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Public pension fund governance: alignment of responsibility with authority

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An important area of public pension fund governance that has not received sufficient attention is alignment of governance responsibility with corresponding authority.

In other words: What are the key decisions? Who is responsible for making them? Do they have the necessary authority?

Boards often are handicapped by being given responsibility for achieving certain outcomes but not having the authority needed to do so. As a result, boards often incur greater risk for participants and plan sponsors than they realize, especially in rapidly changing environments.

It is critical for pension systems to examine their governance alignment to ensure the fiduciary board has authority to consistently fulfill its duties without structural impediments.

Lack of a standard governance model among public pension funds complicates the ability to make comparisons between funds and requires a custom analysis for each governance model.

In the U.S. alone, there are at least four governance models in use among the major state and municipal pension funds:

1. integrated investment and pension administration organizations with a single fiduciary board;
2. separate investment and pension administration organizations with a single fiduciary board;
3. separate investment and pension administration organizations, each with its own board; and
4. a single fiduciary (e.g., treasurer or controller) which manages investments with a separate pension administration that has its own board or multiple boards (for multiple funds)

Regardless of the governance model, public pension systems have the same key governance responsibilities, which are listed below.

Key governance responsibilities for public pension funds:

1. *Establish and maintain effective governance policies and processes*
2. *Set mission*
3. *Set / approve board governance*
4. *Set / approve fund policies and processes*
5. *Hire / fire / compensate executive management*
6. *Set / approve board delegations*
7. *Conduct board self-development*
8. *Set enterprise strategies, including investments, resourcing and risk*
9. *Set enterprise strategy*
10. *Set resourcing strategies and budgets*
11. *Set investment strategies and risk-policy framework*
12. *Promote stakeholder relations*
13. *Provide oversight of investments, operations, risk, and system soundness*
14. *Oversee investment performance, cost effectiveness and liquidity*
15. *Oversee pension administration performance*
16. *Oversee pension system soundness*
17. *Oversee risk and policy compliance*
18. *Conduct board operations*
19. *Conduct hearings (if relevant)*
20. *Conduct self-discipline*
21. *Select board consultants*
22. *Select external auditor*

Typical governance misalignments

The most common misalignments we have encountered include:

- *Hire / fire / compensate executive management.* When pension fund executives are in the civil service system, compensation packages are often not competitive with the private sector. As a result, the fiduciary board does not have the ability to hire and retain appropriate staff expertise.
- *Set resourcing strategies and budgets.* Control of budgets and headcount often remains with the Legislature or state budget-setting apparatus. As a result, some fiduciary boards find themselves unable to adequately staff their operations, leading to higher outsourcing costs and, in some cases, insufficient risk management.

- *Set investment strategies*. There are still examples of legal lists for allowable investments that limit investment options. Consequently, those fiduciary boards might be prohibited from making the most prudent investment decisions.
- *Set risk-policy framework.* A fiduciary board is typically focused on achieving the best risk-adjusted return. However, if another board is responsible for fund actuarial assumptions, the fiduciary board might not be able to fully consider whether the portfolio risk profile is most appropriate for participants and fairly addresses intergenerational transfer of risk.
- *Oversee pension system soundness.* In systems with separate investment and administrative boards, there can be a lack of coordination between assets and liabilities, as well as ambiguity about applicable time horizons and diffused responsibility for stakeholder relations.

Most public pension funds have some areas of mismatch between fiduciary responsibilities and accountabilities, on the one hand, and powers and decision-making authorities, on the other.

Remedies for misalignment

Identifying powers reserved for the board is a key starting point for improving governance alignment. It can be a powerful tool for improving clarity and promoting effective governance. For example, we recently identified 88 specific points of governance authority at a major public pension fund with integrated responsibility for pension administration and investments.

Examining the powers reserved should also include efforts to:

- identify what the whole board does and does not delegate to a committee or to the fund's CEO;
- review and optimize board committee structure, alignment of responsibilities and skill sets; and
- clarify delegations to the CEO and any other direct reports to the board.

When misalignment of responsibilities and authorities becomes obvious, it is usually because of a major problem. Boards would be well advised to examine their governance structure when things are proceeding smoothly, in order to avoid dealing with a crisis, when choices can be more limited.

Given rapidly changing environments and board member turnover, a governance alignment review should be conducted on at a least a biennial basis.

Misalignment of governance responsibility and authority can be costly and increase the risk of governance failures.

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