National Conference on Public Employee Retirement Systems

Best Governance Practices for Public Retirement Systems

Introduction

Increasingly, public employee retirement systems are implementing leading edge governance and risk management practices to position their funds for improved performance, while addressing risks related to the financial markets and global economy.

As the largest trade association for public sector pension funds representing more than 550 funds and nearly $3 trillion in assets, the National Conference on Public Employee Retirement Systems (NCPERS) supports these initiatives.

NCPERS believes that instituting best practices drives accountability, consistency and transparency, which enables improved performance and risk oversight for the benefit of public pension fund members, taxpayers and other stakeholders. To further these outcomes, NCPERS has developed Best Governance Practices for Public Retirement Systems.

Background

Governance is on the front burner for corporations, regulators and pension funds alike. In the private sector, lapses evidenced by overexposure to mortgage related securities, excessive leverage and lack of adherence to risk controls led to the collapse of well – known Wall Street investment banks and contributed to a meltdown that at one point eliminated $4 trillion from pensions worldwide.[i]

Among retirement funds, boards and stakeholders are focusing on considerations such as board practices, standards of conduct, risk management and actuarial practices. In the current environment, there are several points for public fund fiduciaries to consider:

- There is a strong link between best practices and performance. Research has found that effective governance may improve long-term investment returns by up to 2.4%, annually[ii]
- Beyond investments, best practices such as fiduciary training and risk assessments drive performance across administrative, member service and compliance functions
- The current focus on fund governance is likely to increase in light of policy debates that are increasingly focused, largely without merit, on public employee benefit levels
- Managing reputation risk is an increasingly important challenge for public funds. A fund may reduce the probability and severity of risk events by implementing a risk framework
- Notwithstanding public pension funds' record of implementing best practices, the need for communicating how they work to benefit stakeholders has never been greater.

Pension Fund Governance and Oversight

A pension fund's governance structure is typically comprised of its board, executive management, functional staff and contracted service providers. Within this structure and under the fund's statutory framework, the board sets strategy, approves implementation plans and oversees performance and risk. The board delegates specialized functions such as actuarial studies, asset management, benefits administration and auditing to internal staff and contracted service providers. The fund functions within a framework that is comprised of statutes, rulings, agreements, policies and contracts that regulate system operations. Risk oversight is a key responsibility of the board. In the post financial crisis environment, managing reputation risk is an increasingly important responsibility for public funds.

NCPERS Best Governance Practices

NCPERS encourages fiduciaries who have not done so to consider adopting the following practices with the understanding that flexibility in implementation is one hallmark of effective governance.

I. Governance Manual

Whether it is in electronic or paper form, a fund should adopt a governance manual that serves as a central repository for the fund's primary governance documents. A well designed governance manual facilitates effective management and provides a tool to educate trustees and stakeholders on fund operations. Key components include:

- Summaries of statutes, regulations, the plan document and board practices
- The systems' mission statement and, if applicable, its vision and guiding principles
- The organization chart, lines of authority, job descriptions and summaries of contracts
- Board policies, key procedures and, if applicable, charters for committees of the board
- References to rulings and agreements that determine benefits and contribution levels

II. Board Practices

A pension fund should establish, document and adhere to a set of practices that have a proven impact on performance and risk oversight. Some of these practices are mandatory (e.g. actuarial valuations), while others may be optional. Recommended practices include:

- Development of a strategic plan or equivalent that guides the fund towards its goals
- Adoption of a fiduciary education program to continuously improve fiduciaries' skill sets
- A program of assessments and audits to evaluate internal controls, performance and risk
- Actuarial valuations to inform the board of the fund's future financial needs
- Asset allocation studies to identify asset mixes for meeting future financial needs
- A corporate governance approach under which the fund votes its proxies

III. Board Policies

A fund should adopt and adhere to a set of policies designed to guide system operations toward the achievement of stated goals within established risk tolerances. While their form may vary, a board's key policies and procedures should include:

- Standards of conduct, ethics and conflicts of interest rules to codify the duties of fiduciaries
- An investment policy that includes goals, monitoring procedures and board risk tolerances
- Procurement guidelines that document procedures for selecting and monitoring contractors
- A privacy policy that sets forth procedures for protecting members' confidential data
- A risk policy (or equivalent) that defines fund risks along with measures and processes

IV. Risk Oversight

A fund should adopt a risk management framework and document it in a risk policy or within other policy documents (e.g. investment policy, privacy policy). The board should delegate accountability for management of market, credit, operational, asset / liability, liquidity and other risks through job descriptions, contracts and charters. Key components include:

- A governance approach that defines risk categories, accountabilities and reporting
- Risk assessments (e.g. audits) to test controls and potential outcomes of risk events
- Key measures to assess market, operational, credit and asset / liability risk exposures
- Access to information technology to collect and distribute risk data across the fund

V. Strategic Planning

A fund should adopt a strategic planning approach either in the form of a multi-year plan or within other documents. Strategic planning is a hallmark of successful organizations. It provides the board with a mechanism to map out long-term goals along with the implementation steps necessary to achieve them. Key components include:

- Goals and performance measures for key functions such as benefits administration
- Long-term investment goals, investment risk tolerances and diversification objectives
- Multi-year budgetary needs for fund operating units and for the system
- Service quality goals, measures and tactical plans for achieving them
- Plans for strengthening the fund's compliance program and internal controls

VI. Reporting: Key Performance and Risk Measures

Reports to the board should include a set of key performance and risk measures to help the board assess the fund's progress toward goals across actuarial, administrative, audit, compliance and investment functions. Given their expansive duties, boards rely on efficient reporting to provide effective oversight. Key measures include:

- The funded ratio as measured by the ratio of fund assets to fund liabilities
- Net annualized investment returns relative to the return assumption and benchmarks
- Timeliness and accuracy of distributions paid to members and beneficiaries
- Member satisfaction with fund services as measured by surveys and correspondence
- Future benefits owed to members as measured by the actuarial accrued liability
- Net assets available for benefits and changes thereto as reported in the annual audit

VII. Stakeholder Communications

A fund should communicate regularly with members and other stakeholders through multiple media including web site notifications, publications and letters as well as required reports. Communications provide transparency into fund operations and may increase member satisfaction, while strengthening the fund's reputation. Key components may include:

- A mission statement that describes the fund's purpose to members and the public
- Surveys that measure participant satisfaction, while providing a basis for improvements
- Updates, letters, annual reports on fund operations and forms for member beneficiaries
- Reports on fund performance, board initiatives and external events that impact members
- Governance principles that summarize the fund's structure and statutory framework

Challenges and Opportunities

It is important to note that development of a set of well written policies is by no means a guarantee of favorable results. In fact, common pitfalls of governance can lead to suboptimal performance for the most well intended organizations. These include:

- Lack of adherence to policies and rules that leads to compliance and/or risk failures
- Excessive bureaucracy (e.g. too many committees) that slows or halts decision making
- Unattainable policies and goals that increase the probability of compliance failures
- Cumbersome documentation that discourages stakeholders from understanding policies
- Overly rigid rules that take discretion from experts who are compensated to exercise it

An organization can avoid these pitfalls by adhering to basic principles, many of which are embodied in NCPERS recommended practices. Enablers of effective governance include:

- Training to equip board and staff to adhere to policies (especially when they are new)
- Clear documentation of authority for decisions in job descriptions, charters and contracts
- Brief summaries of policy documents that trustees are asked to exercise decisions on
- Reasonable flexibility in applying performance targets, risk thresholds and timelines

Conclusion

Public pension funds have played a leadership in delivering high quality, cost-effective benefits to their members through effective oversight, accountability and transparency. However, the need for continuous improvement and for communicating how these practices work to benefit stakeholders has never been greater.

The practices we recommend are intended to provide a means for ongoing improvement and for maximizing long-range organizational performance through market cycles and management changes.

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[i] *Pensions & Investments, November 13, 2008*

[ii] The Ambachtsheer Letter, How Much is Good Governance Worth?*, June 2006*

Modernizing Pension Fund Legal Standards for the Twenty-First Century, *Keith L. Johnson and Frank Jan de Graaf, Rotmam International Journal of Pension Management, Spring 2009*