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Pitfalls of fiduciary management

Christiaan Tromp outlines the necessary criteria for successful and long-lived fiduciary management partnerships

Over the past 10 years, fiduciary management has proven itself a welcome addition to the pension fund steward's toolkit. In general, it has brought a wider and fuller appreciation of all the moving parts of pension supervision and provided a framework to better integrate their management. But like every management discipline, while fiduciary management has numerous advantages, there are also a number of risks. After more than a decade of real-world experience, we can see not only the value in such an approach but also the pitfalls we should be wary of when entering into a fiduciary relationship.

The first order of business for truly effective fiduciary management is that both the provider and client must use the same definition. With that in mind, it would help to establish a clear definition of the term.

Fiduciary management consists of the co-ordination, organisation and control of the strategic, tactical and operational activities of a pension fund or similar institutional investor in a comprehensive, unified package. It presumes that relationships between pension funds and providers are entered into for the long term, and that providing overall, integrated solutions stands paramount in such a relationship.

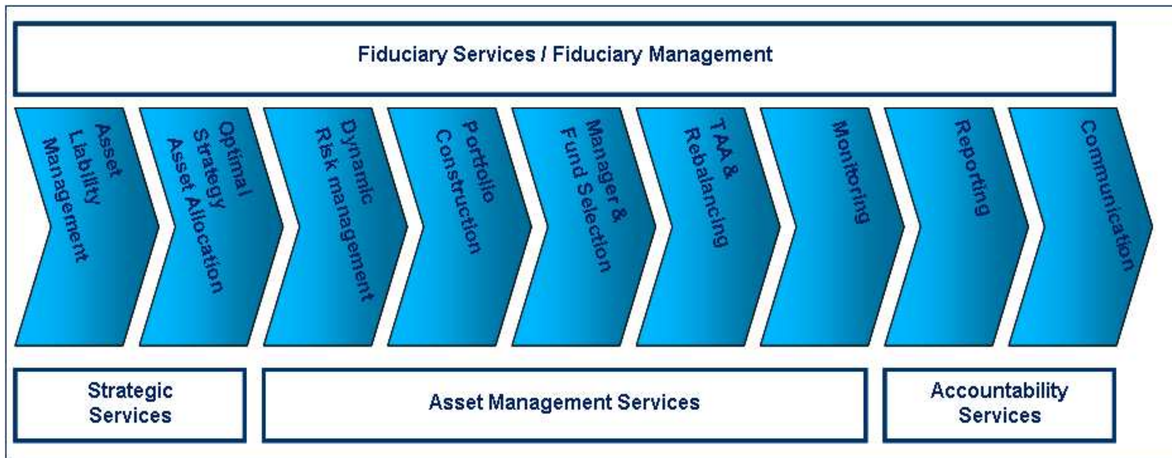
It encompasses the full sweep of all the relationships between pension funds and their various providers of financial services such as asset liability management (ALM) consultants, investment managers, custodians and actuaries. The range of activities provided to a pension fund can roughly be divided into three main areas:

- **Strategic services**
- **Asset management services**
- **Accountability services**

These areas can be subdivided into nine primary processes and these, in turn, can be split up into hundreds of activities. Fiduciary management is, in essence, the governance superstructure that oversees all those activities and seeks to ensure that their outcomes are consistent with the fund's objectives and liabilities. But there are pitfalls.

Responsibilities
The first pitfall is to lose sight of a fundamental fact of fiduciary life: tasks can be delegated but responsibility cannot. This is a variation on an old theme, that the responsibilities of the agent can never exceed those of the principal nor indeed match them.

It is a concept well-settled in law around the world but carries particular freight when the stakes are as high as they can be for a large pension fund: the livelihoods of beneficiaries, the treasuries of sponsoring companies and the reputations and personal liabilities of fund executives and board members. Keeping this one key fact in mind and using it to inform all the decisions made about a fiduciary management relationship and the rules and procedures that govern it will pay big dividends.



Partnership expectations
Most often, fiduciary management is conceived and conducted in the form of a partnership. In fact, a well-defined working partnership is one of the basic premises; it would otherwise be impossible to establish a long-term relationship that could weather the stresses of market volatility and evolving regulatory standards. However, when put into practice, partnerships may not function according to expectations. For instance, they do not explicitly express or record their mutual expectations. As a result, there is little sense of a clearly understood mutual commitment.

Of course, the term ‘fiduciary’ has everything to do with trust – but many pension funds take this understanding too literally. They assume their fiduciary manager is equally committed to the challenges facing the fund and will always be at their beck and call; not only in the best of times but also in the worst. Fund executives and board members also expect to be warned if their pension fund enters the danger zone, so the fund can take adequate measures to prevent under-funding or decrease risk. However, it is here that the partners are most often remiss in their duties, particularly if there has not been a clear and detailed examination of expectations. Clearly defining these elements upfront will save lots of heartache later.

It must be said that fiduciary managers have been complicit in keeping such notions alive, to the detriment of their relationship with pension fund clients. They must always know when their partner’s expectations are unrealistic and speak up before real disappointment arises. A manager must make a judgment about whether or not their partner has sufficient insight to fulfil their obligations to the fund. If this is not the case, the manager should open a dialogue and ensure that the partner obtains the necessary information. This instils confidence in both parties and strengthens the relationship.

To establish and nurture a good partnership and avoid the pitfalls inherent in poor communication and unmet expectations, it is essential that the manager knows the partner well and vice-versa. Each party

should know the other’s position on key issues like facts and figures and goals and procedures. It is a good idea for pension funds to provide their actuarial and business operations memorandum (ABTN), with an extensive commentary to their fiduciary agency. In addition to being a crucial document for accountability to De Nederlandsche Bank (the Dutch Central Bank, DNB), the ABTN defines the organisational structure of the pension fund and its guiding principles. There is no better foundation on which to build a solid mutual understanding and an effective working partnership.

A fiduciary manager should, in turn, draw up a responsibility matrix of all processes for which it is accountable. As a result, the pension fund will always know whom to turn to should any problems or questions arise that need to be solved straight away and all parties will be able to fulfil their assigned tasks without debate or lost time in the event of an emergency.

Service level agreement

Trust is a wonderful thing but it is not a proper basis for managing the complexities of a pension fund or the expectations of a working relationship. Failing to draw up a service level agreement (SLA), setting out in detail the services to be provided and the mutual obligations of the partners and attendant parties, is another significant pitfall of fiduciary management.

A pension fund should be able to rely on the general integrity of its fiduciary manager and the solidity of their contract to guarantee an effective partnership, but when it comes to the management of specific tasks, a clear, concise, comprehensive and unambiguous SLA is a must. This is doubtlessly one of the most important prerequisites for entering into an effective, surprise-free, long-term fiduciary relationship. Transparency is the key to an SLA and detail is its best servant: better to spend extra time in definition and dialogue up-front than to find that the partners don’t agree on things when an emergency appears.

A fair and effective SLA can only be based on clearly defined mutual obligations between the partners. A pension fund should also indicate its responsibilities in the SLA so that the fiduciary manager can be confident it will be called upon to deliver its services at the desired level on a fair playing field.

To monitor the effective delivery of the services described, an SLA should contain guidelines for assessing the performance of a fiduciary manager per service. Agreeing on fair measurements up-front will help providers stay on top of their game and the pension fund assess its partners’ performance.

Remuneration structure

An important pitfall in fiduciary management is that performance incentives can lead to unwelcome outcomes. The basic principle of a remuneration structure should be that a fiduciary manager receives payment for the services performed with some consideration for the quality of services delivered. In practice, a manager’s remuneration generally consists of two components: a base fee and an outperformance fee. The base fee is usually expressed in the basis points of the assets under management (AUM). The outperformance fee is calculated by the excess return achieved by the fund above a particular benchmark.

It is actually rather peculiar, a relic of habit and history, that the base fee is linked to the AUM. There is often no direct connection between the quantity and quality of the services and the fund’s AUM. Rather, these are based on the requirements set by the pension fund’s management board in respect of the services to be provided. This is why it would often be better for the partners to agree on a fixed base fee.

Basing remuneration primarily on the extent of outperformance creates a significant misalignment of interests between the pension fund and the fiduciary manager. With an outperformance fee as an inducement, a fiduciary manager may be tempted to concentrate primarily on attaining this

outperformance, often at the expense of increased risk. He is, in effect, increasing his client's risk to sweeten his payday. That is obviously not in the best interest of the pension fund.

It is important to remember that a pension fund's top priority should concern meeting its liabilities, followed by the need to meet the regulator's demands (pension funds generally want to avoid any 'hassle' with the regulator). A third priority entails the compilation of reports to members of the management board on the investments made, the risk run and the risk to be taken. The performance of the investments could be a fourth priority, with outperformance taking fifth place. It would therefore be inexpedient to over-emphasise the role of outperformance in remuneration.

To effectively co-ordinate remuneration with the services performed it would be advisable to agree on a flat fee per activity (see figure), with a bonus/malus system expressed in relation to the quality of the services delivered by the fiduciary agency, as described in the SLA.

Another issue relevant to the remuneration of fiduciary managers concerns the investment of pension fund's monies in a manager's in-house managed funds or allowing their own managers to manage these monies. If fiduciary agencies are permitted to use their own funds and managers to manage pension funds' monies, this will inadvertently result in a non-transparent remuneration structure. Moreover, the question remains whether the solution chosen is the best in the particular case, or whether there is conflict of interest.

Independent evaluation

In current practice, the partnership between the fiduciary manager and the pension fund is hardly ever evaluated. This amounts to both a missed opportunity and significant risk. At least annually, a formal assessment of the partnership should be conducted. One could compare such an evaluation process to an employee performance interview.

The partnership evaluation process is based on the SLA, in which the services and activities the fund expects the manager to perform have been recorded precisely. Of course, the activities and requirements of a pension fund may be modified in the course of time for various reasons. Partners can also reach follow-up agreements during an evaluation interview for the services required in the year to come, which would then be recorded in a new version of the SLA. This will ensure that the SLA is kept up-to-date and the partnership 'shock-proof'.

We recommend bringing in an external party to assess the agency every three to five years in addition to the annual assessment. This will allow pension funds to examine their partnership more closely. An independent and unbiased evaluation conducted by a knowledgeable party can put matters in a clear perspective for both the fund and the agency.

Perhaps the most critical issue an independent eye can examine is the conflict of interest that may exist between a fiduciary manager's contractual obligations to its client and its own business goals. In the absence of such conflict, the pension fund can expect its manager to do everything in its power to act in its

clients' best interest. The pitfall lies in the fact that the manager is also accountable to his own managers for meeting normal business targets. This can result in a conflict of interest. If, for example, the bonus a fiduciary manager receives for bringing in a new client is higher than the fee for services provided to an existing client, the agency in question will be more intent on canvassing for new clients than on other activities. This is why it is crucial that pension funds understand that a fiduciary manager cannot serve two masters.

A pension fund that has arranged its fiduciary management affairs to the highest standards – a well-organised governance structure, investment, operational and reporting processes that are clearly described and observed, a contract that complies with the outsourcing regulations of the regulator, an SLA that is assessed on an annual basis with the fiduciary partner and periodic reviews of its entire fidcuciary management terrain with an unbiased third party – will be able to rely confidently on its fiduciary partner to act in its best interest and will likely avoid the pitfalls we have outlined here.

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