Funds are major financial institutions having enormous power to influence Socio-Financial Economy. Though primarily they are institutions to accumulate retirement savings, managing investment of accumulated savings and creating wealth for providing post retirement income for their members; they also play a crucial role in promoting financial inclusion and financial deepening in the economy. With huge financial assets at their command, pension funds provide fillip to economic growth through capital market development. The pension funds in modern economy touch every walk of socio-economic life directly or indirectly. However the immensely potential and influencing role of pension funds can be translated into operational achievement if they are managed effectively. Here comes the crucial question of quality governance policy and structure in Pension funds governance.

Governance challenges in Pension Funds are multi faceted and multi dimensional; and the extent of challenges may differ from country to country depending on the pension fund regulatory regime, market environment, sponsored of the funds, real expectation of the sponsors, ethical practices in business, quality of management and governing board etc. However certain generalization is possible in view of the basic objective of pension funds i.e. to provide maximum risk adjusted return to its members. The nature of challenges confronted by pension funds in Defined Contribution (DC) System differs from that of Defined Benefit (DB) System. We, however, would focus on pension funds in DC System like New Pension Scheme (NPS). The distinctive character between the two is the investment risks. While investment risks in the DB System is borne by the pension providers, investment risks in the DC System is transferred to the investors .This makes governance of the funds essentially more complex and critical.

The System Contour

In a Defined Contribution pension system like NPS, there are several entities which are involved in collecting contribution, managing accounts and records, managing investment and administering pay outs. In NPS funds collection is the function of government designated entities for the Central & State Govt. funds and PFRDA designated POPs collect the funds for All Citizens Scheme. CRA is responsible for Record Keeping and Fund Accounting; while Pension funds undertake the Investment Management. Funds are collected by designated collecting bank, and Custodial Services perform by a Designated Custodian. Further there are Central Regulator i.e. PFRDA and single Central Board of Trustees i.e. NPS Trust. All of them are individually and jointly responsible for managing retirement savings and pension funds of the subscribing members. Defined Contribution Pension Fund architecture therefore involves a large number of stake holders. Pension funds governance therefore becomes a very complex issue since a large number of stakeholders are actively involved. Unless governance system includes all the stakeholders in managing pensions, risk may be transmitted through them. It is critical, because there are no pension guarantees or any assured returns and therefore utmost care needs to be taken to ensure optimum rate of return. This is possible if the funds are administered efficiently in a cost effective manner. Therefore pension fund governance has a wider connotation-while each individual entity must have its own governance format and parameter, there should also be a governance system and identified system parameters for the entire NPS. We however, restrict our discussion on Governance to Fund Management Company.

Funds Management Governance

The issue of governance occupies prime importance due to the objective and nature of activities of pension funds. Pension funds pool resources form investing public and it remains with them for a very long period say 30 to 35 years and therefore prudential administration and investment operations are essentially important to optimize risk adjusted long term return. In India Pension Fund Managers (PFMs) under the NPS are companies who are registered under company Act and authorized by PFRDA to manage pension fund assets under New Pension System effective from 1st January 2004. Pension Fund Managers are the most important entity in the pension system as they are accountable for managing funds with expertise and generate highest possible return for the members. Quality of governance has a direct bearing on the efficiency and performance of pension funds which are crucial for protection and enhancement of retirement income. An interesting study by Keith Ambachtsheer (2007) observed that "High –Quality funds outperformed low quality funds by about 2% per annum." Therefore institutionalization of high quality governance is very essential for performance management in pension funds.

Sources of Good Governance

Good Governance practices in a pension fund depends on a number of factors like prudential regulations with clear direction, Company Governing Board with a clear vision, a competent operational Management team with knowledge, expertise, commitment to excellence and superior performance. Basically two important sources of good Governance are: Regulatory Regime (RR) and a well documented Internal Control System (IRS). Internal control improves the management efficiency while regulation acts a safety measure to protect the investors' interest. Good Governance therefore establishes a linkage between the two and imparts efficiency in pension fund administration which in turn influences fund management performance. However these are basic instruments of good governance, but they are required to be implemented sincerely by the operating management team under guidance and monitoring of the governing board. Good governance, however, primarily depends on the sense of responsibility, accountability, self governance of the management team. Some of the important areas which promote good governance are:

- Efficiency in internal administration
- Efficiency in Compliance Management
- Efficiency in Cost Management
- Efficiency in Investment Management
- Efficiency in timely information disclosure

Able and efficient internal administration of a pension fund will enable the fund to reduce the time lag between collection and investment, minimize the collection and distribution costs, minimize the operation and investment costs etc. which will be ultimately reflected in value enhancements in the accumulated assets. Cost management in Fund Administration assumed great importance because higher costs may reduce the quantum of terminal assets. OECD (1999) has observed that "one percent charge on assets managed per year can reduce the accumulated balance at retirement by between ten and twenty percent, in a forty year contribution record at different return scenario."

The major area of governance concern in a pension fund is however, the investment management function, the core to pension fund operation. Primarily the fund management activities are governed by the Investment Regulation / Guidelines issued by the Regulator, which is quantitative in nature in India. However, prudence is required while managing funds with reference to investment guidelines. Investment Strategy is very critical for investment management since investment is made in an uncertain market environment, which undergoes several market cycles, changes in interest rate regime, and inflationary threat. In such a situation, an appropriate investment strategy is very essential. Investment activities like stock selection, duration matching, portfolio reallocation, secondary market trading etc need careful consideration based on experience and knowledge. Governance must also important to contain attitude of the fund manager to take undue extra risk for short term gain, which may seriously affect the long term portfolio return adversely. Therefore governance in investment management is very critical for return and safety of funds.

The Role of Corporate Board

The external Regulation and internal control sets the governance format and operating management required to manage the funds accordingly to promote good governance practices. However, these idealistic expectations often remain unfulfilled due to several pressure and constraints. Vision, Mission and Wishes of good governance remain merely statement of intent. Here the role of Corporate Governing Board assumes great significance. A competent Board without any outside/ external pressure can emerge as a guiding force behind the operating management and good governance become a reality. Many studies have indicated that good governance and high performance of a pension fund influenced to a great extent by the governing board. But there are certain pre-conditions for establishing an active and performance oriented governing board. Many authors have mentioned several factors and following are a few of them:

- The desire of the sponsor to have a board with members who possess requisite knowledge, expertise, willingness to act in the broader interest of the members of the funds and stake holders.
- The members of the board should have necessary time and interest in taking initiative to promote competency and performance oriented functional management through knowledge based and direction based support.
- The board must be capable and competent enough to take independent decisions to resolve conflict among the stakeholders namely sponsor, functional management and pension fund members.
- All the board members irrespective of outside status must work to attain the fund objective in unanimous manner. The board must be cohesive and competent to oversee the implementation regulatory requirements, provide necessary and timely support to the functional management.
- The board must have necessary competence in understanding relevant legal , regulatory issues as well as basic operational constraints confronted by functional management and desire to resolve them in the within shortest possible time to avoid cost escalation , conflict and operational constraints.
- While the board members independently and jointly are responsible for policy accountability, they should delegate appropriate functional authority to the operational management to remove possible operational constraints and make them responsible and accountable for performance in the best interest of the members of the fund.

Regulatory Regime

Regulatory regime has an important role in promoting good governance practices in pension funds. Regulations not only provide a general framework of Governance but also act as a facilitator. Since knowledge, expertise, commitment for excellence are important requirements for governance, quantitative regulation should be supported by Prudent Person Rule.

In NPS, many important provisions are incorporated to create a format of good governance. As per PFRDA guidelines; the activities of a Pension Fund are directed and guided by a Board of Directors constituted with 50% independent Directors, which provides direction to the company monitor their performance and oversee the actions and performance. There is a mandatory Investment Committee constituted with at least two Independent Directors, Chief Executive Officer, and Chief Investment Officer and a Risk Management Committee constituted with at least one independent Director, Chief Executive Officer and designated Risk Officer. The performance and investment activities are also regularly monitored and reviewed on quarterly basis by the NPS Trust. It is the responsibility of the governing Board and operating management team to implement the regulations.

Corporate Governance

Pension funds have an immensely influencing role in promoting quality of corporate governance in the corporate sector. Pension funds play a very significant role in promoting capital market by creating demand for various financial instruments in order to diversify investment risk of portfolio. Pension funds invest in corporate securities for a long term and in their own interest would like that the corporate are managed efficiently and in a transparent manner. The Pension funds are able to force the corporate to adopt a more transparent method of information disclosure. Voting rights are given to pension funds in many countries and they can influence the corporate policy in the interest of general shareholder and their own investors. Pension funds can also improve the role of independent Directors in the Company. Pension funds in the years to come will exert considerable influence on corporate sector by virtue of being one of the largest investor.

There is strong evidence that pension reforms through introduction of Defined Contribution Scheme exerted significant influence on capital market development in Latin American countries, which were the first in introducing such reforms in 1981. But to exert a meaningful influence on the corporate governance of capital market entities, pension funds themselves need to have quality governance practices. The questions to be asked here are; what are prerequisites, formats and constituents of such quality governance.

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