Board Smart

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FIVE KEYS TO IMPROVING BOARD EFFECTIVENESS IN PUBLIC RETIREMENT SYSTEMS

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Introduction

The success of public retirement systems is critical to public employees, public employers, and the general public. Good governance is key to that success.

This article is the first in a series that describes five keys to improving board effectiveness. The goal is to help public pension fund trustees and executives successfully respond to the challenges they face.

> *"It is not the strongest of the species that survives, nor the most intelligent; it is the one most adaptable to change."*
>
> - CHARLES DARWIN, BRITISH NATURALIST

Being a trustee can be a tough job!

U.S. public retirement system trustees have demanding fiduciary duties. They must make decisions with consequences affecting more than 20 million people. These trustees invest more than $6 trillion in assets. They need to compete with the private sector to invest those funds… but are often constrained in the compensation they can pay and the staff they can hire. And every decision is made in a public "fishbowl" environment, with multiple stakeholders critiquing every move.

Being a public retirement system fiduciary is a tough and often thankless job. And it has gotten tougher.

The first two decades of the 21st century have been characterized by rapid change and high uncertainty, if not outright chaos. Sudden shifts have occurred in everything from geopolitics to the economic environment to the state of scientific knowledge.

In uncertainty, public retirement systems, like every enterprise, need to be both agile and resilient to thrive, or even just to survive. Effective governance is critical for rapid adaptation to uncertainty.

Research has shown good governance can improve investment performance by as much as 1-3% annually.[1,2] But what is meant by good governance?

Governance challenges for lay boards

The board must collectively direct, oversee and ensure effective control and functioning of the retirement system. To do so effectively, there needs to be a common understanding of roles, and responsibilities in how to govern well.

Govern: To collectively direct, oversee and control the system

Trustees are part-time volunteers, with a vital diversity of backgrounds, experiences, and expertise. Trustees bring different understandings, expectations, and perceptions of governance, performance, and risk.

All but the few trustees who are already investment or benefits experts are faced not just with a new field, but a whole new language. Few have been on the board of an operating organization with billions in assets.

Onboarding for new trustees is often overwhelming. There are steep learning curves for trustees and there is no forgiveness period.

But getting informed and staying informed is a duty for all trustees, not just those who are new. Adding to the challenges, public pension issues rarely have simple answers, thus placing a premium on informed judgment. Being informed and situationally aware is critical.

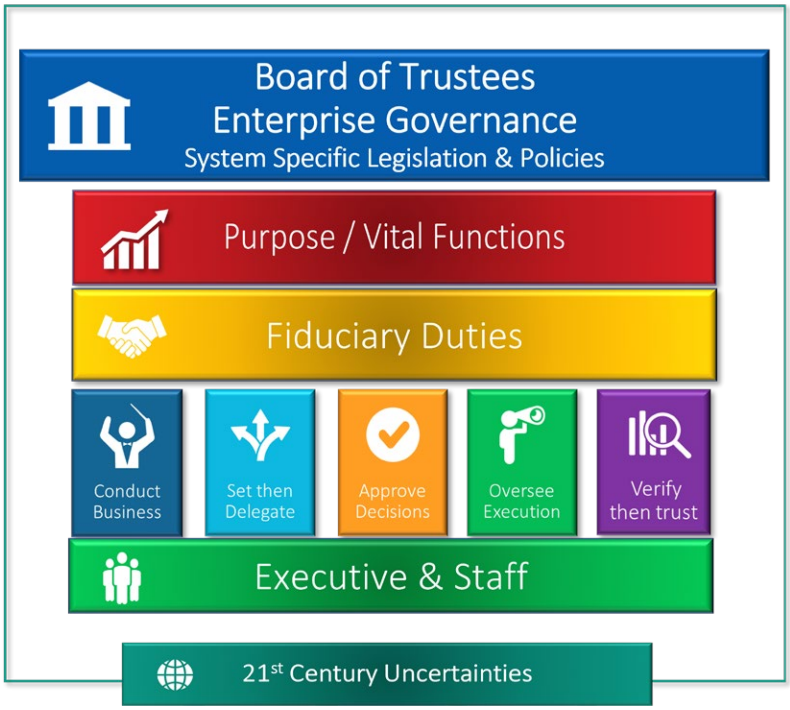
Trustees also face a host of conflicting influences: Whose interests do trustees represent? Those that elected or appointed them? The jurisdiction? Taxpayers? Members and beneficiaries? Current and future? The system overall?

Success in uncertainty demands clarity and consistency of leadership and direction. The diverse views, experiences, and skill sets trustees bring to the board room should create robust discussion. Boards and staff should welcome and encourage diverse opinions and constructive challenge. Understanding how to better exercise the powers of the board can help trustees come to a common understanding, acceptance, and commitment to an informed, clear and unified direction for the system.

Trustees need to be able to quickly develop a clear and common understanding of effective governance. This understanding includes the respective powers, roles, and responsibilities of the jurisdiction and its oversight bodies, the board, the board's auditors and independent advisors, and the executive and staff.

Enterprise Governance for Public Retirement Systems

The enterprise governance framework described in the graphic below results from an analysis of the legislation, bylaws, and other structures governing public retirement systems, as well as insights gained through consulting with scores of systems, with aggregate assets of more than $2 trillion. While recognizing that every system is unique, there are some overarching lessons learned.



System-specific legislation and policies

Legislation typically describes the purpose of the public retirement system, the vital functions it performs, the board's fiduciary duties, and the powers reserved for the jurisdiction and the board to fulfill those duties.

Purpose and vital retirement functions

Generally speaking, the purpose of a public retirement system is to administer benefit programs and sustainably create and protect value for all current and future members and beneficiaries despite uncertainties.

The retirement functions can range from investments and member services to health care and administration.

Core fiduciary duties

The core duties of a fiduciary are to:

- Act loyally and impartially in the best interests of all current and future members and beneficiaries
- Be prudent by exercising care, skill, and diligence
- Stay informed and aware
- Diversify assets and control costs
- Comply with the law
- Don't turn a blind eye to misdeeds of other fiduciaries

> Prudence is demonstrated by process

Whether a fiduciary acts in compliance with the prudent investor rule depends on the facts and circumstances at the time of the fiduciary's action – "not by hindsight". In other words, the rigor of the process used to arrive at the decision is critical.

Five key powers reserved exclusively for the board to fulfill its duties

Regardless of jurisdiction, the authorities of a retirement system board can be organized into five key types of powers reserved. A power reserved is a decision or an authority that can only be exercised by a specific decision-maker. Fiduciaries fulfill their fiduciary responsibilities through the prudent exercise of the five powers.

1. Conduct the business of the board and its committees. This power includes governance policies, agenda-setting, rules of order, self-evaluation and development, committees (structures, charters, composition, selection/election of chairs and vice-chairs), evaluation, compensation, and succession of the executive director (ED), and the chief audit executive (CAE), and board member dynamics and engagement. It also entails having clear lines of relationship with the board.

2. Set direction and then prudently delegate. This power includes strategic thinking and planning, choice of goals, objectives, and related risks (risk appetite), and providing policies to guide the operations of the board and implementation of the strategic direction (risk tolerances).

3. Approve key decisions. This power identifies which decisions and thresholds require board approval and which can be wholly delegated to management.

4. Oversee the execution of direction within policy. This power includes establishing vital signs for vital functions consistent with the system's risk appetite and risk tolerances, escalation criteria, and processes, to facilitate effective oversight.

5. Verify then trust. This power includes verifying the reliability of the information received from executives and assessing reassurance and verification from parties independent of management such as internal and external audits as well as other parties retained for that purpose. A key responsibility is to ensure there is an effective system of internal control.

The board can and should retain independent auditors and advisors.

The executive director and staff are, in turn, responsible for:

1. Executing board approved direction within policy
2. Maintaining accurate records and providing timely reports
3. Researching policy issues / recommending options
4. Engaging / consulting with key stakeholders
5. Reasonably assuring the board that performance is (or is not) as expected

A more in-depth discussion of the effective exercise of each of these key powers is the subject of the five articles which follow in this series.

Three governance principles

There are three principles that help boards effectively exercise all three powers reserved. They are characteristic of effective boards.

One size fits one.[3] While there may be "lagging", "prevailing" and "leading" practices, "best" practice is that which best fits the individual situation of a particular system, so as to effectively and efficiently achieve a goal of that organization. One size fits one asks the board to choose its options within the specific facts and circumstances that apply.

Situational awareness matters. Organizations exist in an ever-changing environment. Disruptive events, new technologies, and regulatory changes are just some of the challenges boards must navigate. It is essential to understand what is vital, what has changed, is changing, or will change; how rapidly, and what impact it will have on the organization. Situational awareness alerts boards to those changes.

Constructive challenge is the respectful but effective questioning of management, other board members, and other advisors and presenters to the board. Constructive challenge both enhances board understanding and ensures proper due diligence has been performed. Constructive challenge ensures that the options the board considers have been properly understood and vetted.

Be well governed for successful adaptation!

Successful adaptation to an ever-changing environment means understanding the organization's available options and choices and the strengths and weaknesses of those options in advance of when they are needed.

An Enterprise Governance Framework can help public retirement systems improve governance and thus system performance by:

- Providing a quick reference guide
- Simplifying and providing a context for otherwise random listings of duties and responsibilities
- Improving clarity of roles, authorities and accountabilities
- Accelerating the learning curve
- Providing a common language
- Improving engagement

We hope the series will stimulate your thinking and contribute some ideas on how to improve the effectiveness of your board by improving the exercise of the five key powers. The next article in this series describes nine leading practices to help boards more effectively conduct the business of the board and its committees and establish clear lines of relationship with the executive and staff and the board's independent auditors and advisors.

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[1] * ISS / Harvard demonstrated best-governed companies—as measured by the ISS Corporate Governance Quotient—had mean returns on investment and equity that were, respectively, 18.7 percent and 23.8 percent better than those of poorly governed companies during the year reviewed

[2] "How much is good governance worth?" Chapter 19, Keith Ambachtsheer (2007). Pension Revolution. Wiley.
Ammann, Manuel, and Christian Ehmann (2014) "Is Governance related to Investment Performance and Asset Allocation? Empirical Evidence from Swiss Pension Funds." University of St. Gallen Working Paper, Journal of Asset Management (2008), "Best-Practice Pension Fund Governance" Gordon Clark and Roger Urwin. Boston College 2019, Center for Retirement Research. "Does Public Pension Board Composition Impact Returns?" Jean-Pierre Aubry and Caroline V. Crawford.
See also earlier studies by ISS and Harvard that demonstrated that best-governed companies—as measured by the ISS Corporate Governance Quotient—had mean returns on investment and equity that were, respectively, 18.7 percent and 23.8 percent better than those of poorly governed companies during the year reviewed.

[3] One Size Fits One: Building Relationships One Customer and One Employee at a Time. Wiley; 2nd edition (April 26, 1999)