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Mabbett, Deborah (2020) Expertise in pension trusteeship. In: Agnew, S. and Davies, P. and Mitchell, Charles (eds.) Pensions: Law, Policy and Practice. Oxford, UK: Hart. ISBN 9781509922703. (In Press)

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## **Expertise in pension trusteeship**

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Forthcoming in S Agnew, PS Davies and C Mitchell (eds), *Pensions: Law, Policy and Practice* (Oxford: Hart, 2020).

Acknowledgements: I am grateful to the editors, particularly Charles Mitchell, for their comments and suggestions on earlier drafts of this chapter. I am also grateful to my fellow members of the Joint Expert Panel on the UK Universities Superannuation Scheme, from whom I have learned a lot about pension scheme valuation and governance. All remaining errors and contentious interpretations are my own responsibility.

## **1. Introduction**

Occupational defined benefit (DB) pension schemes in the UK are generally constituted as trusts, placing control over pension fund assets in the hands of trustees who make or shape decisions about investment, contributions and benefits. Regulatory reforms since the turn of the century have fastened on trustees as crucial actors in pension scheme governance. Reforms have sought to strengthen their role, define their responsibilities, and improve their qualifications. In this paper, I examine the hopes and expectations of these reforms. More trustee expertise has been advocated as the solution to two quite different kinds of problem: increasing the security of pension promises and reducing the risk of calls on public funds, and improving schemes' investment strategies. These different problems are matched by different conceptions of what expertise really entails. I argue that there has been a tendency to promote expertise in the form of conventional and shared knowledge. This has created an illusion of greater security in pension promises, and has done nothing to improve schemes' investment strategies.

It is commonly said that trustees have wide discretion, but in the context of pension funds this claim is misleading. Trustees have to make decisions and find solutions that are acceptable to employers, members and the regulator. While only the regulator has a formal (if rarely exercised) veto power over trustee decisions, employer agreement is necessary for decisions on ongoing contributions to a pension scheme. Disaffected employers can respond to trustee demands by closing the scheme to new members or new accruals. Even members can respond if they are not satisfied with trustee decisions: they can sometimes choose not to join a scheme, they can negotiate a cash alternative, and via employer-union negotiations they can influence employers' decisions.

These possibilities for exit may seem remote, but many occupational pension schemes have closed in recent years, so exit is happening. This may be for reasons unrelated to trustee decisions, or because trustees are powerless to make a difference given the pressures that schemes are under. However, closure may also indicate that trustees have exercised their discretion poorly, and have failed to steer a course sufficiently close to the interests of the parties to prevent exit. The following discussion explores this possibility. Specifically, it examines whether moves to enhance the financial expertise of trustees could have had the effect of propelling more schemes towards closure.

At first sight, this is a counterintuitive hypothesis. More financial expertise should mean that funds are better managed, increasing the size of the pension 'pie' and making it easier for trustees to settle on decisions which satisfy the conflicting interests of the parties. However, when one looks carefully at what financial expertise is meant to bring to pension management, few claims are made for 'pie', and the evidence reviewed below is inconclusive and even sometimes negative. The reason for this can be summarised briefly as follows. If financial markets are efficient, it is not possible systematically to 'beat the market'. Star managers cannot deliver 'alpha': sustained outperformance in a particular asset class. Instead, a pension fund's investment performance will depend on two things: the selection of asset classes, and the fees and commissions incurred. By

investing in riskier classes of asset, a pension fund can achieve higher returns. For reasons discussed below, financial experts may advocate low-risk investment, which will mean less ‘pie’.<sup>1</sup>

Thus the appointment of more financial experts to be pension fund trustees is not generally advocated on the grounds that it will mean that the scheme will achieve investment outperformance. The following discussion takes a close look at exactly what advocates of more expertise have sought. It is shown that advocates have rested their arguments on two opposing conceptions of financial expertise. One, which I term ‘pluralist’, sees expertise in terms of capacity to challenge, contest and argue. This is the conception advanced in the 2001 Myners Review of institutional investment in the UK. This review is often seen as the inspiration for reforms to trusteeship in the 2004 Pensions Act, and yet the promotion of trustee expertise subsequent to that Act has embraced a quite different conception, in which expertise means a common body of knowledge and understanding. It is argued below that the incentives of the regulator have contributed to the promotion of this conformist or conventional notion of expertise. Conformist experts may choose policies which are close to the preferences of the regulator but too distant from the interests of employers and members to ensure scheme survival.

The following discussion starts by reviewing available studies on the difference that trustees make to outcomes. The lack of conclusive evidence of a relationship between trustee expertise and scheme performance presents a puzzle: why has there been such a drive to enhance expertise? Focusing on the UK case, section three takes up the arguments of the Myners Review in detail, and section four describes how trustee expertise has been promoted post-Myners. Section five reviews theoretical accounts of the tension between representation and expertise, and examines why experts might not have the same preferences over outcomes as members and employers, and section six concludes by drawing out some implications of the expertise-based distancing of trusteeship from member and employer engagement.

## **2. Expertise and the size of the pension fund pie**

Funded pension schemes gather contributions now and promise to pay pensions later. For schemes to thrive, the promise must be credible. The employer’s backing is one source of credibility, but the thrust of regulatory change in UK occupational pensions has been to create another source of credibility, based on the pension fund itself. There is a focus on valuation: the promise is credible if the fund can be demonstrated to be adequate to meet the commitments that have accrued. But the process of valuation leaves margins of discretion, and members’ confidence in the exercise of discretion depends on the governance of the fund. Members themselves are not in a position to take decisions about the investment strategy of the fund, nor to establish an appropriate discount rate for

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<sup>1</sup> One of the most reliable ways to increase the pie is to reduce costs. One way to do this is to adopt a passive (index-tracking) investment strategy, which should mean that the scheme matches benchmarks for the asset classes chosen, while incurring minimal costs. Another way is to create larger schemes which can take advantage of economies of scale to reduce costs. Insofar as such schemes could also support more expertise on their trustee boards, this can mean that expertise is correlated with lower costs, but this is not necessarily a causal connection.

liabilities (accrued commitments). The task of making these decisions is delegated to trustees.

Trustees are a particular kind of agent. One of their distinguishing features is the suppression of their own pecuniary interests: the duty of loyalty requires them to act without regard to their personal gain. Traditionally, trustees have often executed their functions without payment, a practice which emphasised their lack of financial interest in the trust. Pension fund trustees are nowadays usually paid in compensation for the time they spend, but they do not have incentive contracts which reward them for achieving specified outcomes. Such a contract would be wrong in principle as it presumes that trustees are financially motivated; it could also be seen as fettering the discretion of trustees in the direction desired by the incentive designer.

In large UK pension funds, there are usually three groups of trustees: employer nominated trustees (ENTs), member nominees (MNTs) and 'independents', selected for their expertise, particularly in investment matters. In DB schemes, ENTs have a strong incentive to put effort into enhancing the performance of the scheme, as employers are the residual claimants: they have to make up deficits, and they benefit from surpluses through reduced contributions.<sup>2</sup> However, while ENTs have clear incentives to control administrative costs, their effectiveness in enhancing investment returns is more contentious. They have incentives to seek high returns; the difficulty is that they also have incentives to accept risk, perhaps excessively so. If corporate decision-makers contemplate insolvency with equanimity, they have a one-way bet. Either the strategy pays off, or the employer becomes insolvent and defaults on its obligations to the scheme. As the next section discusses, statutory efforts to strengthen the institution of trusteeship, and make trustees more independent of the employer, followed from employer failures.<sup>3</sup>

In the (presumably) more general case where insolvency is not in prospect, Exley et al<sup>4</sup> drew on the insights of financial economics to argue that a pension scheme that uses a risky strategy to meet its liabilities imposes a hidden cost on the shareholders of the firm, who are bearing more risk than they (may) realise. If shareholders are alert to the risks being taken with their equity, they should insist that the pension fund is de-risked, and place a discount on the market price of equity if this is not done. It follows that attention to shareholder value maximisation may raise the cost of pension schemes.<sup>5</sup> However, there is no conclusive evidence that shareholders 'punish' employers for pension scheme risks.<sup>6</sup>

If ENTs have incentives to favour a high-risk, high-return investment strategy, this might be countered by MNTs concerned to ensure that members' benefits are safe. But the

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<sup>2</sup> Besley T and Prat A, 'Credible Pensions' (2005) 26 *Fiscal Studies* 119, 128.

<sup>3</sup> Mesher J, 'The Operation of Pension Funds' (1992) 21 *Industrial Law Journal* 232.

<sup>4</sup> Exley CJ, Mehta SJB and Smith AD, 'The Financial Theory of Defined Benefit Pension Schemes' (1997) 3 *British Actuarial Journal* 835.

<sup>5</sup> Monk AHB, 'The Financial Thesis: Reconceptualizing Globalisation's Effect on Firms and Institutions' (2009) 13 *Competition and change* 51

<sup>6</sup> Orszag JM and Sand N, 'Corporate Finance and Capital Markets' in Clark GL, Munnell AH and Orszag JM (eds), *The Oxford Handbook of Pensions and Retirement Income* (OUP 2006).

choice of investment strategy for MNTs is complex.<sup>7</sup> If the employer's backing in case of deficits is secure, and at the same time any surplus accrues to the employer, MNTs have no reason to concern themselves with asset allocation. If there is a possibility of employer default, MNTs will tend to favour a lower-risk investment strategy than the employer, and instead press the employer to repair the scheme by increasing contributions. In this situation, MNTs might act as a counterweight to employer influence over the running of the scheme. But if a scheme is threatened with closure or if there is cost-sharing between employers and members, MNTs may tilt towards seeking higher investment returns. The assessment of the costs and benefits of risk-taking will be different for different cohorts of members, from pensioner members to recent joiners. For pensioners, a low risk strategy may be most effective in protecting their benefits. For the workforce, a low-risk investment strategy means higher demands for contributions, which will mean lower take-home pay if there is cost-sharing.<sup>8</sup> If the employer sees the scheme as too costly and closes it, younger members are worst affected. It follows that MNTs who are oriented towards the current and future workforce may accept more risk than those who are oriented towards protecting the benefits of pensioner members.

Some indirect evidence that MNTs do not always force employers to reduce risk and pay more contributions comes from experience in the UK in the decade after the Pensions Act 1995. This Act mandated that boards should have at least one-third MNTs, although there were loopholes. But MNTs apparently failed to force more conservative strategies on employers, leading to further statutory changes in 2004. These sought to change the weight of MNTs' concerns towards conservatism by, among other things, promoting more representation of pensioner interests.<sup>9</sup> Since the 2004 Act there has also been a sustained drive towards having more independent trustees. For reasons discussed below, independents may promote less risky investment strategies.

Turning to the available evidence, a much-cited UK study found that, the more control the sponsoring company exercised over the pension fund (measured by the proportion of ENTs), the more likely it was to pursue a high-risk, high-return investment strategy.<sup>10</sup> The authors interpret this as an agency problem, with employer nominees more inclined to take risks with members' benefits. But this interpretation has been challenged. For example Phan and Hegde<sup>11</sup> argue that high-risk and return investment strategies are associated with sponsoring employers that are in a strong position to bear risk in their

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<sup>7</sup> Some sense of this complexity can be gained from an epic study by McCarthy and Miles which showed how trustees' preferred investment allocation will depend on the security of the employer covenant, the existence of insurance (e.g. a Pension Protection Fund) and the current level of scheme funding. McCarthy and Miles do not distinguish between trustee types, but their account fits the problem facing a trustee who seeks to maximise the welfare of scheme beneficiaries. See McCarthy D and Miles D, 'Optimal Portfolio Allocation for Corporate Pension Funds' (2013) 19 *European Financial Management* 599.

<sup>8</sup> Most economists would expect that higher employer pension contributions reduce take-home pay even in the absence of formal cost-sharing.

<sup>9</sup> Cockerill V, 'Does size matter — How should trustees approach the new member trustee requirement?' (2006) 12 *Pensions* 12.

<sup>10</sup> Cocco JF and Volpin PF, 'Corporate Governance of Pension Plans: The UK Evidence' (2007) 63 *Financial Analysts Journal* 70.

<sup>11</sup> Phan HV and Hegde S, 'Corporate Governance and Risk-Taking in Pension Plans: Evidence from Defined Benefit Asset Allocations' (2012) 48 *Journal of Financial and Quantitative Analysis*.

scheme because they are protected by anti-takeover provisions, and that this is to the benefit of members. More generally, there is a fundamental disagreement in the literature between those who think that any employer-sponsored risk-taking is suspect<sup>12</sup> and those who argue that an employer might choose to use its risk-bearing capacity to offer an attractive contract to employees. On the latter interpretation, it can be in the employer's business interest to control contribution costs by taking investment risk.<sup>13</sup>

Andonov et al<sup>14</sup> examined how trustee board composition affects the investment strategy of US public (state and municipal) pension funds, and found that boards containing more politicians engage in more risk-taking, which they interpret as arising from political incentives to maintain a high discount rate and thereby make the funding position look strong, postponing difficult decisions about contributions and benefits. They also found that the presence of elected plan participants (MNTs) leads to riskier strategies. Accrued benefits are less well-protected in the US than the UK, so MNTs may be acting on a desire to delay reforms which could have negative effects for them. Andonov et al also argue that overall plan performance suffers from acting on these incentives, but their evidence for this is open to interpretation. They find that public funds with politician-trustees marginally underperform the benchmark for each asset class they invest in, but they do not find that risk-taking damages the overall performance of the fund. In other words, it is possible that risk-taking pays off, despite the suspect political incentives that induce it.

Harper<sup>15</sup> also examined the asset allocation and investment performance of US public pension plans, and reached conclusions which are partly consistent with Andonov et al and partly contradictory. Focusing on outsider trustees with expertise, he found that they had no effect on benchmarked investment performance, but they promoted a more conservative asset allocation (a lower share of investment in equities). This is the mirror image of Andonov et al's finding that politicians promote more risk-taking, but contrary to them Harper found that the presence of elected MNTs correlated with a higher funding level, giving more security to members' pensions.

The extensive literature review in Harper indicates that researchers have struggled to find robust relationships between trustee board characteristics and various performance outcomes. The findings of the wider finance literature that 'alpha' (outperformance in a specific asset class) is elusive are not refuted, but some relationships between board composition, risk-taking and funding levels are found. These findings cannot prove that outside experts make 'better' decisions without knowing what risk profile or funding level is optimal for the scheme. Clearly deep and sustained underfunding is undesirable, but the proportion of funds in this position is small and the causes of their difficulties multiple, preventing generalisations about their governance. Furthermore, Harper notes

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<sup>12</sup> See eg Exley et al (n 4).

<sup>13</sup> Blake D, 'UK pension fund management after Myners: The hunt for correlation begins' (2003) 4 *Journal of Asset Management* 32.

<sup>14</sup> Andonov A, Bauer R and Cremers M, 'Pension Fund Asset Allocation and Liability Discount Rates' (2016) Unpublished paper.

<sup>15</sup> Harper JT, 'Board of Trustee Composition and Investment Performance of US Public Pension Plans' (2008) Rotman ICPM Working Paper.

that there might be endogeneity: funds with certain attributes pick trustees who fit those attributes.

These issues have not deterred advocates of more expertise in pension fund governance, who have assembled other evidence to support their position. Clark claimed that ‘there is a significant premium associated with the proper internal governance of pension funds’.<sup>16</sup> However Clark’s conception of that premium is very general; he does not attempt to test the quality of pension fund governance by measuring a premium in investment returns. A later study by Clark and Urwin<sup>17</sup> did argue that ‘good governance’ generated higher long-term risk-adjusted rates of return, but they presented no evidence of this, and indeed noted that a high level of ‘noise’ around investment outturns prevents statistical inferences being drawn. Instead, their method was to examine the governance arrangements of a number of funds which have performed well against their own benchmarks, and thereby identify what appeared to be the key elements of good governance. These key elements turn out to be primarily about clear understanding of goals and effective delegation, rather than trustee skills as such.

Ambachtsheer et al<sup>18</sup> claimed to present evidence of a ‘positive correlation between governance quality and fund performance’. Their measure of ‘governance quality’ was based on the judgments of senior executives in 81 pension funds. Fund performance was measured as ‘Net Value Added’ (NVA), which is excess returns relative to a passive investment strategy, net of investment expenses. As the authors acknowledged, the NVA metric has some limitations and the time period for the assessment was rather short. Furthermore, CEOs’ subjective assessments of governance quality could be affected by fund performance, implying reverse causation.

Ambachtsheer et al found that assessments of governance quality are correlated with an indicator of ‘oversight/ management costs’. They argued that poorly-managed funds underinvest in oversight and management, and they found the correlation of costs with governance quality ‘an encouraging finding’: ‘the CEOs and boards of governors of the high-scoring funds are putting their money where their mouth is’.<sup>19</sup> Clearly other interpretations are possible. CEOs may simply see spending, notably on executive pay, as an indicator of quality. If the results on NVA are robust, it may be that executives in funds which achieve positive NVA capture these returns in management remuneration, raising management costs. There is little that is ‘encouraging’ for pension fund members in these findings; instead, they are a salutary reminder that expertise tends to come at a price.

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<sup>16</sup> Clark GL, 'Pension fund governance: expertise and organizational form' (2004) 3 *Journal of Pension Economics and Finance* 233, 237.

<sup>17</sup> Clark GL and Urwin R, 'Best-practice pension fund governance' (2008) 9 *Journal of Asset Management* 2.

<sup>18</sup> Ambachtsheer K, Capelle R and Lum H, 'The state of global pension fund governance today: Board competency still a problem' (2007) ICPM Working Paper.

<sup>19</sup> *Ibid*, xi.

Finally, Davis<sup>20</sup> cited a study by the Australian Prudential Regulation Authority which found that investment returns in corporate funds with lay trustees outperformed returns on retail funds with expert trustees. The findings, while clear, do not address the question of whether occupational pension funds with expert trustees outperform those with lay members, as retail funds have different characteristics to occupational funds. Their costs are higher, at least in part for justifiable reasons to do with scale and account administration. Critics also argued that the findings were not appropriately adjusted for risk. Retail funds had adopted lower-volatility investment strategies, which arguably they have to do because there is no corporate sponsor to bear risk. What the study really shows is that employers' willingness to bear risk in DB pensions is potentially a significant benefit to those workers who are covered, if it is reflected in the investment strategy.

Summing up, it is difficult to demonstrate that trustee expertise is correlated with superior performance by pension funds. There is some evidence that independent trustees steer funds towards lower-risk investment strategies, and authors writing from a conventional financial economics perspective tend to interpret this as a sign of good governance. Others are inclined to assume that expertise is inherently a good thing, especially given evidence that non-experts make elementary mistakes in interpreting financial risk and choose inconsistent strategies, but the benefits of expertise are not clearly revealed by statistical measures.

### **3. Expertise in the Myners Review**

In the UK, the sustained drive to enhance trustee expertise can be traced back to the Myners Review of 2001.<sup>21</sup> Boeri et al<sup>22</sup> applauded Myners for 'blowing the whistle' on the low level of financial literacy among pension fund trustees. Surveys conducted for the Myners Review<sup>23</sup> and by a team led by Gordon Clark at Oxford University<sup>24</sup> confirmed that both ENTs and MNTs had deficient knowledge of financial markets and investment issues.

The primary focus of the Myners review was the overall performance of institutional investors in the UK economy. Myners was asked by the Labour government to consider how investment practices could be made less oriented to achieving short-term gains on the stock market and more supportive of long-term 'patient' investment. Pension funds, with their high levels of funds under management and long-dated liabilities, were a natural focus for this enquiry. However, trustees were not a natural focus: it was Myners' decision to put them centre-stage. This section seeks to demonstrate that Myners adopted a pluralistic view of desirable trustee expertise, while the next section shows that this orientation has been lost in the subsequent drive to equip trustees with a received conventional understanding of finance and investment issues in pensions.

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<sup>20</sup> Davis RB, 'The survival of the trustee model of governance in the era of financial engineering' in Donald MS and Butler Beatty L (eds), *The evolving role of trust in superannuation* (The Federation Press 2017), 112.

<sup>21</sup> Myners P, *Institutional Investment in the UK: A Review* (HM Treasury 2001).

<sup>22</sup> Boeri T and others, 'Dealing with the New Giants: Rethinking the Role of Pension Funds' (2006) Geneva Reports on the World Economy 8, 26.

<sup>23</sup> Myners (n 21) Appendix A.

<sup>24</sup> Clark (n 16).

Myners' main concern was that the relevant segment of the financial services industry – the market for investment consultancy and management – was highly concentrated and had developed a structure of competition which did not serve the interests of ultimate beneficiaries well. Investment managers competed to hit performance benchmarks. Trustees, presented with a market organised around these benchmarks, could conduct fund manager 'beauty parades', assessing the performance of managers against their peers. But this was not good practice: it resulted in herding around stock-market indices; where there was active investment management, it was short-term in its goals and costly in execution, with fees levied for transactions when a 'buy and hold' strategy would be a better fit with pension fund objectives.

Myners alighted on trustees as the actors in the system who could change these practices, and had incentives to do so. However, he argued that they did not know and understand the industry well enough to challenge the advice of consultants. They lacked the resources and expertise to make investment decisions well. They spent insufficient time and effort on questions of asset allocation, and did not develop investment strategies to match their prime objective of meeting pension obligations.<sup>25</sup>

Two themes recur throughout the Myners report: the need for advice to be contested and challenged, and the desirability of adopting an investment strategy that fitted the particular nature of pension fund liabilities. Myners emphasised that funds had different liability structures (some had more older and pensioner members, others a more youthful profile<sup>26</sup>) as well as different 'risk appetites' on the part of the sponsoring employer. Taking these factors into account, trustees should adopt 'scheme specific' investment strategies. This emphasis on 'scheme specificity' was central to Myners' critique of the impact of regulation on pension fund investment. The 1995 Pensions Act had established a regime for checking that the accumulated assets of pension funds were adequate to cover the benefit promises that had been made (the liabilities that had accrued). Central to this regime was a valuation procedure centred on the Minimum Funding Requirement (MFR). Myners argued that this procedure had driven funds to make investments which matched the reference assets used to calculate MFR discount rates. The valuation rules were distorting funds' investment decisions, and doing nothing for the security of pension promises in the process.<sup>27</sup>

If trustees were to challenge investment consultants and insist on scheme-specific strategies, they needed to understand investment advice as well as knowing the nature of their own scheme. This implied that it was not sufficient that trustees seek expert advice; they should have some expertise themselves. Furthermore, the ideal trustee was not necessarily an industry 'insider', because trustees should be inclined to challenge the assumptions of advisers and the conventions of the industry. MNTs could fulfill this function: Myners did not see a conflict between his proposals for more trustee expertise and the statutory requirements for trustee boards to include a certain proportion of MNTs.

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<sup>25</sup> Myners (n 21) 1.

<sup>26</sup> Ibid 3.28 and fn 5.

<sup>27</sup> Ibid, Summary paragraph 64.

Trustees should think of themselves as accountable to members, and embrace transparency in investment decision-making, for example by providing an annual statement of investment principles (SIP) to members. Wider public scrutiny would also be valuable in making trustees think about whether their investment strategy is sound. Bodies in the wider public which could undertake this scrutiny included trade unions, pensioner support groups and the media .<sup>28</sup>

Some of the tenor of Myners' views can be illustrated by the issue of shareholder activism. Generally, the investment industry has not embraced activism, preferring to signal discontent with company management through exit (selling shares) rather than voice. To the extent that pension funds were being pushed towards activism, a good deal of the push was coming from members. Myners strongly endorsed activism,<sup>29</sup> going so far as to report submissions which suggested that the investment industry's lack of activism might reflect conflicts of interest which placed fund managers in breach of their fiduciary duties.<sup>30</sup>

Myners' embrace of contestation over investment advice and support for pluralism in scrutinising investment allocation took a more concrete form when he discussed the need for investment strategies to match the particular long-term nature of pension fund liabilities. The desirability of 'asset-liability matching' or 'liability-driven' investment strategies is uniformly endorsed in the investment management field, but the interpretation of exactly what these terms mean is contested. To give a succinct sense of the issues, we can focus on whether bonds are particularly suitable assets to match pension liabilities.

For Myners, they were not. Writing in the context of the MFR, he argued that pension fund investment was excessively oriented towards bonds because funds tried to reduce volatility in valuations by matching MFR reference assets. Regulation had created an artificial bias towards bonds, which scheme-specific funding should go some way to remove. But his argument also implied a more general criticism of the notion that bonds are the assets that best match pension liabilities. In brief, the claim that bonds are matching assets rests on their effectiveness as a hedge for interest rate risk affecting the valuation of pension liabilities. If the present value of liabilities is calculated using a discount rate based on current interest rates, it follows that liabilities will rise when interest rates fall. Since bond prices go up when interest rates go down, the rise in liabilities is matched by an increase in the value of the scheme's assets.

This 'asset focused' view of risk can be contrasted with an 'income focused' view. On an income-focused view, the liabilities of a pension fund are promises to pay benefits at specific times in the future. To match these promises, fund managers might seek assets which will provide a stream of income at corresponding future dates. It does not matter if the price of these assets is volatile, provided the income stream they deliver is secure.<sup>31</sup>

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<sup>28</sup> Ibid 8.33.

<sup>29</sup> Ibid, Summary paragraph 79.

<sup>30</sup> Ibid 5.86-7.

<sup>31</sup> Merton RC, 'The Crisis in Retirement Planning' (2014) July–August Harvard Business Review.

This is why pension funds can be ‘buy and hold’ investors, tolerating volatility in asset prices because they could afford to take a long view.

Myners was sharply critical of the emerging trend for UK pension funds to shift into bonds, which he attributed to an asset-focused view of risk driven by the regulatory regime for pension fund valuation (the MFR). There is considerable academic support for his argument that bonds are not necessarily the best match for pension fund liabilities.<sup>32</sup> Blake showed that, while the conventional understanding is that pension liabilities are ‘bond-like’, a matched portfolio based on the empirical characteristics of UK DB pension fund liabilities and the available assets would contain only a modest proportion of bonds.<sup>33</sup> Surprisingly, property investments turned out to be well-matched with pension liabilities. This result was not idiosyncratic to Blake’s approach; a contemporaneous study by PWC found that most asset-liability matching (ALM) models produced a high weight on property, but this result was ‘often suppressed by the programmer’.<sup>34</sup>

Summing up: for Myners, the small community of investment consultants had adopted conventional practices which should be challenged by informed trustees. They would need some expertise to make this challenge, as well as time and in-house support. The adoption of scheme-specific funding would advance the cause of less herding and less investment in bonds, provided trustees were sufficiently equipped to develop a suitable investment strategy for their own scheme. Myners’ approach was pluralistic, in that he saw public debate and challenge as fruitful for investment management.

#### **4. Expertise in the regulatory regime**

Myners’ recommendations were, apparently, warmly embraced, but it should not be forgotten that they landed in an environment in which key policy actors had other concerns. In particular, the government was dealing with other emerging difficulties with the MFR. The MFR was widely understood as ensuring that pensions were secure, but it did not promise or achieve this, and in the early 2000s there were some high-profile scheme failures where members were left bearing losses. In 2004, the Parliamentary Ombudsman announced an enquiry into complaints made by about 100 members and trustees of pension schemes, which claimed that the government had ignored evidence in failing to warn members of the risks to their schemes, and also had provided members and trustees with inaccurate information.<sup>35</sup> Eventually, the government was forced to compensate those affected.

In this context, Myners’ recommendation for a scheme-specific funding regime was very attractive, because it would place on trustees, rather than the government, the responsibility for assessing the adequacy of a scheme’s funding. However, the regulator

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<sup>32</sup> Bauer R, Hoevenaars RPM and Steenkamp T, ‘Asset Liability Management’ in Clark GL, Munnell AH and Orszag JM (eds), *The Oxford Handbook of Pensions and Retirement Income* (OUP 2006).

<sup>33</sup> Blake (n 13) Table 3.

<sup>34</sup> Quoted *ibid* 49.

<sup>35</sup> Thurley D, ‘Minimum Funding Requirement’ (2008) House of Commons Library Standard Note: SN/BT/1215, 13.

had a strong interest in ensuring that trustees produced the ‘right’ answer, because, if they made the wrong assessment, the newly-created Pension Protection Fund (PPF) would have to step in. Compared with the public liability that the MFR had created, the PPF promised less: accrued rights were only partly protected. This ‘co-payment’ by members should mitigate any tendency for trustees to take excessive risks, but studies at the time suggested that there could be some gaming of the PPF.<sup>36</sup> It followed that it was necessary for the regulator to monitor the solvency of schemes in order to protect the PPF, and indeed this was one of the primary elements in the mandate bestowed on the newly-created Pensions Regulator (TPR) in the 2004 Act. TPR monitored solvency in the only way it knew how: by focusing on the triennial valuation. In so doing, it took the opposite direction to Myners, upholding an asset-focused approach to risk and embracing the conventions that went with that. Compounded by changes in accounting standards that made companies more sensitive to valuation volatility, one effect was that UK funds continued their trend of moving out of equity and raising the share of bonds in their portfolios.<sup>37</sup>

The main reception of Myners’ recommendations focused on the provision of training for trustees. TPR produced a Code of Practice for trustees which emphasised their duty to ensure that they had an adequate understanding of their functions, and a modular training programme called the Trustee Toolkit was developed. These initiatives were widely welcomed: for example, Cockerill argued that the emphasis in the legislation on ensuring adequate trustee skills and training ‘represent[ed] an opportunity for a step change in effective trustee governance.’<sup>38</sup>

However, there is very little match between the Myners report and the training material produced by TPR. The focus of the latter is on trustees’ understanding of the analyses produced by actuaries and advisers: particularly, their understanding of how different assumptions affect the valuation. In the Toolkit, trustees are encouraged to think of how they can implement an investment strategy within an ‘integrated risk management’ framework. This framework, as developed by TPR, instructs trustees to think of investment allocation in terms of the division of the fund between ‘matching assets’ and ‘growth assets’, where matching assets are deemed to be gilts and corporate bonds, and growth assets are equities, property and various kinds of alternative investment. The balance that trustees can strike between matching and growth assets depends primarily on the strength of the employer covenant.<sup>39</sup>

The Toolkit gives a fair summary of current mainstream thinking about pension valuation and investment strategy, but it deviates substantially from Myners’ central arguments. First and foremost, it is highly oriented towards the triennial valuation. Myners was critical of investment strategies that were designed to minimise valuation volatility, yet that is effectively what the regulator advocates. The tolerable level of volatility depends

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<sup>36</sup> McCarthy D and Neuberger A, 'The Pension Protection Fund' (2005) 26 *Fiscal Studies* 139.

<sup>37</sup> Kay J, 'The Kay Review of UK Equity Markets and Long-Term Decision Making: Interim Report' (2012) HM Government Department for Business, Innovation and Skills, 4.8-4.9.

<sup>38</sup> Cockerill (n.9) 17.

<sup>39</sup> The Trustee Toolkit, Investment in a DB scheme, Tutorial 1

on the strength of the employer covenant: if a scheme goes into deficit and the covenant is deemed insufficiently strong, it is compelled to change (specifically, ‘de-risk’) its investment allocation. Furthermore, the classification of investments into ‘matching’ and ‘growth’ categories is conventional and not empirically supported.<sup>40</sup>

In short, the Codes of Practice for trustees, the Toolkit and other regulatory efforts to educate trustees incorporate conventional knowledge rather than promoting expertise. This is not a reflection on specific failings of the regulator: it works in close concert with the industry, and the Toolkit has been developed with industry advice. Within the industry, the issues raised here about the nature of matching assets are reasonably well-known, yet no sense of disputation found its way into the Toolkit. Evidently, there is a strong drive to promote certain conventions. The following discussion seeks to illuminate the reasons why.

### **5. The tension between expertise and representativity**

The discussion so far has shown that there is a significant and consequential gulf between the conventional application of financial expertise and the views advanced by critics. The conventional interpretation is asset-focused and biased towards investment in bonds, often described in financial sector shorthand as ‘de-risking’. Myners envisaged that trustees with expertise might challenge the asset-focused view of risk. They could be robust in accepting that triennial valuations would show volatility in scheme balances, and keep their eyes on the longer term, where so-called de-risking can substantially *increase* the risk that income from the pension fund will not be adequate to pay the pensions promised.<sup>41</sup>

Myners offered few clues about where these exemplary trustees would be found. Given the available evidence that ENTs and MNTs lacked financial knowledge, one possibility endorsed by Myners was that ‘independents’ might be recruited who would be able to test and challenge the advisers to pension schemes. However, as the first section showed, there is little evidence that independent trustees do improve the running of pension schemes. This section considers the hypothesis that independent trustees are susceptible to a kind of agency drift because they are not primarily oriented towards serving the interests of employers or members. This can potentially produce a tension between expertise and representation, assuming that representatives do cleave faithfully to the interests of those they represent.

Besley and Prat<sup>42</sup> set up their analysis of pension fund trustees by positing that there can be two types: professional experts and caring insiders. Professional experts are assumed to be motivated by career concerns, and their performance is evaluated by their peers. Given the emphasis on financial expertise in pensions, it is safe to assume that these peers

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<sup>40</sup> See Blake (n 13).

<sup>41</sup> Jacka S and Hernandez E, 'Monetary risk and prudence in pension fund valuation' (2019) The Royal Society, London. Conference Proceedings: How should pension liabilities be valued? Risk aversion and demographic uncertainty.

<sup>42</sup> Besley T and Prat A, 'Pension fund governance and the choice between defined benefit and defined contribution plans' (2003) No. 03/09 IFS Working Papers, Institute for Fiscal Studies (IFS).

are found in the financial services sector. Caring insiders have intrinsic motivation stemming from their responsibility to their fellows: they lack a wider career interest in financial services. Using this simple distinction, it is possible to make some predictions about the level of effort that the two types of trustee will put in, and the direction of that effort. Caring insiders will always make a certain amount of effort, whereas the effort invested by experts will depend on the relationship between effort and the outcomes monitored by peers. Besley and Prat provide only a brief sketch of what those peer-monitored outcomes might be. One possibility is that peers monitor benchmarked investment returns, which implies that they would be susceptible to the herding behaviour that Myners criticised, or at least that they would fail to counter herding. More generally, there is no reason to suppose that professional experts drawn from the world of financial services will deviate from conventional practices if their performance is judged by their peers. Furthermore, there is a risk that professional experts will invest little effort compared to caring insiders: this will happen if the relationship between effort and outcome is very noisy: for example, if monitored investment returns are dominated by the effect of exogenous shocks.

Davis<sup>43</sup> saw the incentives of experts somewhat differently, taking the lack of evidence for the benefits of expertise as a sign that experts can have interests that conflict with those of members. His analysis implies that experts do know more than non-experts about the relationship between policy decisions and outcomes, but they misuse this knowledge to pursue outcomes that are not in the interests of members. Specifically, they have a conflict of interest with members over administrative fees and charges, allowing these to become inflated. They might derive excessive fees directly from the trust, or the sharing-out of work can create a circuit of excessive remuneration. There are hints of similar issues among independent trustees in the UK, especially where corporate trustees have ties to large pension consultancies. For example, the Work and Pensions Select Committee hearings on the failure of the retailer BHS included exchanges with the professional chair of the trustees about the remuneration that his company derived from the scheme and its relationship to the scheme's adviser, Willis Towers Watson.<sup>44</sup>

If experts have interests which diverge from those of members and employers, this produces a tension between expertise and representation. The structure of the problem is often analysed in the political theory of delegation as follows.<sup>45</sup> Experts know more about the relationship between policy decisions and outcomes than representatives; indeed this knowledge about the policy 'production function' defines their relevant expertise. Setting uncertainty and random events to one side, if experts desire outcome A, they know the policy that will achieve A. Suppose now that representatives desire outcome B, but they do not know the policy that will achieve B. If they make policy themselves, they may end up with C or D. If A is nearer to B than C or D, representatives will delegate to experts even though they know that experts do not share their preferences about the outcome, and

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<sup>43</sup> Davis (n 20).

<sup>44</sup> Work and Pensions Committee, Minutes of Evidence, Wednesday 25 May 2016, Questions 615-629

<sup>45</sup> Bawn K, 'Political control versus expertise: Congressional choices about administrative procedures' (1995) 9 American Political Science Review 62.

will be able to use their knowledge to pursue their own preferences. Representatives will resent this ‘drift’ on the part of experts, but there is little they can do about it.

This analysis is straightforward to apply to the case discussed by Davis. Outcome A is good investment performance with high fees; B is good performance with low fees. If representatives take over investment management, they will not achieve good performance (but instead C or D), so they resentfully pay the fees of financial experts. As it happens, advocates of passive investment strategies have offered a way out, demonstrating how B might be attainable by investing in tracker or index funds.

The analysis can also be applied to the case discussed here, where the nub of the issue is that different groups of actors have different preferences about risk. As discussed above, ENTs can be expected to accept a relatively high level of investment risk in order to contain contribution costs, subject to various caveats.<sup>46</sup> The standard expectation is that MNTs are more risk-averse, but this depends on the weight given to pensioner members compared with young members, as well as the degree of cost-sharing and the threat of scheme closure. The regulator has an incentive to contain risk, as it reaps no benefit from scheme risk-taking, while incurring reputational and PPF costs if schemes fail. Arguably, the incentives of independent trustees mirror those of the regulator: an independent trustee of a failed scheme incurs a reputational cost, but does not reap clear benefits from risk-taking.

In this setting, the conflict between expertise and representation can be described as follows. Suppose that the regulator prefers de-risked outcome A, while the ENTs and MNTs prefer to accept more risk at outcome B. The policy to produce outcome B is not known to the ENTs and MNTs: it involves a complex sequence of interrelated decisions about investment strategy and valuation. Independent trustees understand investment strategy and valuation, and can steer these processes towards their desired outcome, which, due to their career concerns, is nearer A than B.

An important objection to this type of argument is that it assumes that trustees make decisions in accordance with their own interests. The law is clear that trustees have a duty of loyalty, which means that they should not be unduly influenced by their personal interests, whether pecuniary or reputational. The political theory of delegation assumes that the interests of the relevant actors can readily be identified, and that actors pursue those interests. The theory is blind to the possibility that trustees are sincere in their insistence that they seek to do the right thing for the scheme as a whole.

This objection gains force when the interests in question concern attitudes to risk and uncertainty. Uncertainty leads actors to have recourse to patterns of behaviour that are not calculative and strategic. They may turn to rules of thumb or ethical principles in response. Furthermore, actors like trustees have to formulate responses to uncertainty in a collective setting, in cooperation with other actors (other trustees and the scheme

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<sup>46</sup> In a more fully specified analysis, such as that provided by Blake (n 13), employers also take into account that a risky investment strategy is likely to make contributions more volatile (although lower overall).

executive, employers and the regulator). The adoption of common standards or principles facilitates agreement between the parties, reducing the transaction costs of uncertainty. In this setting, expertise in the form of conventional knowledge is valuable in bringing about cooperation and agreement. However, coordination around conventional knowledge can also produce bad outcomes. Arguably, the incentives to coordinate in finance are excessive, producing herding and instability.<sup>47</sup>

It is possible to accept that (all) trustees are acting sincerely to produce the best outcome for the scheme, and nonetheless defend a pluralistic conception of expertise in which the varied social backgrounds of trustees lead to disagreement about the best course of action. But here we find another tension between expertise and representation, in which experts are portrayed as impartial and without interests, while representatives are impugned for their assumed responsiveness to interests. Both ENTs and MNTs are vulnerable to the claim that they cannot comply with the duty of impartiality if they participate in decisions which benefit them personally as sponsors or scheme members. However, the courts have set aside this concern when there are ‘substitute guarantees of fairness’ such as the presence of a balance of interests on the board of trustees.<sup>48</sup> Issues regarding the impartiality of MNTs were addressed by s.39 of the Pensions Act 1995, which provides that MNTs should not be prevented from exercising their powers as trustees merely because such exercise may benefit them as members of the scheme.<sup>49</sup>

However, TPR’s guidance on conflicts of interest betrays a different understanding to that upheld by Parliament and the courts. It is highly attentive to conflicts of interest affecting ENTs, arguing, for example, that it is ‘inappropriate’ for a trustee who is also the finance director of the employer to be involved in funding negotiations. Furthermore, ‘trustees who, for example, are scheme members or who hold trade union representative roles’ are also seen as susceptible to conflicts of interest.<sup>50</sup> This conflates the representative role of ENTs and MNTs with a conflict of interest, and implies that representative trustees are less well-equipped for their role than independents.

This is a tendentious position for the regulator to take. A consistent account of trusteeship might be based on trustees’ own interests or it might assume that trustees act sincerely in the interests of beneficiaries. If an own-interest analysis is adopted, it is possible to identify the interests of all trustees: independents as well as ENTs and MNTs. By the same token, if it is possible for some trustees – independents - sincerely to set aside their own interests and comply with the duty of loyalty, then it is possible for others (ENTs and MNTs). The regulator’s promotion of independent trusteeship appears in this light to be based on a biased account of trustee interests that constrains the pluralistic exercise of judgment and entrenches conventional expertise. Trusteeship does not have to be rule-bound in this way. The pursuit of the common good means that each trustee sets to one

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<sup>47</sup> Nelson SC and Katzenstein PJ, 'Uncertainty, Risk, and the Financial Crisis of 2008' (2014) 68 International Organization 361

<sup>48</sup> Gardner S, *An Introduction to the Law of Trusts* (OUP 2011) 162 and n 44.

<sup>49</sup> I am grateful to Charles Mitchell for bringing this statutory provision and the relevant case law to my attention.

<sup>50</sup> <https://www.thepensionsregulator.gov.uk/en/trustees/managing-db-benefits/governance-and-administration/conflicts-of-interest>

side the interests of the faction that placed them on the board, but it also means that trustees bring to the table their own best judgment of the common good and how to achieve it.

## **6. Conclusion**

This chapter has sought to investigate how the expertise of trustees might be expected to affect the operation of pension schemes. It has examined both the nature of expertise – whether it is conventional or pluralistic – and the nature of the agents carrying that expertise. While it is not inevitable that independent trustees bring conventional expertise, there is much in the regulatory set-up that points in that direction. Conversely, representative trustees (ENTs and MNTs) may have little expertise or may be highly receptive to conventional views, but they could also be important sources of pluralism in expertise.

One interpretation of the decline of DB pensions in the UK is that regulation has driven schemes towards closure. The regulator has been an important promoter of conventional expertise. Independent trustees in particular might be seen as agents of the regulator, adopting similar views about the desirable level of risk in a scheme. Analysis of the interests of TPR and independent trustees, compared with the interests of ENTs and MNTs, supports this view.

However, a more subtle process may be at work to defeat the pluralistic conception of expertise advanced by Myners and replace it with a set of conventional practices. The financial soundness of a pension scheme is profoundly uncertain. Practices around scheme valuation can be seen as attempts to manage this uncertainty by coordinating the beliefs of interested parties. In this process, expertise is important in lending authority to one set of beliefs over others, which facilitates coordination. We can see that experts themselves are affected by uncertainty, and seek reassurance in agreed positions. Despite the known limitations of an asset-focused approach to assessing risk, the approach offers a computable and replicable assessment of pension scheme soundness. It may be quite wrong or misleading in fundamental ways, but it provides a reassuring anchor for its users.

It follows that the tension between representation and expertise runs more deeply than that identified by Davis.<sup>51</sup> In Davis's account, experts have different interests to representatives, and yet representatives must still rely on them. In the account advanced here, all parties are affected by uncertainty. Only the experts appear to offer a way of converting uncertainty into calculable risk. Even though there is much that is spurious in that calculation, representatives can offer nothing comparable. This is, fundamentally, the reason why Myners' pluralistic vision has never come to pass. Representatives on trustee boards may have a strong sense that the investment strategy could be different and that the assessment of risk is flawed, but conventional financial models have a coordinating function and problem-solving capacity that is difficult to dispense with.

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<sup>51</sup> Davis (n 20).

There are no simple prescriptions for resolving this problem, so long as risk management is essentially financial and financialised. Trustees can avoid the regulator's Toolkit and develop more pluralistic expertise, but this could just make it harder to reach agreements about the soundness of schemes. The best alternatives for MNTs and ENTs may lie in the promotion of non-financial ways of managing risk. Most notably, faced with unexpectedly good or bad outcomes, representatives might agree to manage the consequences by renegotiating the benefits provided by the scheme. Renegotiation is not part of the regulatory approach to risk management, and legislation has constrained the renegotiation of accrued rights. Furthermore, the trend in UK pension fund governance has been to detach trusteeship of the pension fund from negotiations between employers and scheme members. The autonomy of trustees from employers and members steers schemes towards financial risk management. The fact that closure is more common than reform is an indication of the rigidity of this structure, perpetuated by the dominance of conventional expertise.