Best practice board composition – what can we learn from corporate governance?

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Board composition is finally near the top of TPR's agenda. Their recent response to the consultation on Trusteeship and Governance had a clear focus on board diversity, covering diversity, professional trustees, and trustee board member training and skills. But what is best practice board composition? And what might we learn from corporate governance in this area?

Board diversity

There is no doubt that TPR has greater board diversity in its sights. While it's final consultation stopped short of requiring pension boards to report on the efforts they're taking to increase board diversity, it did announce the creation of an industry working party to consider what diversity and inclusion really means for trustee boards, and what best practice board composition looks like.

Board diversity has been a talking point in the Corporate Governance world for some time. Gender diversity was taken up by the Davies Report in 2011, recommending that by 2015 the FTSE 100 should have 25% female representation on their board. The 2016 Hampton-Alexander Report raised the bar to 33% by 2020. Listed companies were also asked to disclose a policy for board room diversity, including measurable policy objectives.

So why do we need board diversity? According to the 2016 revised UK Corporate Governance Code, one of the key pitfalls board diversity helps to solve is group-think - the tendency of like-minded people to reach a decision without adequate critical scrutiny. This reasoning highlights that it is cognitive diversity we are really trying to achieve, which is created through a mix of gender, social and ethnic backgrounds, and a range of cognitive and personal strengths.

In the pensions world we are very far away from optimal board diversity, with the 2016 PLSA Annual Survey finding that, on average, 83% of trustees on a board were male. TPR research in 2016 also found that half of chairs and a third of trustees are over 60.

TPR's new industry group is therefore a welcome initiative, provided it gives clear practical steps for how boards can improve diversity, and recognises the challenges for closed schemes in certain industries whose membership and workforce simply aren't diverse on anyone's definition!

The Executive/Non-Executive debate

One of the most distinctive differences between corporate boards and the average pension board is the executive/non-executive split. Non-executive directors only became common on UK corporate boards following the 1992 Cadbury Report. The report recommended that there should be sufficient non-executive directors for their views to make a difference, and that the majority should be independent, with the intention that they would bring judgement and experience to board deliberations that executives alone would not. As such, corporate boards now typically consist of both executive and non-executive members.

So are pension scheme trustees executive, non-executive, or a mixture? The 2003 Higgs Report into the Role and Effectiveness of non-executive directors concluded their role had four elements – strategy development and challenge; oversight of executive performance; internal controls and risk management; and deciding remuneration for executive directors. The work of many pension trustees fits into this framework – they develop and challenge strategy; they oversee advisers and administrators; they have risk management and internal controls in place; and they set the terms of contracts with their advisers. But are the majority independent?

In the corporate world, the independence of the majority of non-executive directors is usually the responsibility of the nominations committee. The committee identifies suitable candidates for appointment to the board and periodically reviews composition and skills requirements. However, no such counterpart is common in the pension scheme world - professional trustees are often appointed by a single sponsor contact, and member-nominated trustees commonly voted in by the membership. Neither of these recruitment methods may be optimal in a world where both board diversity and true independence is assuming greater importance.

The 'selection' versus 'election' debate has sometimes been controversial with members. But a robust panel selection process for all trustees (not just member-nominated ones) could go a long way to helping board composition in terms of diversity, required skill-sets and independence.

A word on tenure

The Cadbury Report did not suggest a maximum term for non-executive directors, but did suggest that they become less independent over time. Likewise, the 2018 Corporate Governance Code states that board membership should be 'regularly refreshed'. Nine or ten years is a common maximum tenure in the corporate world, yet some pension trustees have been on the board for 20, or even 30 years! While there's a balance to be struck between making board changes too frequently vs too infrequently, we must start to question effectiveness when the same group meet for many years and become immune to new ways of thinking and doing.

So, what is the direction of travel for board composition?

We'll no doubt see increased guidance on diversity and recruitment methods as well as a greater focus on independence and maximum terms. Master Trusts already face rules on their board composition, with a minimum board of three, a maximum 10-year stint (re-appointment after 5 years) and with the majority of board members having to be non-affiliated.

Diversity, independence, tenure - three words to watch in pension board composition!

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