

# **Public Pension Governance That Works**

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## Overview

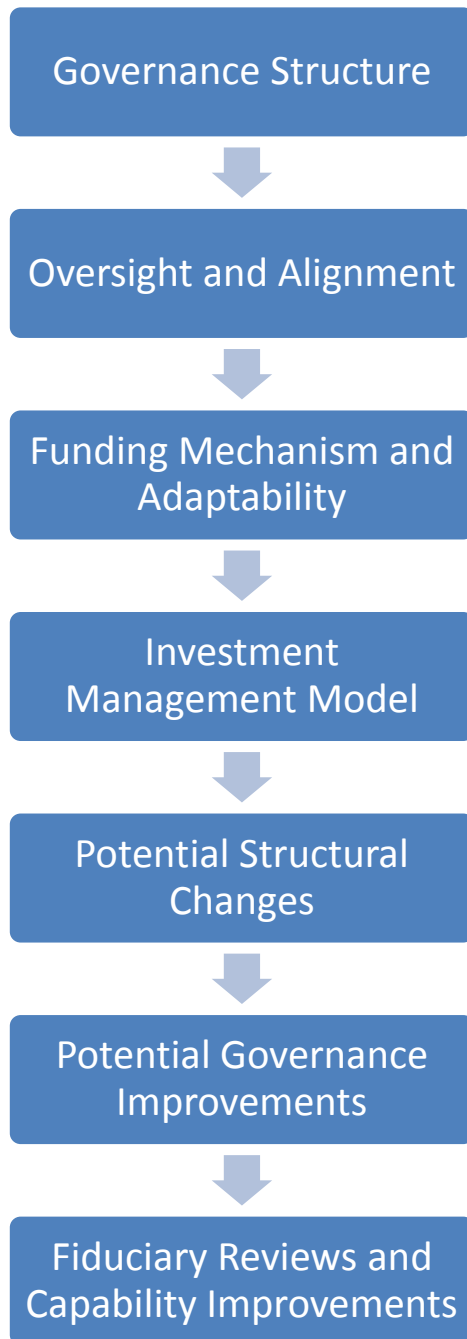
Public pension funds in the United States are facing increasing pressures from all of their key stakeholders – employees, pensioners, employer agencies, taxpayers, elected officials – but the issues don't seem to be defined and understood with any degree of clarity or consistency.

There are a number of issues to be addressed and many different views on what the real problems are and the alternatives to solving them. This article attempts to give a balanced perspective on how state governors and legislators, as well as trustees, should consider their options for improving the performance of their state and local pension funds.

We start with an analysis of the different governance structures typically in place at state pension funds, key issues regarding alignment of authority, responsibility, oversight and expertise, the adaptability of the retirement system to changing funding levels and market returns, and different investment model strategies. Potential structural changes which can lead to improved fiduciary and investment performance are identified and discussed.

There are also actions trustees can take to improve fiduciary performance which do not require fundamental changes to the laws or governance structure. These can be identified through a fiduciary review which compares a fund's governance and policy framework, investment operations, and compliance and controls, and compares them to peers and leading and prevailing industry practices. This type of independent review can help challenge "conventional wisdom" and provide a more objective perspective on fund governance and operations. Such a review can produce reasonable assurance the fund is being governed and managed effectively and efficiently and identifying operating improvements. Such improvements can include clearer lines of authority, improved decision-making and accountability, greater operational effectiveness and efficiency, strengthened controls, and more robust policies.

## Major Themes



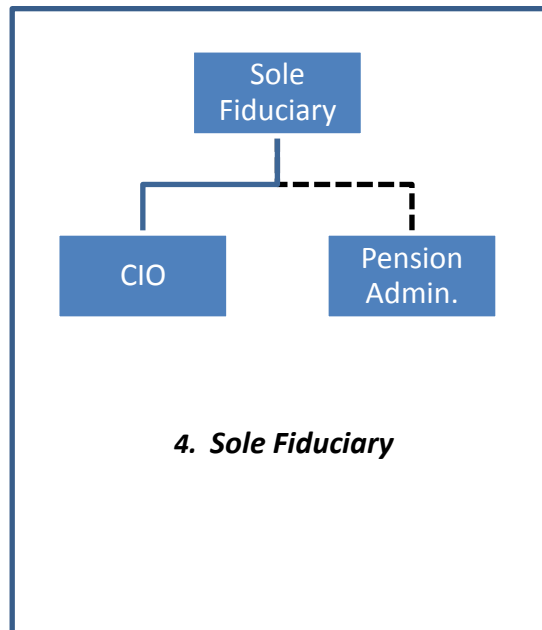
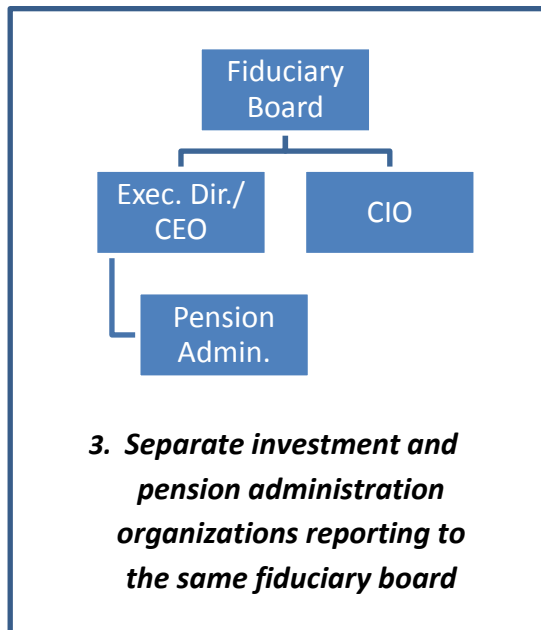
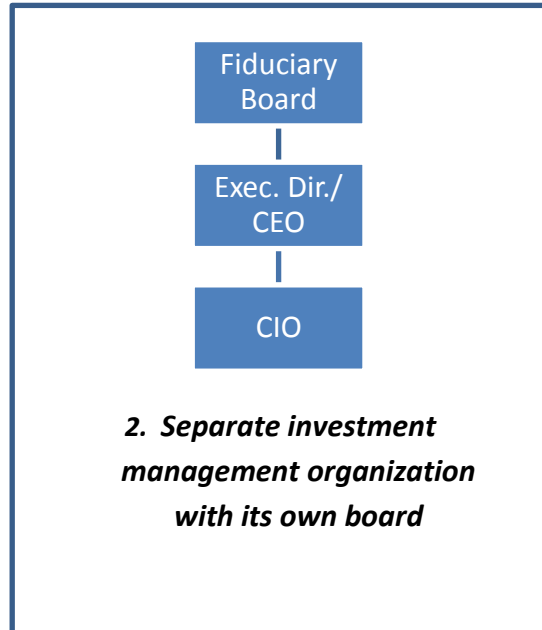
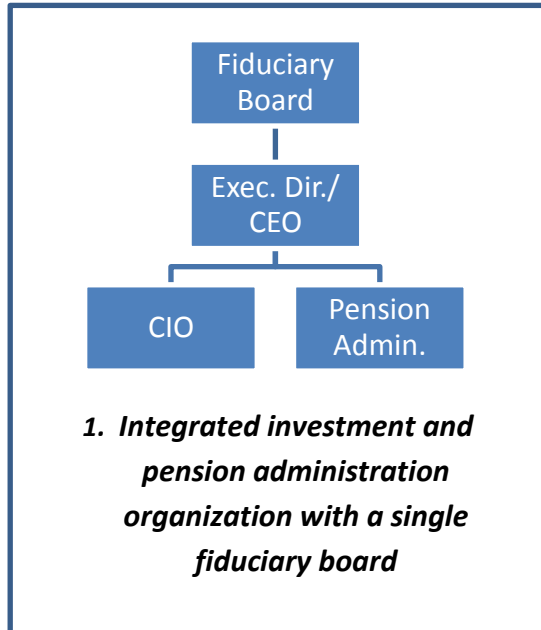
## One size fits one!

One of the fundamental challenges in understanding the U.S. public pension situation is the diversity among the public pension funds themselves – of oversight and governance structure, liability structures, investment management strategies, operational models, and laws, regulations and policies.

There are at least four basic fund governance models in use among the major state and municipal pension funds:

1. ***An integrated investment and pension administration organization with a single fiduciary board***, the most common form, has an Executive Director or CEO responsible for the entire organization. In this model, the board has authority for investments and pension administration and delegates its authorities through the CEO. Examples of this model range from the Teacher Retirement System of Texas and New York State Teachers' Retirement System to the School Employees Retirement System of Ohio and Teachers' Retirement System of Oklahoma. Thirty-three of the largest fifty-five, or 60 percent, of state public pension funds in the U.S. utilize this structure.
2. ***A separate investment management organization with its own board*** is the second most common structure and includes states such as Wisconsin (State of Wisconsin Investment Board) and Massachusetts (Massachusetts Pension Reserves Investment Management Board). In each instance of this model, the board has responsibility for investments only and pension administration is operated under a separate organizational structure which coordinates with the investment board for asset and liability matching. Twenty-percent of the largest funds utilize this structure.
3. ***Separate investment and pension administration organizations reporting to the same fiduciary board***, the third most common form, is similar to the integrated model, but the board typically delegates pension administration responsibilities to an Executive Director or CEO and investment responsibilities to a Chief Investment Officer (CIO), with the CEO and CIO each reporting directly to the board. Examples of this model include CalPERS and CalSTRS in California, the Virginia Retirement System, and the Public Employee Retirement System of Idaho. Seven of the largest fifty-five funds use this model.
4. ***Sole fiduciary*** is the fourth governance model, where responsibility is vested in an elected or appointed state official, typically the state treasurer or comptroller. Investments are managed by the state treasurer or comptroller department through a CIO and investment staff, with support from an expert investment advisory board. Typically there is a separate pension administration organization which may have its own board or multiple boards (for multiple funds) and may or may not report to the sole fiduciary. Several states have abandoned this model in recent years (e.g., South Carolina), and there are currently only four remaining states with major pension funds using the sole fiduciary governance model: Connecticut, Michigan, New York, and North Carolina.

## Primary U.S. Public Pension Fund Governance Models



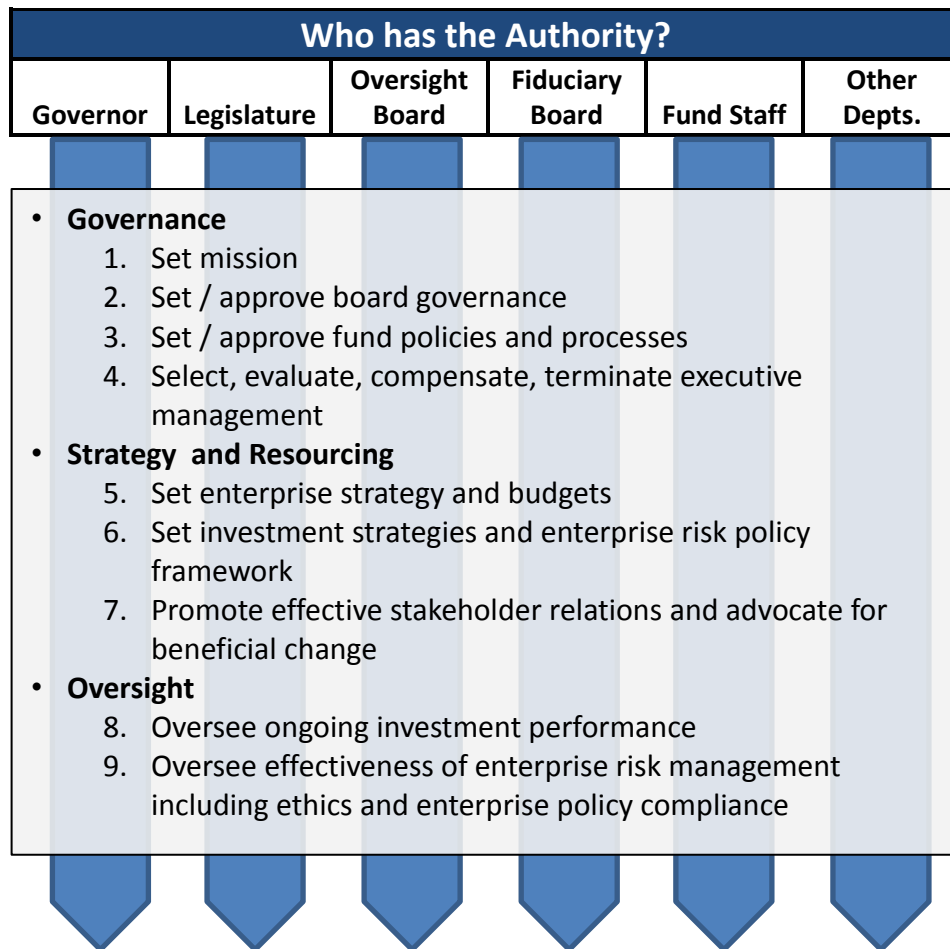
## Oversight

Somewhat independent of the governance model is the oversight structure established through state law and regulation. The critical differentiator among pension funds tends to be the ability of the board (or sole fiduciary) to fulfill its fiduciary duties unimpeded by legal or legislative constraints. State legislators often have difficulty taking their hands off the tiller and limiting their role to oversight of the fund fiduciary. The most common examples of this are:

- Control of budgets and headcount often remains with the legislature or state budget-setting apparatus. Our research indicates that about half the state funds require legislative approval for their annual operating budget, even though the funding comes directly from pension fund earnings, not state coffers. Restricting budgets and headcounts often results in understaffing in critical areas such as investment management, risk management, due diligence, compliance as well as key support functions such as information technology.
- When pension fund executives are compensated according to a civil service or otherwise imposed salary structure, compensation packages are often not competitive with the private sector. As a result, the fiduciary board does not have the ability to offer market-based compensation packages to hire and retain appropriate staff expertise. This typically results in a higher level of external investment management and significantly higher investment management costs borne by the fund. According to our research, about half the state funds must comply with imposed compensation guidelines for investment staff salaries and bonuses.
- There are many examples of legal lists for allowable investments that limit investment options (in our research this applies to the majority of funds). Such limits may prevent those fiduciary boards from making the most prudent investment decisions for the fund or could trigger sub-optimal required rebalancing activity.
- Most public pension funds are exempt from standard state procurement processes for hiring of investment managers and investment consultants. However, there are instances where information systems and non-investment-related third party support procurements must comply with standard state purchasing policies and processes. This can inhibit the ability of a fund to implement and update their infrastructure in a timely fashion to adapt to the increasing complexities of found in most portfolios today.

## Oversight and Alignment of Authority, Responsibility and Expertise

- **Oversight:**
  - Review, monitoring, and supervision of governance structure, policies and direction
- **Governance:**
  - The authority to decide and direct
- **Powers Reserved:**
  - What are the key decisions?
    - Governance
    - Strategy and Resourcing
    - Oversight
  - Who gets to make these decisions? What information and expertise do they need to make the best decision under the circumstances? How are they doing?



Note: 66 specific authorities have been identified within the nine powers

## **Why are some states in better shape than others?**

A significant number of states do not reliably pay their pension bills – a recent report from Standard & Poor's<sup>1</sup> indicates that only 42% of U.S. states fully fund their actuarially required contribution (ARC) every year, and 30% have not fully met their obligations for at least the last three years. Regardless of how well managed a pension fund may be, if the fund is not receiving the promised payments from the sponsoring employer (the state or local government) its beneficiaries are being shortchanged. In those cases of non-payment, the pension fund fiduciaries do not have the authority to make the plan sponsors pay what is due.

### **Funding Structure and Adaptability**

Aside from the willful non-payment of contributions, there are structural factors which affect the ability of the states and municipalities to fund their pension commitments to their workers. For example, there is a wide range of different funding mechanisms among the states which define the amounts which must be paid into the funds by employers and employees. Here are several diverse examples:

- CalPERS (California Public Employees' Retirement System), the largest state public pension fund in the U.S. with over \$275 billion in assets, manages the pension assets for state employees, school employees and agencies across California. Contribution rates for participating employers are updated annually and adjusted based upon actuarial calculations. If there is a decrease in the funded status due to either poor investment performance or adverse actuarial experience, the rate paid by the employer increases. Although there is a significant range in employer contribution rates by category, there are some categories where the employer rate has risen to more than 30% of base pay.

In a time of increasing contribution rates, the only potential relief mechanism for an employer (i.e., a state agency, school district or municipality) is to renegotiate contracts with its employee bargaining units or for the legislature to reduce benefits through legislative reform.

- The Ohio Public Employees Retirement System (OPERS), with assets over \$85 billion, is the largest of five public funds in Ohio. For OPERS, the maximum employer contribution rate limits are defined by state law as 14.0% of earnable pay for employers of state and local workers and 18.1% for law enforcement and public safety personnel. These rates include 4.0% for health care benefits funding. The statute authorizes OPERS to calculate rates for employees. When contribution rates reach the limits and are inadequate to fulfill projected commitments to members, the legislature must intervene with legislative reform to either reduce benefits or increase maximum contribution rates.
- The Wisconsin Retirement System (WRS) is typically at or near 100% funded status due to a unique structure with shared risk and reward among all plan participants. The WRS



is a hybrid plan that provides a final pay formula benefit that accrues at 1.6% of final average salary for each year of service as well as a defined contribution benefit. Each member of the plan accrues both a formula benefit and defined contribution benefit during the years they are actively participating. Contributions are required from both employees and employers.

By law, any increase or decrease in contribution rates must be divided evenly between the employee and employer contribution rate. The structure of post-retirement benefit increases is also unusual. Retirees receive a guaranteed annuity benefit; however, annual post-retirement adjustments to the monthly annuity benefit are based solely on investment returns. If a surplus is created by investment experience, annuity benefits may be adjusted upward. These post-retirement adjustments are called “dividends” and are not limited by the Consumer Price Index (CPI) or any other type of cap. However, dividends are not guaranteed and can be reduced when investment returns decline.

For the WRS, an investment return of -26.2% for calendar year 2008 caused the assets of the annuity reserve to fall below the liabilities, resulting in the first ever “negative dividend” of -2.1% being applied to all annuities in force that had received positive dividends in prior years. These negative dividends continued through 2013. In addition, employers and employees combined have experienced a series of contribution rate increases beginning in 2010. Because investment experience is smoothed over a five-year rolling period, losses from 2008 were recognized over five years and offset by past and future investment gains. Despite a total decline in the fund’s asset value of over \$20 billion during 2008, the funded status of the WRS, based on the actuarial value of assets, remained above 85%. WRS was cited by the Pew Foundation as the only state in nation with a 100% funding status in fiscal year 2010.<sup>2</sup>

As indicated by these three examples, the ability of each state fund to adapt to changing circumstances varies dramatically based upon the funding provisions set forth in the fundamental structure of the pension system laws and regulations and impacts their ability to maintain a healthy funding ratio.

## **Investment Management Model**

Significant differences in investment operations of public pension funds can also be found in their approaches to investment management. One of the well-documented benefits of large defined benefits (DB) plans vis-à-vis defined contribution (DC) plans is the economic effectiveness of large DB plans.

For example, a National Institute for Retirement Security (NIRS) study<sup>3</sup> found that “the cost to deliver the same level of retirement income to a group of employees is 46% lower in a DB plan than it is in a DC plan.” According to a recent Towers Watson study<sup>4</sup>, “Among the largest one-sixth of plans, defined benefit plans have outperformed defined contribution plans by almost a percentage point since 1995... Among both DB and DC plans, larger plans outperformed smaller ones... Presumably, larger plans outperform smaller plans because they have access to a wider variety of investment options, economies of scale, more investment expertise and lower average expense.”

### ***The “Canadian Model”***

Even though the investment portfolios of large U.S. public pension defined benefit funds tend to perform better than smaller funds and as well as defined contribution funds of all sizes, they have not performed as well as large Canadian funds such as the Ontario Teachers’ Pension Plan (OTPP), Ontario Municipal Employees Retirement Plan (OMERS), and the Canada Pension Plan Investment Board (CPPIB). As described in a 2012 article in *The Economist*, “the Canadians prefer to run their portfolios internally and invest directly. They put more of their money into buy-outs, infrastructure and property, believing that these produce higher returns than publicly traded stocks and bonds. They are in some ways like depoliticized sovereign-wealth funds... So far the funds' strategy has paid off. Over the past ten years Ontario Teachers’ has had the highest total returns of the biggest 330 public and private pension funds in the world.”<sup>5</sup>

OMERS, for example, currently has a target portfolio allocation of 47 percent to private assets. To facilitate this high level of private assets, as well as reduce the investment management costs for both public and private assets, OMERS has a target of 90 percent of its total assets to be managed by internal staff.

*The Economist* article continues, “Those seeking to understand how Canadians have pulled it off are given two answers: governance and pay. There is little political interference in the funds' operations. They attract people with backgrounds in business and finance to sit on their boards, unlike American public pension funds.

Just as important is their approach to compensation. In order to recruit the best executives, Canadian pension funds have ensured their pay is competitive with Bay Street, Toronto's version of Wall Street. They pay a base salary, annual bonus and long-term performance award (which many pension funds elsewhere do not) to make their employees take a long-term view of investments. Mr. Leech, President and CEO of Ontario Teachers’, made over C\$3.9m in 2010; 51% of that was a long-term performance award, 36% his annual bonus and only 13% of his

base salary. He would doubtless earn more on Wall Street, but this is a huge pay packet by public-pension standards.”<sup>6</sup>

The Canadian approach differs dramatically from the typical U.S.-based state public pension fund. Based upon Funston Advisory Services LLC benchmarking data, the average level of internal investment management is about 44% for the largest U.S. state pension funds, those with \$50 billion or more in assets under management. For the largest Canadian funds, the level is over 80%. The U.S. funds also tend to internally manage the asset classes which have the lowest external management costs, such as passive fixed income and passive large cap domestic equities, and outsource the very high cost alternative asset classes such as private equity, hedge funds and real estate. Even for a U.S. fund with one of the highest levels of internal management, CalPERS, at about 77% internally managed, the ratio of external to internal management costs is about 10 to 1. In other words, the 23% of assets managed externally requires outside management fees which are ten times the internal costs of managing the other 77% of assets in the portfolio.

## What can states do to improve public pension fund performance?

### Potential Structural Changes

Looking broadly at the U.S. public pension fund universe, what would be some of the changes to consider if there was a desire to have the most cost-effective fund management?

- **Increase the scale of funds** – Most pension funds do not begin to undertake internal investment management unless they have at least \$30-40 billion in assets under management. Some states (and major cities such as New York, Chicago and Los Angeles) which have multiple smaller funds could consider consolidating fund investment management to improve scale, achieve cost economies and allow moving investment management in-house, with the potential to improve net portfolio returns. Such consolidation has typically been resisted due to loss of representation and influence over the fund's direction, with different benefit structures often used as a reason not to combine. However, the many successful state investment boards (e.g., Massachusetts, Minnesota, Washington, Wisconsin) which serve multiple retirement plans with unique benefit and contribution structures demonstrate the possibilities.
- **Give the fiduciary board authority which matches its responsibility** – As mentioned earlier, most states do not give their public pension fund fiduciary boards authority to make all decisions. In particular, many boards cannot set the overall budget or increase the headcount for the investment organization, and they also cannot set compensation levels for the investment staff. These restrictions are often barriers to having investment operations with an optimal balance of internal and external investment management with appropriately-resourced support functions such as risk management, research and compliance.

Another barrier can be legal lists of allowable investments. A fiduciary board should have the freedom to operate under the prudent expert rule and set its own asset allocation policies and investment guidelines for its investment staff to implement.

- **Provide effective oversight to improve long-term performance** – Some states which allow their fiduciary boards to operate under prudent expert rules and set their own budget and compensation structure have created an oversight body which monitors the pension funds without being obtrusive. In the case of Ohio, the Ohio Retirement Study Council (ORSC) includes members of the state Senate and House of Representatives as well as gubernatorial appointees. The Council's charge is to advise and inform the state legislature on all matters relating to the benefits, funding, investment, and administration of the five statewide retirement systems in Ohio.<sup>7</sup>

Although the pension fund fiduciary boards in Ohio have decision authority commensurate with their responsibilities, the ORSC provides both oversight and a facilitation role between the legislature and the funds, forming a check and balance in the governance structure and removing the legislature from day-to-day control.

## **Potential Governance Improvements**

Trustees and staff at public pension funds face a growing number of major challenges:

- Boards and staff must deal with high uncertainty and conflicting expert opinions.
- Trustees need to understand the long-term consequences of today's decisions.
- Effective functioning of a fund requires appropriate delegation of authority, along with proper alignment of responsibilities, authorities and expertise.
- The Board must find the right balance between strategy and oversight and day-to-day management.
- Regardless of background or experience, new board members must assume immediate full responsibility of fiduciary duties without a transition period.
- Unlike corporate directors, elected and appointed public pension boards typically can't choose to fill gaps in expertise, so targeted board education and self-development is essential.

Good governance is critically important for public pension funds to achieve optimal performance and maintain the confidence of their constituencies. Through our work with public pension funds, which includes research, benchmarking and expert input, we have developed *Six Principles for Effective Public Pension Fund Governance*:

1. ***Effective and Capable Fiduciaries*** – The Board functions effectively, investments are prudently selected and managed, the fund is operated cost effectively, customer service and operations are high quality, and the fund is reliable as a source of information for pension and benefit choices.
2. ***Ethical Leaders*** – The board and executive team share values, work together constructively, and set the tone at the top. The Board and staff are free from conflicts of interest and have credibility with regulators and legislators. The Board operates with discipline and is self-policing. There is a culture of compliance with applicable laws, regulations and organizational policies and there are clearly-established whistleblower policies and procedures.
3. ***Open and Accountable to Stakeholders*** – The Board and executives are appropriately open in the way key decisions are made and publicly disclosed. The organization structure and processes provide clear lines of authority and responsibility. Effective metrics are used to monitor strategic, investment, operational, financial and compliance results. Executives are accountable for their performance, and their compensation is directly linked to performance outcomes over appropriate time periods that reflect agency goals and beneficiaries' short- and long-term interests.
4. ***Risk Intelligent and Insightful in Decisions*** - The Board approves the risk preferences and tolerances of the fund, and ensures the enterprise is prepared for low-probability

risks and long-term sustainability. An effective enterprise risk management framework is used to consistently monitor and report aggregated risk exposures and the effectiveness of mitigation and control. The management reporting process provides insight, not just data, to enable the board to provide appropriate direction and advice to management and fulfill its oversight responsibilities.

5. ***Long-Term View for the Needs of Beneficiaries and System Participants*** – The board integrates short-term and long-term perspectives on both assets and liabilities to ensure financial soundness and effective retirement solutions for members and employers. The board is alert to long-term unintended negative consequences of short-term decisions and maintains strategic flexibility to allow for uncertainty.
6. ***Continuous Learning and Adaptation to Changing Conditions*** – The Board conducts a regular assessment of its performance and capabilities. A board self-development plan addresses the continuous learning and development needs for all board members based on a comprehensive and tailored individual development process. Performance feedback is obtained through an annual board self-assessment process.

From these principles, leading policies, practices and desired outcomes can be developed, and the principles form the basis for conduct and guide the decision-making and behavior of the Board, the executive team and staff.

## **Fiduciary Reviews**

Public pension funds are increasingly conducting fiduciary reviews, which are independent expert reviews. These are usually voluntarily commissioned, but there are some states where it is a statutory requirement, such as New York, Ohio and South Carolina. The purpose of a review is to help improve the capabilities of a fund using a structured approach to:

- Provide independent reassurance to key stakeholders that the trustees are fulfilling their fiduciary duties and that the fund is well run;
- Evaluate current policies and practices and compare them to leading practices;
- Identify strengths and opportunities for improvement; and,
- Identify pragmatic implementation options.

Fundamental questions addressed by fiduciary reviews include:

- Are we meeting our fiduciary responsibilities?
- How do recent changes affect our fiduciary duties?
- How well are we managing potential conflicts of interest?
- Are governance processes working as well as they can/should?
- Do we have the most appropriate policies and practices?
- How are we doing compared to leading practices?
- Where can we improve? How can we be more effective and efficient?
- What is best for our fund and beneficiaries, given our current stage of development?

The scope of such a review usually falls into seven major areas:

1. ***Asset/Liability Study and Discount Rate*** – How effectively do we assess our obligations and timing, develop asset allocation strategies, and manage long-term investment return expectations? Have we defined our risk tolerance and preferences?
2. ***Legal and Regulatory Framework*** – How does our legal and regulatory framework compare to other funds, e.g., governance structure, statutory authorities or limitations, investment limitations, control of budget and staffing, transparency requirements?
3. ***Governance and Policy Framework*** – Considering the legal and regulatory framework in which we operate, how do our policies compare to other funds, e.g., charters, role of board officers, powers reserved and delegations, ethics / conflicts of interest, risk oversight, independent reassurance, board performance (self-assessment, self-development, and time commitments), reports to the Board or sole fiduciary.
4. ***Investment Operations and Risk Management*** – Within our legal, regulatory and governance structure, how effectively do we manage our investment operations? This typically includes investment beliefs; risk policies and metrics; use of benchmarks;

investment cost management; investment manager selection, due diligence, monitoring, and termination; use of investment consultants; custodial services; securities lending; and other third party providers.

5. **Administrative and Support Operations** – How well do we run our administration and support operations, including benefits or health care administration (if applicable), member services, investment accounting, human resources, succession planning, information systems, infrastructure and support, and business resumption?
6. **Compliance** – Are we effectively and consistently complying with the laws, regulations and policies which govern our fund, including ethics, delegations, Board and/or committee operations, contracts, trust and custody, due diligence, risk reporting, compensation, internal audits and documentation management?
7. **Controls** – Have we developed and do we maintain an effective control environment for the fund and its operations (externally-managed assets, internally-managed portfolio, cash transfers, cash equitization, securities lending, foreign exchange, performance calculations and investment management fees)?

This type of independent review by an experienced team can help challenge “conventional wisdom” and provide a more objective perspective on fund governance and operations.

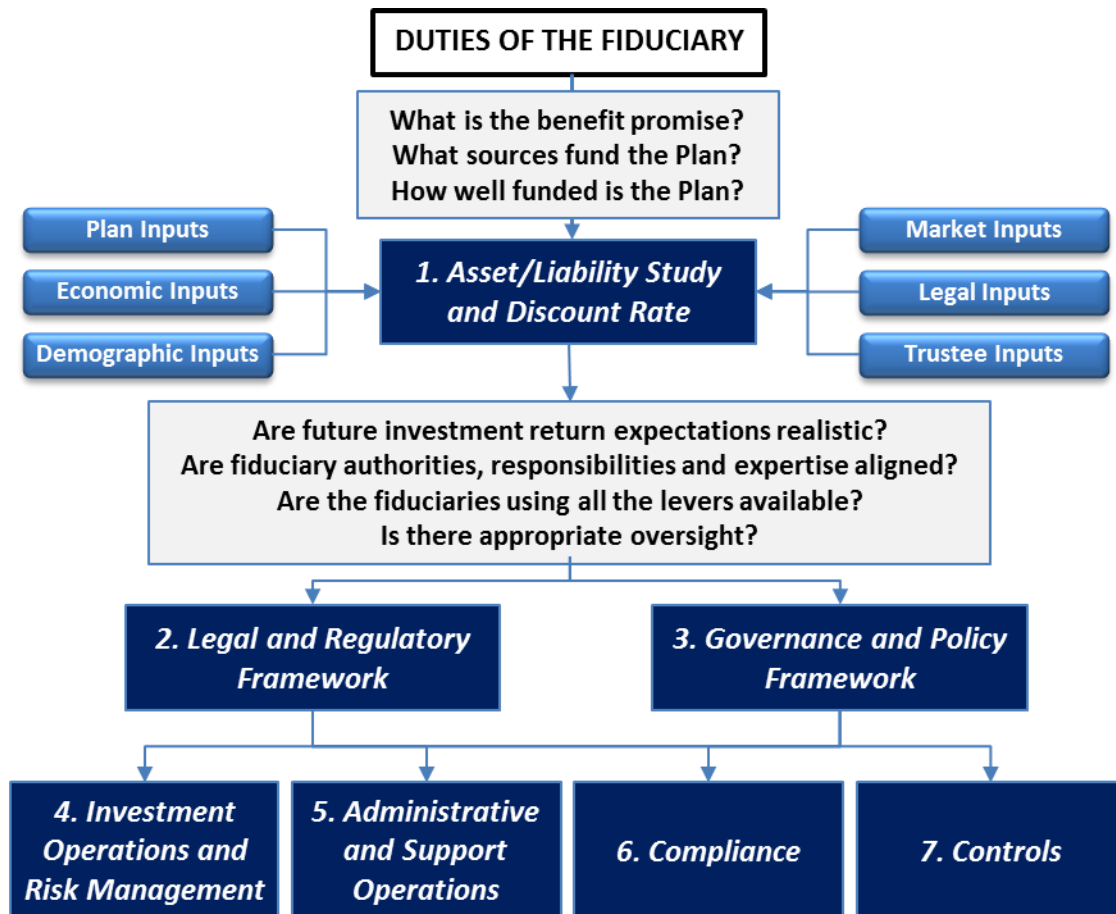
Examples of typical benefits include:

- Stakeholders are reasonably reassured that the fund is being governed and managed effectively and efficiently.
- The board and staff have a better understanding of what is working well and priorities for improvement.
- In some cases, legal and regulatory barriers which impede fund effectiveness are identified and alternative courses of action for improvement are considered.
- Fund executives and staff have a roadmap for prioritizing and driving operational changes.
- Examples of typical operating improvements include:
  - Clearer lines of authority and improved decision-making;
  - Better use of board and staff time;
  - Increased focus on strategy by the board and improved accountability;
  - Refined operational practices resulting in greater operational effectiveness and efficiency; and,
  - Strengthened controls and more robust policies.

Leading practice is a matter of opinion, and what is best can only be determined by the fund itself based on its current stage of development and capacity for change.



# Fiduciary Review Approach



## Where to begin?

A fund should start by assessing the fundamental structure of its public pension funds:

- Do the funds have sufficient scale to operate cost effectively?
- Is the funding structure adaptable to avoid significant increases in contribution rates?
- Is the governance structure appropriate (fiduciary board composition, oversight)?
- Does the fiduciary have sufficient authority to adequately staff the fund to successfully manage investments cost effectively?
- Are there any undue restrictions on investments which may tie the fiduciary's hands?

If the answer to any of these questions is "no," then alternatives should be explored to develop a better governance structure.

Regardless of the structure, laws and regulations, each fund can also perform a fiduciary review of its operations to identify pragmatic improvement opportunities in consideration of leading practices at other funds. As described earlier, this can include an assessment of policies, investment operations and risk, administrative and support operations, compliance and controls. The results provide a roadmap for optimization and continuous improvement of fund operations and independent reassurance that fund governance is appropriate and effective.

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### Endnotes

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<sup>1</sup> "A Bumpy Road Lies Ahead For U.S. Public Pension Funded Levels", John A. Sugden, Standard & Poor's, July 16, 2013

<sup>2</sup> "Pension Sustainability – The Wisconsin Example," David Stella, Secretary, Wisconsin Department of Employee Trust Funds and Keith Bozarth, Executive Director, State of Wisconsin Investment Board, *Benefits & Compensation Digest*, Vol.47, No. 2, February 2010

<sup>3</sup> "A Better Bang for the Buck - The Economic Efficiencies of Defined Benefit Pension Plans," Beth Almeida and William B. Fornia, FSA, August 2008

<sup>4</sup> "DB Versus DC Investment Returns: The 2009 – 2011 Update", Brendan McFarland, Towers Watson, May 22, 2013

<sup>5</sup> "Maple revolutionaries," *The Economist*, March 3, 2012

<sup>6</sup> Ibid. *The Economist*, March 3, 2012

<sup>7</sup> <http://www.orsc.org/>