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Insights

Mitigating the Employer's Fiduciary Risk in Tier 2 and Tier 3 Defined Contribution Plans

In our recent publication we highlighted the fiduciary responsibility conferred by the Pensions Act of 2008 ("The Act) on employers, and outlined the risks associated with employers assuming this new role. In our opinion, the most significant risk that employers need to manage and mitigate is the risk of being sued by current and former employees for non-performance of the employer's fiduciary duty as the sponsor of the Tier 2 or Tier 3 pension scheme. In this paper we recommend some concrete steps that employers may take to manage and mitigate this risk.

Under the Act it is the responsibility of employers to provide an Occupational Pension Scheme (Tier 2) to their employees, and to facilitate employee contributions into Provident Funds or Personal Pension Schemes (Tier 3). This puts the employer in a fiduciary relationship with the employee.

The employer's role in establishing the defined benefit pension scheme

The Government of Ghana has commenced the implementation of the Pension Act of 2008 ("The Act"), which created a three-tiered pension regime to replace the one-tier regime administered by the Social Security and National Insurance Trust ("SSNIT"). Under the Act, every employer is mandated to provide an Occupational Pension Scheme for their employees (Tier 2), and to facilitate employee contributions into Provident Funds or Personal Pension Funds (Tier 3). The specific responsibilities that the employer has assumed may be summarised as follows:

- Designing the structure of the overall scheme and establishing its governance and oversight framework.
- Deciding on the form of the trustee and selecting external and independent trustees if required.
- Monitoring the performance of the trustee and making changes where required.
- Making contributions to the custodian and submitting reports to the authorities.

What is the fiduciary duty?

As stated in the Act, a fiduciary is not permitted to profit from the fiduciary's position and owes undivided loyalty to the other party, in this case the employee or pension scheme participant. The fiduciary must avoid conflicts of interest unless otherwise authorised by the other party after full disclosure. Legal precedent for companies sponsoring defined contribution schemes in the UK and US outline the fiduciary responsibility as follows:

1. Acting in the best interest of scheme participants and not yourself.
2. Acting impartially and not discriminating among different classes of employees.
3. Acting prudently, responsibly and honestly; acting in a way that a prudent person would in their own affairs.
4. Avoiding conflicts of interest.

Given that the funds being invested in Tier 2 and Tier 3 schemes are effectively the employees' contribution – employees contribute 5.5% of their salary, of which 5% is allocated to the Tier 2 scheme - and that the money will be invested in assets that could gain or lose value, employers need to take particular care in ensuring that the proper governance and operational structures are in place for performing the functions required by the Act. Clearly, this is uncharted territory for most companies in Ghana, and puts them in a relationship they have hitherto not had with their employees.

Risks associated with this new role

The risks associated with the employer's new role as pension scheme sponsor are legal risk, reputational risk, regulatory risk and strategic risk. Of these, we believe

Defined Contribution Schemes

- Tier 2 and Tier 3 schemes are defined contribution scheme. In a defined contribution scheme the employee contributes a fixed amount, typically on a periodic basis. The payout to the employee on retirement is not a predetermined amount but depends solely on how well the investments of the scheme have performed.

Employers should establish a committee to recommend the scheme structure and create a process for selecting and evaluating trustees.

that the legal risk - the risk of legal action by employees for actual or perceived breach of the fiduciary relationship - is the most significant. It is therefore important that at the highest governance levels of the company these issues be discussed and a structure put in place to effectively govern the employer's defined contribution schemes. Implementing an effective governance structure is essential for mitigating the legal risk the employer assumes through its role as pension scheme sponsor, and increases the likelihood of the scheme being successful in providing adequate returns for participants.

Limiting and mitigating the employer's legal risk

Mitigating the potential liability that employers are exposed to begins with establishing clear, documented processes for decision-making and oversight. Established processes, and a disciplined adherence to them, are what demonstrate that the employer has acted in the best interest of scheme participants. This is true even when investment results are not exactly what the employer and the employees would hope for. Some concrete steps that employers may take as they begin to implement their Tier 2 and Tier 3 pension schemes under the Act are:

1. Establish a committee to oversee the scheme. Ideally, the mandate of the committee should be established by a board resolution and should specify details like how often the committee will meet, who the specific titles or roles within the company to serve on the committee are, how and how often individuals on the committee will be chosen, and how often the committee will need to report to the board of directors. The committee will be charged with recommending the scheme structure and the trustee choice to the board for approval.
2. The committee should implement a written policy that documents how trustees are chosen, monitored and, if need be, replaced. The policy should be detailed enough so that anyone reviewing the initial choice of trustee and any subsequent changes would understand the decisions that were made and why. If the committee decides to establish a trustee made up of representatives from the company, it should be clear that the trustee is independent of the employer.
3. The board should ensure that all committee deliberations and communications are properly documented.
4. Implement and follow a process for monitoring the fees paid within the scheme.
5. Document the contributions process and ensure that it is robust. Keeping employee contributions for even a few days beyond the legal limit puts the employer at regulatory and legal risk.
6. Ensure that there is a 3-way communication strategy among the employer, the employees and the trustee. Regular communication with scheme participants builds trust and provides early indications of administrative and investment concerns that employees might have.
7. Have a formal process for auditing the key operational elements of the plan to ensure that

Clear, documented processes for decision-making and oversight, and the discipline to adhere to these processes is necessary for demonstrating that the employer is acting in the best interest of scheme participants.

established processes are being followed.

8. Consider hiring an independent third party to oversee this process and ensure that all the above elements are in place. In addition, where the trustee is made up of representatives of the employer and other individual trustees, an independent third party may also be hired to advice on investment policy formulation, asset allocation, and fund manager selection and monitoring.

Summary

The Act has placed Ghanaian employers into the new role of defined contribution pension scheme sponsor and has introduced a new relationship between employees and their employers. Although the responsibilities that employers have assumed expose them to risks that they have not had before, the management and mitigation of these risks are fairly simple. However, it requires the establishment of an appropriate governance structure, and a disciplined adherence to process and documentation. With the proper structures and processes in place, employers will be able to effectively mitigate these risks while ensuring that their Tier 2 and Tier 3 defined contribution pension schemes have a high likelihood of producing the competitive investment outcomes.

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