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The governance game

In search of effective pension board planning

John Por is founder and president of Cortex, a Toronto-based consulting firm with a US practice. Cortex specializes in pension governance and fiduciary risk management, and the firm's roster of clients includes the likes of the California State Teachers' Retirement System, EDS, DuPont, IBM, Lockheed Martin, and the Virginia Retirement System. The erudite Por, who holds a Ph.D. in engineering, has long argued that many of the inefficiencies that get in the way of intelligent decision-making in the pension arena are frequently a function of ineffective governance procedures. He talked with *Plan Sponsor* Editor-in-Chief Charles Ruffel about what can be done to get pension governance right.

Why did you move from an international consulting giant like Mercer to start your own firm?

Por: Opportunity, to a large extent. It became clear to me 10 years ago that there was no professional consultancy that specialized in managing the total fiduciary risks that face sponsors and the trustees. Our experience has convinced us that many of the problems that arise in this area can be traced back to a lack of good governance and fiduciary decisionmaking (across process, structure, knowledge, and monitoring). All of this indicated to us that there was a problem that was important, and that no one was addressing. That was the opportunity.

What is the difference in pension governance issues between public sector and private sector pension plans?

In the private sector, not enough executive attention is dedicated to the issue. The fact is that senior executives do not have the time—or choose not to spare the time—to devote to pension issues, despite the fact that pension assets actually often compare in size with operating assets. As a result, too many decisions, especially when it comes to 401(k) plans, are effectively made without early input of senior executives. That poses huge risks.

In the public sector, pension boards have problems of their own: heterogeneous membership; conflicts between constituency interests and fiduciary duties; absence of effective trustee education; and the lack of a sound board governance model are issues shared by way too many public plans. In addition, pension board accountability is ill-defined, yet, at the same time, the board's power is almost unlimited.

In various forums, you have made clear that you believe that the lack of proper participant education is the Achilles' heel of the 401(k) arena. Moreover, you say that failure to provide properly for education will likely lead to significant legal challenges to plan sponsors in the future. Can you talk us through that?

Education is driven by vendors with a strong vested interest to add to their own bottom lines

We found that even the most sophisticated sponsors do not follow a well-thought-out education approach that is commensurate with the complicated programs and myriad choices that their participants face. It is not unusual for plans to offer a large number of options to participants, often in fact many more options than they apply to their defined benefit plan which is, by contrast, managed at the highest level of the company (variously by board committees, the CFO, the treasurer, an investment committee and, often, a director of pensions).

Compare that expertise with the knowledge that the average or even the most sophisticated participant has at his or her disposal. Moreover, those participants are bombarded on a daily basis by perhaps the best-funded mass marketing machine ever invented—the US financial services industry. We also have come to understand that the education is driven by vendors of money management services with a strong vested interest to educate participants on issues that add to their own bottom lines.

As a result of this imbalance (in theory, if not, one would hope, in practice), there are as many potential lawsuits as there are plan participants. These participants may start looking for deep pockets if the retirement income they receive lags their expectations, an increasingly likely prospect given that these expectations are created by the financial services industry. Hence, education and demonstration of prudence are paramount.

What are the main obstacles to effective pension board governance?

These are many and various. Here are a few: lack of discussion of the job of the board as a fiduciary and crisp documentation of trustees' roles and responsibilities; lack of clarity as to what is actually delegated to the executive director; lack of shared and appropriate knowledge possessed by the trustees—despite claims to the contrary, the current available education programs are not delivering that knowledge. Trustees are not developing that knowledge together as a board, though they have to make decisions as a board. Different levels of understanding of the issues lead, inevitably, to ineffective board decisionmaking.

All too often, there is a lack of well-thought-out and crisply written policies that actually aid decisionmaking by providing guidelines for decisions. Instead, there are all too often details that have no relevance to the board's job. Likewise, there is a lack of appropriate monitoring on the part of the trustees that report on the most important issues to insure that they concentrate and not get lost in the details. There is also a reluctance to examine how boards can best spend their time and

what they can delegate to professional staff. Micromanagement is the enemy—it leads to suboptimal results, disgruntled pension staff, and lack of accountability. It has to be avoided at all costs.

There seems to be an overabundance of seminars where trustees can learn about investment. Why is this an issue?

To date, most of the programs of this nature are financed one way or another by the investment industry, which has its own interests to promote. The trustees, on the other hand, are not managing money or asset classes—instead, they are charged with overseeing a complex asset/liability consideration and a total portfolio-driven program. Investment managers have a different point of departure. In addition, trustee knowledge should be different in nature and depth—you do not want trustees to tell your staff how to run investments based on two conferences a year. That sounds absurd, but that is too often exactly what is happening.

The fact is that a new approach, directed to the whole board on the most essential issues, is called for. Trustees do not need to know what a Sharpe ratio or beta is, but they do have to understand the risk created by the asset/liability mismatch and the hierarchy of risks that the pension fund is exposed to, without getting into technical details. That straightforward accumulation of relevant knowledge brings remarkable changes in how a board operates.

What is the state of the art when it comes to the use of strategic planning by pension boards?

Strategic planning, if you really dissect it, is about choices between alternative uses of capital—that is why corporations developed it in the 1970s. The mission of the pension system is clear and, to be honest, it can rarely be changed (not least because of ERISA and state legislation). So, by definition, applying strategic planning principles to pension systems is not without problems. But planning is a good exercise; it just has to be tailored to the specific circumstances of a pension system. We found that planning around fiduciary risks would ensure relevance and consistency over the years.

Interviewing trustees about their perceptions is useful but it has to be complemented by analysis of the different risks, and planning should be about how the board plans to mitigate these risks. Finally, it is important that the role of the board and staff are distinct in planning; if not, the planning exercise will invite the trustees to act as staff on planning issues. That is exactly the opposite of what they should be doing—they should be overseers and not doers. (PS)