National Conference on Public Employee Retirement Systems

Best Governance Practices for Public Retirement Systems

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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 approximately 500 funds that collectively oversee more than $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 and Segal Marco Advisors, a leading independent investment solutions firm, have 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 board effectiveness assessments, fiduciary training and risk assessments drive performance across strategic oversight, 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
- Undertaking board evaluations to ensure board governance is optimal and aligned to current best practices
- 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
- Adoption of governance, administration and communication technologies to improve efficiencies and reduce 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
- A communication policy that outlines standards and procedures for trustees and executives
- 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
- Whistle blower; discovery of errors and illegal acts; and special investigations policies to protect strong financial oversight
- 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

A *Model Risk Management Framework* is included in Exhibit A to provide an example of best practices funds employ to manage risk across investment program exposures and functions.

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
- Succession plans for key executive and board roles

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
- Allowing policies to become outdated or irrelevant

Challenges and Opportunities (cont'd)

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 are the subject of trustee decisions
- Reasonable flexibility in applying performance targets, risk thresholds and timelines
- Timely and regular reviews of all key policies to ensure that they are valid, up to date, and still relevant to the current operating environment

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*

Exhibit A

Model Risk Management Framework

The ______________________ (the "Fund") employs a risk management framework to enable measurement and management of risk across exposures and investment program functions. While maintaining responsibility for oversight, the Board of Trustees (the "board") delegates implementation to Fund management, the investment consultant, auditor, actuary, custodian, investment managers and counsel who are responsible for managing risk within the scope of their functions.

As summarized below, the framework includes a risk governance approach, assessments, key measures and reporting processes designed to manage categories of risk that are common to defined benefit funds including, but not limited to, market, asset / liability, liquidity, operational and credit risk.* The risk management framework encompasses reputational risk, which may be caused by failures in other risk categories, including but not limited to operational risk events (e.g. compliance failures) that may lead to financial loss.

Risk Governance

Risk governance includes board practices, committee structures, contract provisions, policies and procedures the Fund employs to measure and manage risk. Governance is enabled by the investment policy, which documents roles of fiduciaries, asset allocation structure, risk tolerances and portfolio rebalancing, as well as surveillance of financial controls and risk exposures through audits, assessments and reports prepared by Fund advisors, service providers and investment managers.

Audits and Assessments**

Assessments include, but are not limited to, the annual audit, asset/liability modeling (ALM)***, experience studies, asset allocation modeling, liquidity tier analysis, cash flow projections, stress testing and expense reviews that provide transparency into risk exposures and costs. Assessments also include investment policy and asset allocation reviews, investment manager searches, benchmarking, portfolio reviews, procurements, sensitivity analyses, due diligence exercises and governance reviews.

Key Measures

Key risk measures include, but are not limited to, the funded ratio, changes to the accrued unfunded liability, changes to net assets available for benefits, asset class exposures relative to policy targets and thresholds, diversification across markets, sectors and currencies, down market capture ratio and standard deviation as a measure of volatility. Measures also include Value at Risk (VaR), security issuer concentration, Sharpe ratios, tracking error, average duration, credit ratings, default rates and, where permitted, utilization of leverage and financial instruments that may magnify market risk.

Reporting

The Fund’s ability to manage risk is enabled by reports generated by management, the auditor, actuary, investment consultant, custodian and, investment managers. Reports include, but are not limited to, management reports on the Fund’s financial positon, actuarial valuations, the custodian’s full accrual, multi-currency accounting statements and risk management dashboards. Reports also include the investment consultant’s quarterly performance reports and attribution analysis, recurring investment manager reports, the Comprehensive Annual Financial Report (CAFR) and actuarial reports. The Fund and its service providers utilize information technology and external databases to facilitate reporting processes, modeling, benchmarking, peer comparisons and sensitivity analysis.

*Risk categories include market, liquidity, asset/liability, operational and credit risk:

- Market Risk - Market risk is the risk of loss due to adverse movements in market factors such as asset prices, currency rates or interest rates.
- Liquidity Risk – Liquidity risk may be described as the risk of loss due to an asset owner being unable to sell an asset in a timely manner and for its actual value.
- Asset / Liability Risk - Asset / Liability is that the risk that the Fund’s liquidity will not be adequate to meet operational requirements or financial obligations, namely liabilities related to benefit payments.
- Operational Risk - Operational risk is the risk of loss resulting from inadequate or failed processes, people and systems of from external events.
- Credit Risk - Credit risk is the risk of loss due to failure of obligors (e.g. bond issuers) to honor their payments.

**Assessments and reports include applicable disclosures under GASB and Actuarial Standards of Practice.

***Asset / Liability Modeling typically includes stress testing under various actuarial and market scenarios.