Do Fiduciaries Need Better Incentives to Make the Retirement System Work?

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Editor's Note: The views and opinions expressed in this article are solely those of the authors and are not intended to represent the views and opinions of Executive Decision.

Imagine a time in the not too distant future. Retirement systems everywhere are in disarray. An outside specialist is asked to diagnose the problem and suggest a cure. A capitalist at heart, solutions-oriented and cognizant of a fiduciary imperative, she identifies the usual suspects—complex regulations, compelling demographics and overly optimistic economic assumptions.

Then, defying conventional wisdom, she asks the unthinkable. Has anyone looked at the role of fiduciary incentives? Do those in charge get rewarded for what they do well or penalized for what they fail to do? Who, if anyone, claims ownership of the retirement issue? Are these individuals empowered to effect meaningful change? How do we measure accountability for achieving plan goals? What alarm bells will ring in time to permit corrective action?

The room is quiet. No one knows what to say. The silence is deafening.

Sadly, current attempts at pension reform are likely to fail because they do not effectively address human behavior. People are motivated by rational self-interest and the promise of recompense for a job well done. This is not a bad thing. To the contrary, it is a cornerstone of a well-functioning market economy. Make it worthwhile and some clever person will figure out how to deliver a better mousetrap at a lower cost with the end result that we all benefit.

How does the notion of rational self-interest relate to the retirement system? For most fiduciaries, there is no formal mechanism in place to distinguish good players from bad, and reward accordingly. (Litigation is a likely outcome in the event of fiduciary breach but it is seldom a deterrent before the fact and rarely encourages best practices.) Honor alone won't pay bills nor is it likely to push people to action. That's why senior executives are normally compensated with tangible payback instruments such as cash, stock or options.

Where does this leave us? It does not take a rocket scientist to see that the fiduciary framework, as it is usually exercised, is in need of a significant overhaul. At best, current fiduciary practices are seldom tied to meaningful goals and, when they are, the rewards are non-existent or fail to align gatekeepers' interests with those of trust beneficiaries. At the very worst, the absence of incentives promotes dysfunctional behavior that is off-purpose and counter-productive to the competency apropos to managing a private retirement plan system.

There is no reason to believe that fiduciaries are malicious. They are just operating within an ineffective, poorly designed incentive system where the threat of personal liability frequently outweighs any potential gain. Why would someone choose to be a fiduciary under these circumstances? Yet it is now, more than ever before, that we need good stewards to guide the process through troubled waters.

Fiduciary Selection
A team is only as good as its members, so you may be surprised to know that pension committees often consist of people who get the job by default, are asked to "squeeze in" administrative duties or are given the job because no one else wants it. The irony is breathtaking. Experts spend countless hours trying to design optimal benefits programs for the purpose of attracting and retaining qualified workers. In stark contrast, scant attention is paid to hiring and compensating knowledgeable individuals who can and will commit sufficient energy and time on behalf of plan participants.

Lest there be no confusion, we think this means going well beyond mandated minimum duties and instead embracing best practices, challenging the status quo and being courageous enough to recognize the need for a new paradigm. Not an easy task, perhaps it's time to impose a Sarbanes-Oxley type of "expert" standard. Consider the City of San Diego. They now require members of a newly formed Board of Administration to "have the professional qualifications of a college degree in finance, economics, law, business, or other relevant field of study or a relevant professional certification" and must have worked in pension administration, pension actuarial practice, investment management, real estate, banking or accounting for at least 15 years.

While some may argue about what constitutes a proper gauge of expertise, this kind of requirement could create another dilemma. Why? There simply may not be sufficient numbers of qualified professionals who can pass muster. An increased demand for experts, given a fixed supply, would inevitably drive salaries upward, thereby increasing expenses for pension plans already struggling with funding gaps. However, in the absence of adequate compensation, few will stand up to be counted as experts, leaving little room for improvement and a vicious cycle ensues.

Fiduciary Compensation
Notwithstanding a possible limited availability of experts, reflecting on the substance of an ideal incentive system is a worthwhile exercise. At a minimum, it would encompass sound financial and fiduciary principles such as care, loyalty, objectivity and independence. Goals, once set, would be evaluated on the basis of understandable, consistent and measurable rules. For example, compensation might reflect efforts to reduce retirement plan expense (regardless of who bears that expense) by 5% per year or require that trustees attend at least half of the meetings with the actuary or pension consultant.

The system would have to be flexible and recognize that the multidisciplinary nature of being a fiduciary rejects the notion of "one size fits all". If the system was well engineered, the incentives would be dynamic and comport with existing law by allowing for "the circumstances then prevailing," while still exercising a prudent expert standard of care in all elements of plan management.

One approach is to ask the appointing fiduciaries of the compensation committee of the board to outline the compensation structure for the fiduciaries whom they appoint. After all, they already do so for the company's executives with regards to other business goals. Moreover, because they have personal liability for monitoring those whom they appoint, it makes sense that they assure themselves that the correct incentives are in place, are aligned with the plan sponsor's goals and reflect a strategic interest in compliance, empowering human capital and reducing liability exposure.

Another consideration is to send the message to both employees and shareholders that managerial excesses will not be condoned nor will the employees be asked to make sacrifices at the same time that executives plan to pocket large retirement gains. Do you think things would change if the benefit payouts from the supplemental executive retirement plan and top hat plans were directly tied to the financial health of the ERISA plans?

Incentives count. It's that simple. Failure to recognize this core element of human behavior is a mistake. Moreover, it sets the stage for retirement train wrecks, which invariably means more regulation. Which do you prefer? Taking voluntary action now and preserving flexibility or waiting until regulators are forced to create additional, expensive and often ineffective safeguards in response to public outcry? Remember, it only takes a few bad sailors to capsize the boat.

It is time to start asking tough questions before it's too late. For the many who accept their solemn responsibility to beneficiaries, Gandhi's words bear repeating: "You must be the change you want to see in the world."

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