

Good Pension Governance: An Advocate's Guide for Improvement

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In the February 2000 issue of *The NAPPA Report*, Philip Lochner and Richard Koppes present a strong argument for better pension board governance ("Good Corporate Governance and its Advocates: The Governance of Public Pension Funds and the Governance of Public Companies").

In their call for better governance of public pension funds, Lochner and Koppes discuss and assess a number of criticisms that have been directed at public funds by the corporate community and other critics. These include incidents of self-dealing, investing in dubious projects with questionable returns, divesting of legitimate investments with excellent returns, and failing to provide the levels of public disclosure that public funds demand from private corporations, to name just a few.

Lochner and Koppes observe that public funds have benefited from benign neglect by the national financial and business media, and they suggest that this is unlikely to continue forever. They urge public funds to take steps to reform themselves voluntarily, rather than find themselves vulnerable to criticism and be forced to change - the outcome of which would almost certainly be sub-optimal.

Based on our experience providing management consulting services to large public funds, we share the views of Lochner and Koppes, and we support the authors in urging public funds to be proactive in improving their governance practices. In this article, we would like to pick up where Lochner and Koppes left off. Specifically, we would like to offer some practical suggestions as to how public funds can improve from a governance standpoint in order to fend off potential criticism. Before suggesting solutions, however, we will first describe some of the problems we have noted in the course of our work with public funds, and their underlying causes.

Lack Of Clear Roles

Public funds have generally failed to establish distinct and meaningful roles for boards, management, and key service providers. This has resulted in numerous problems such as strained

working relationships between board and management (staff), excessive micro-management by boards, and operational inefficiencies that arise because every issue must be brought to the board.

While it is generally accepted that the board's role is to set policy and management's role is to implement it, public funds need to go much further in defining these roles in specific terms. The devil is in the details and, in the case of a public pension fund, there are an awful lot of details. For example:

- Who hires service providers (e.g. investment managers, custodians, investment consultants, computer consultants)?
- Who hires staff (the Chief Investment Officer, portfolio managers, etc.)?
- Who approves investment strategy and manager structure?

It is rare that the board's answers to the above questions are consistent with management's answers. If one looks at the many activities that must precede the above decisions, the delineation of responsibilities becomes murkier still. For example, before a decision is made to engage an investment manager, numerous activities and decisions must take place (e.g. establishing a long list of candidates, research, site visits, establishing a short list, interviewing candidates, etc.). Seldom is there a full discussion on who should be responsible for each of these preliminary activities. Instead, it is generally assumed that the board should participate in each of these activities, though the nature of this participation is again usually ill defined.

Furthermore, having a vague decision-making structure in which the board is heavily involved in every decision makes it extremely difficult for management to play a meaningful and challenging role. Public funds have been fortunate to date in finding high caliber executives able to carve out meaningful roles for themselves. Finding such talented and flexible individuals, however, will almost certainly prove more and more difficult in the years to come.

Lack Of Policy Focus

Many public boards have not come to terms with their role as policy setting bodies. As a result, they have great difficulty gaining closure on relatively straightforward issues that arise in the normal course of business. They regularly re-visit past decisions on a wide range of issues including trustee travel, asset allocation, investment strategy, social and ethical investing, human resource management, and communications. While we support regular review to ensure the continued appropriateness of current policy, the approach taken by many public funds goes far beyond a simple review and often amounts to reinventing the wheel. When faced with a number of decisions or events that are similar in nature, boards tend to make a decision on each of them, rather than recognizing that they are all variations on a theme and can be adequately addressed by a single policy decision.

Thus, for example, a single trustee education policy can obviate the need for boards to assess the worth of every educational conference that comes along. Establishing a policy for hiring service providers can lessen or even eliminate the need for a full presentation to the board every time a service provider is hired. A Communications Policy can eliminate the need for boards to review every newsletter before it is issued to the membership. A CEO (Executive Director) Performance Evaluation Policy can eliminate the need to annually establish a process for assessing the CEO's performance. A Social and Ethical Investments Policy can dramatically reduce the energy required to assess every investment decision with social or ethical implications.

Admittedly, recognizing issues that require a policy and crafting policies that will provide effective guidance to management in a wide range of scenarios is somewhat of an art. But it is an art that boards can and should learn; after all, setting policy is their main purpose. While it may at times seem like a waste of time to be debating and drafting policies, once completed, they will save enormous amounts of time for everyone, clarify the roles of the board and management, and enhance the overall efficiency of the organization.

Lack Of A Business Model

Many public funds may be operating on the basis of a flawed business model. Of course this can be said of many private sector corporations, as

well. To effectively govern any organization, one must understand three crucial questions:

1. What outcomes constitute success for the organization?
2. What are the driving factors that will determine whether the organization is successful?
3. What are the major risks that need to be managed in connection with the business?

The answers to the above questions constitute the model of the business, and every business operates on a different model. The model adopted by many public funds appears to contain certain flaws. For example, with respect to the first element of the model, most industry experts would argue that the true measure of success for a public fund is the funded status of the plan. Most public funds, however, seem to operate on the basis of a model in which investment returns of the total fund or of individual managers constitute the primary measure of success. The adoption of such a model explains why many public funds focus primarily on the asset side of the organization, and focus relatively less on asset/liability management.

In terms of the second element of a business model – the driving success factors - most public funds operate as if the primary driver of success is effective selection of investment managers. In fact, manager selection has relatively little impact on the success of the Fund. The real driver of success is asset allocation in light of plan liabilities, yet public funds spend relatively little time trying to fully understand plan liabilities and the relationship between liabilities and assets.

There also appear to be some misconceptions among public funds about the third element of a business model – the major business risks. Again, it would appear that most trustees view the major risks to lie with the investments; e.g. stock market declines and selection of poor investment managers. In fact, the major risks for public funds do not lie with the investments, but with the system of benefit administration system. Few, if any, trustees have ever been sued for poor investment performance. Lawsuits concerning benefit payments, member communications, and service levels, on the other hand, are commonplace. To the extent that there are major risks involving investments, they pertain to human resources; i.e. ensuring public

funds maintain adequate staff to properly oversee the investment program. Again, this risk receives relatively little attention.

Without a thorough understanding of the appropriate business model, public funds will have great difficulty organizing themselves to greatest effect. They will, instead, invest their energy on inappropriate activities in an attempt to achieve misguided goals. At best this is terribly inefficient; at worst it is counter-productive.

Ineffective Education Programs

Trustees, to their credit, devote considerable time and effort to education, primarily by attending a variety of conferences that are geared to public funds and that focus on investments. But in the vast majority of cases, these conferences are not designed to provide trustees with a sound understanding of the appropriate business model (with the exception of certain conferences sponsored by not-for-profit industry associations).

Rather than addressing the big questions - what constitutes success, what do we really need to do well in order to succeed, what risks have to be managed, and what is my role, as a trustee? - most conferences focus on what in many ways can be described as the nitty-gritty of the investment function: short-term market outlooks, the future prospects of China, alternative investments, hedge funds, and various other tantalizing topics. Most conferences are driven and financed by the financial services community, which operate on a different business model and have a different view of the nature and scope of a trustee's role. Accordingly, conferences introduce trustees to concepts and issues that are not directly related to their duties as policy makers and overseers. They neither encourage trustees to develop the broad vision they need to set policy, nor do they provide the practical grounding a board needs to oversee a fund's operations.

This is not to say that conferences do not have a role to play. They provide an opportunity for trustees to network and share experiences. They may also provide trustees with a perspective on the money management industry. But conferences alone do not provide trustees with the fundamental knowledge they need to effectively govern the pension business from a policy and oversight perspective.

Legislative Impediments

Perhaps the biggest and most fundamental problem with public funds is the inherent difficulty trustees have in trying to balance the various roles they inevitably must play: fiduciary, elected official, retiree representative, labor representative, and protector of the interests of the general public, to name a few. Perhaps no other issue has caused more grief for public funds and proven more difficult to resolve. The root cause of this problem, unfortunately, lies in the design of most governing statutes that prescribe how pension funds will operate. These statutes typically enshrine the representative nature of public pension boards. More importantly, most pension statutes do not adequately align the interests of plan members and sponsor by, for example, establishing an equal sharing of risk (funding deficits) and rewards (surpluses). When interests are not aligned, parties have an incentive to capture as much reward as possible for themselves, while shifting as much risk as possible to the other party. Clearly, this is a recipe for never-ending friction.

We have devoted considerable time and effort in trying to develop practical solutions to the above problems. For the most part, the solutions are, at least in theory, reasonably easy to implement.

Here are four suggestions:

1. Establish Position Descriptions

To establish greater clarity around roles and responsibilities, we would suggest that boards initiate a review of their committee and board charters and the job descriptions of senior management. The aim of the review should be to examine every major decision or task and ensure that accountabilities are clear and, equally important, reasonable and sound. For such a review to be effective, boards must avoid simply confirming past practices. Instead, every aspect of the existing decision-structure should be questioned and all reasonable alternatives should be given fair consideration. Boards may wish to begin the process with a workshop that is open to board and management, during which fundamental governance principles can be discussed and agreed upon, major business risks can be identified, and specific decisions can be made concerning delegations of authority that will ensure proper risk management.

2. Establish Governance Policies

We have found that boards of trustees can benefit significantly from establishing a collection of governance policies covering issues such as the process for developing policy, evaluating the performance of the CEO, developing budgets and business plans, conducting due diligence, and overseeing trustee travel, to name but a few. Developing such policies not only enhances the efficiency of the operations of the board, but also helps to further clarify the roles and responsibilities of the various decision-making bodies.

For example, a due diligence policy should clarify the roles of the board, its committees, and the CEO/CIO in the due diligence process. In developing governance policies, it is important to recognize that while the resulting written policies are important, it is the discussion and debate that is generated in the process that are most valuable. Therefore, the process used to develop one's governance policies should be carefully designed to encourage and stimulate as much discussion and interaction by trustees and management as possible.

3. Develop a Trustee Education Policy

To help ensure that the trustee education programs of public funds yield maximum results, we would urge public funds to develop written education policies. An education policy should set out the objectives of the education program, the expectations and standards to be met by trustees, and should define appropriate methods for obtaining relevant education. We would suggest that the cornerstone of such a policy should be an emphasis on ensuring that trustees gain an understanding of the business model of the pension fund; i.e. the success measures, driving factors, the significant risks to be managed, and the role of trustees and management within the model. As mentioned above, however, such knowledge is not readily gained by attending traditional conferences, so we would suggest that any education policy include a requirement to dedicate some minimum level of effort to internal seminars or workshops that can be tailored to dealing with these important issues.

In order to help trustees to balance the various competing roles that they play, we would also suggest that an education policy should place heavy emphasis on the topics of fiduciary duty

and conflict of interest. For example, a policy could stipulate that every new trustee be briefed by counsel on these topics and in addition, that the entire board receive a refresher course on the subject annually, again delivered by counsel.

4. Statutory Change

We noted above that perhaps the most difficult challenge public funds face is ensuring that trustees effectively balance the multiple roles they often are required to play. With the exception of providing education concerning trustees' fiduciary duties, there are no solutions short of enacting radical changes to current statutes governing public funds. Though we support Lochner and Koppes in suggesting that public funds have a role to play in seeking appropriate changes to the statutes that affect their powers, activities, and structures, we are less optimistic that such changes can actually be achieved. Over the years, vested interests have become well entrenched and are unlikely to welcome major change.

The above represent suggestions that public funds may consider as part of an effective defense against criticism by the media, the corporate community and, most important, the regulators. The path to enhanced governance practices is not an easy one, nor a short one. But demonstrating a commitment to ongoing improvement, even if the improvement is gradual, may be just enough to prevent the imposition of legislative or regulatory cures.

(Editor's Note: This is another in a series of articles written by non-NAPPA members. Mr. Por and Mr. Iannucci are with the Toronto-based Cortex Applied Research, Inc. From his own experiences the editor believes the General Counsel of the pension fund plays a key role in making many of the above excellent recommendations happen with his or her board.)

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