A Review of the Governance Models of Police & Fire Department Retirement Plan & Federated City Employees' Retirement System

A Presentation for the City Council of the City of San Jose

November 19, 2013

By Cortex Applied Research Inc.

One Public Fund's Story …

"… how would you run the Pension Plan?"

Answer: "*Like a business*."

"As CEO, I would oversee the business and not check with the Board at every move. I would be candid. I would manage to objectives. We would agree on goals and our team would be challenged to meet them. We would have corporate titles. Hiring and firing would be done by the CEO and his team. We would have a compensation plan that would be reasonably competitive and include incentives."

That was 1990 …

Today …

"Over the past ten years, the Fund has had the highest total returns of the biggest 330 public and private pension funds in the world."

The Economist, March 3, 2012

"Ranked first in the world for pension service."

CEM Benchmarking Inc., 2011

Plan is 97% funded.

OTTP Annual Report, 2012

Of course, past performance is no guarantee of the future …

Introduction…

- I have been asked by the 2 retirement boards to present my report recommendations to Council.
- Cortex is in no way representing the retirement boards or speaking on their behalf today.
- **The boards accepted our report, but took a position on only 1 of our recommendations, leaving the others for stakeholders to consider and debate.**
- As in 2008/09, Cortex was given complete freedom to carry out its analysis and offer our best, independent recommendations.

Background

- Cortex has worked with 100+ pension plans.
- Cortex completed a study for the City in 2008/09.
- The City implemented some but not all of our recommendations.
- In 2012, the two retirement boards asked Cortex to update the study and provide recommendations.
- I am here to share *all* our recommendations, not just the one the two Boards took a position on, because Cortex believes the recommendations need to be understood in their totality.

Background Principles

- A plan's mission is to produce a stream of checks that:
  - Are accurate, timely, and do not bounce; and
- Maintaining ***intergenerational equity*** for ***both*** the plan members and the taxpayers is also a key consideration.
- A public plan is a monopoly that competes globally and fiercely for investment opportunities and human resources:
  - Active management is a zero sum & success is measured in bps.
- Trust assets:
  - Fiduciary duty of loyalty and prudence
  - Extremely high standard of care under the law
  - High degree of personal risk exposure

Sources of Research & Literature

Sources

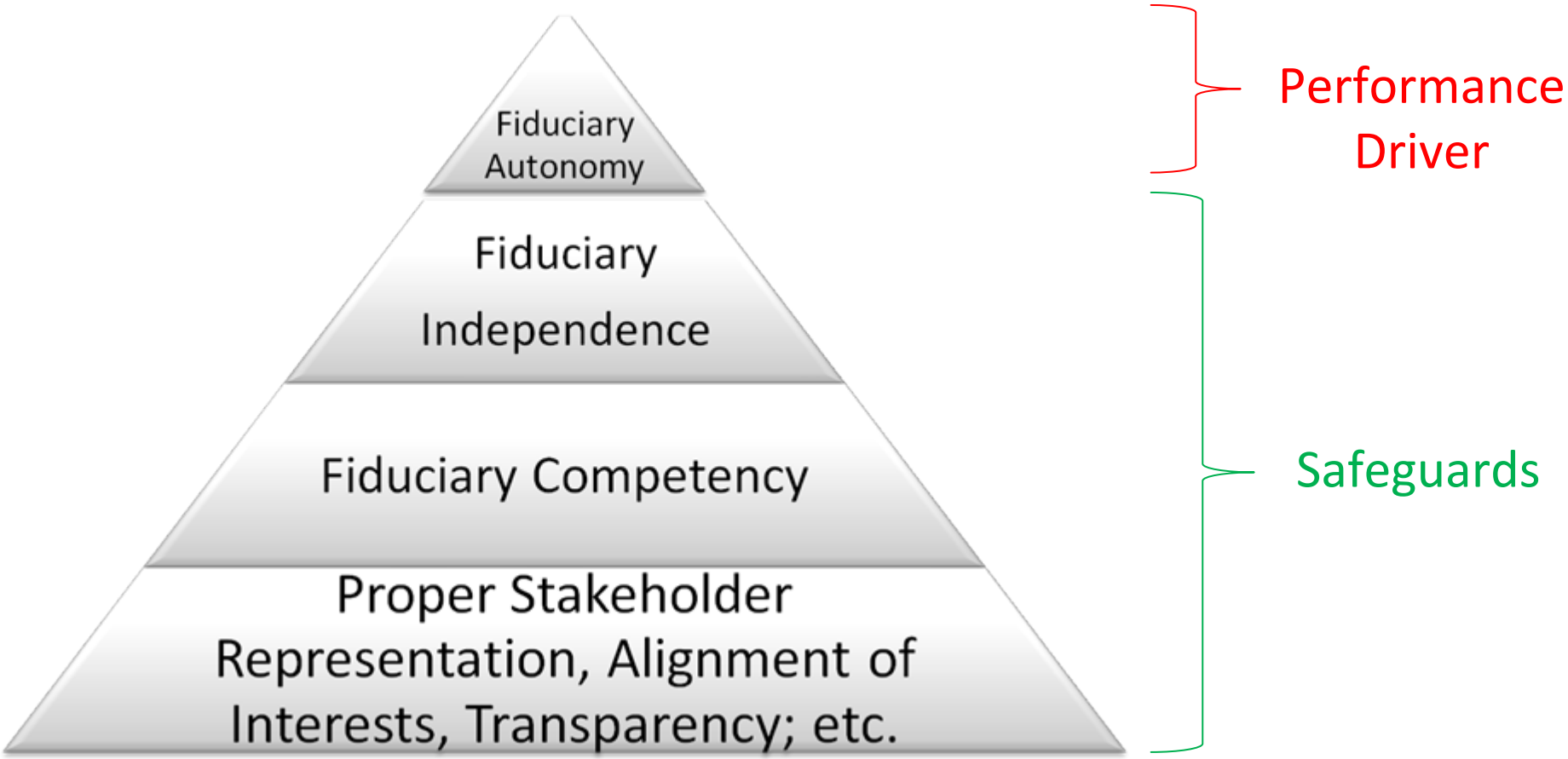
- Published standards and models (e.g. Clapman Report, GFOA Guidelines, and model laws)
- Academic research
- Industry commentators
- Cortex's own experience

It would be nice if all of the data which sociologists require could be enumerated because then we could run them through IBM machines and draw charts as the economists do. However, *not everything that can be counted counts, and not everything that counts can be counted.*

William Bruce Cameron "Informal Sociology: A Casual Introduction to Sociological Thinking" 1963

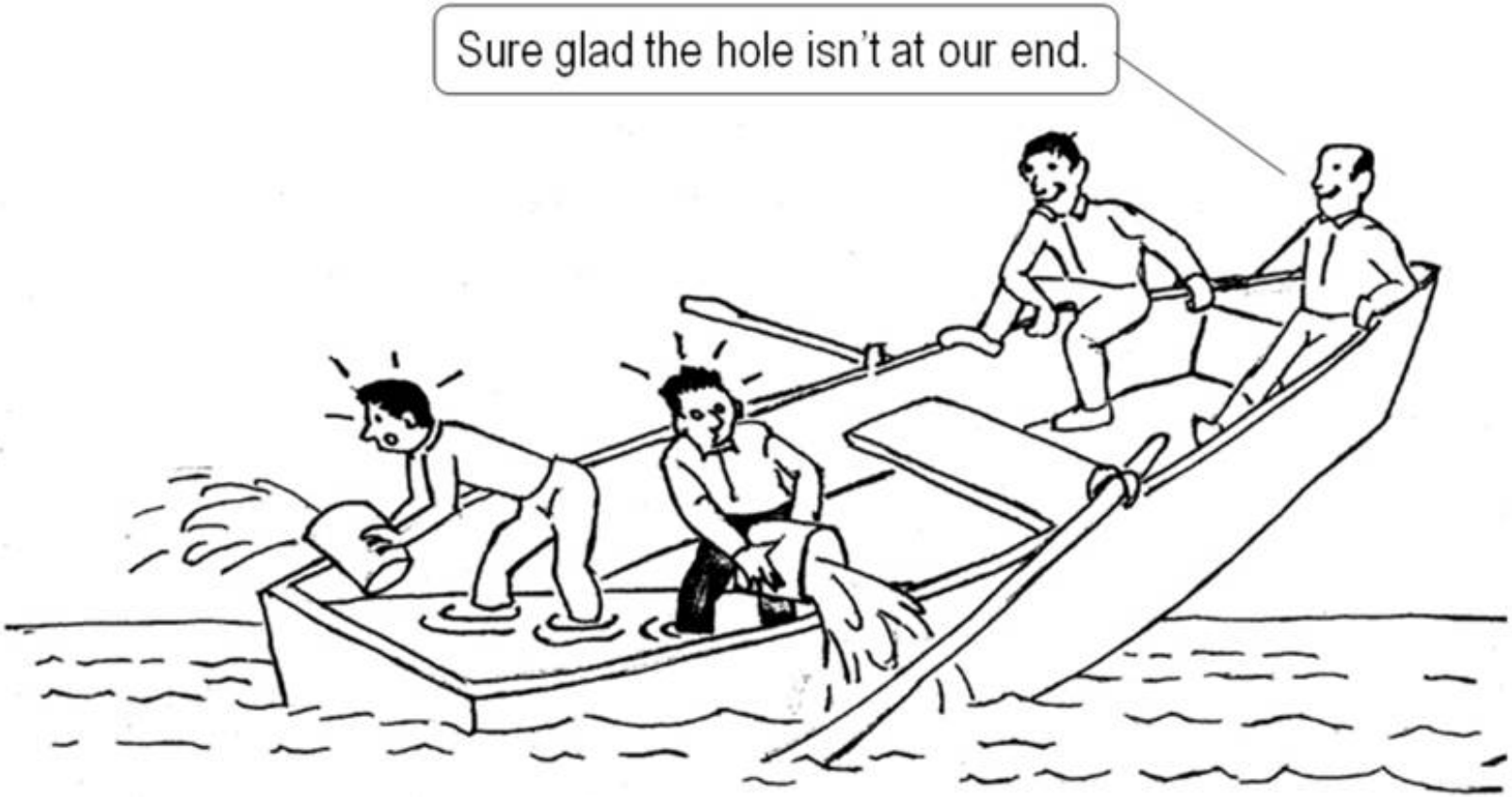
Cortex's Model of Governance Best Practices

Best Practices Governance Models: Cortex's View



Lack of Fiduciary Autonomy = Competitive Disadvantage

Alignment of Interests: A Powerful Safeguard



Question …

Should a plan sponsor and other stakeholders support granting fiduciary boards full autonomy?

- ***Yes***, but not without also ensuring adequate safeguards to protect all stakeholders:
- Primary safeguards:
  - Substantially independent fiduciary boards
  - Substantially qualified fiduciary boards
- Secondary safeguards:
  - Mechanisms promoting disclosure and transparency

Is Cortex's Model Well Supported?

- You will likely not find the Cortex model set out in full within industry, academic, or legislative documents.
- But we believe *each element of the model* is supported by industry, academic, and legislative documents.

Support for Fiduciary Autonomy

- Published standards
- Industry practices:
  - Isolated examples of autonomous US public funds:
    - SBCERA/MOSERS/Texas TRS
  - But most plan sponsors attempt to maintain some control over the authority of their retirement boards through:
    - Control of operating budgets, staffing/compensation, selection of certain advisors
  - Fiduciary autonomy is more advanced outside the US:
    - Ontario Teachers Pension Plan
    - The Dutch model

Support for Fiduciary Autonomy (cont'd)

"Pension boards should have the authority to hire and fire the organization's chief executive officer."

Gregorio Impavido, *On the Governance of Public Pension Fund Management*, The World Bank, Aug. 2002.

"A governing body should have authority to select or dismiss key staff and independent advisors and counsel." *The Clapman Report*

Support for Fiduciary Independence

- Duty of loyalty is central tenet of trust law.
- Consistent with published standards & model law.
- Some academic support exists.
- **But** fiduciary independence is not prevalent in US public fund industry, which generally has:
  - "interested board model"
  - sole trustee model

U.S. Model Law & Independence

Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations. In the absence of independence, trustees may be forced to decide between fulfilling their fiduciary obligations to participants and beneficiaries or complying with the directions of others who are responding to a more wide-ranging (and possibly conflicting) set of interests."

UMPERSA, Section 5

Support for a Highly Qualified Board

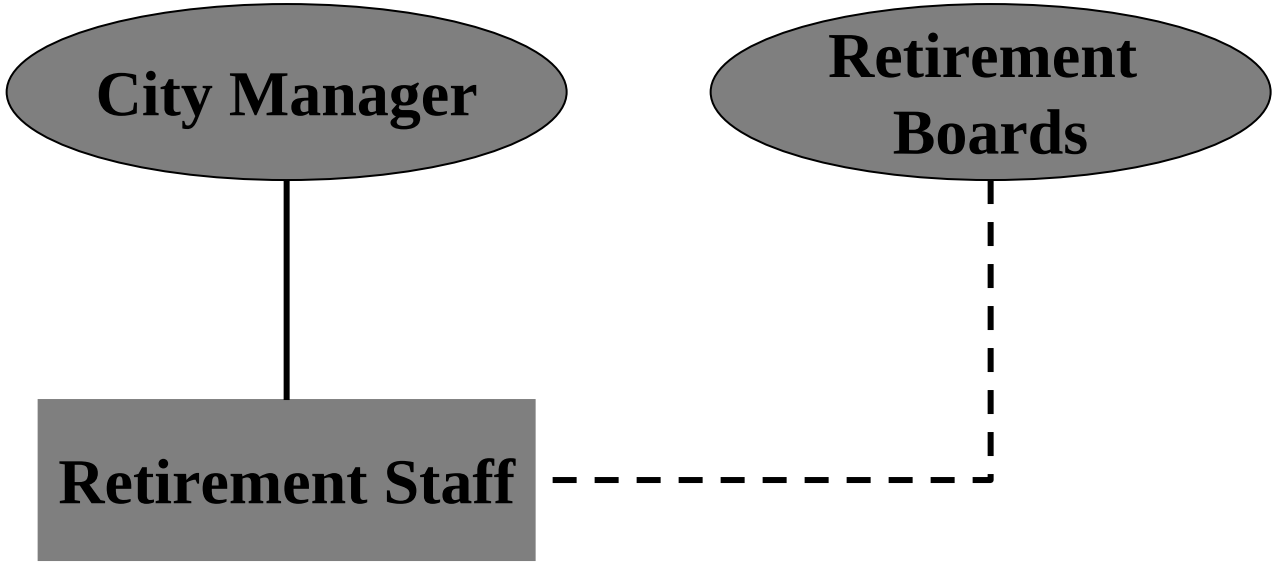
- General recognition of a lack of requisite knowledge on public funds boards
- Need for expertise on public fund boards is supported by published standards
- Limited academic research to show a relationship between expertise and fund performance

Findings Concerning the City of San Jose Pension Plans

3 Years After Our Last Study …

- Retirement boards continue to be significantly constrained in fulfilling their fiduciary duties.
  - Cannot hire their own staff – cumbersome process to replace staff who depart
  - Inefficient decision-making process
  - Unclear accountabilities
- The City and other stakeholders continue to be concerned about:
  - Funded status and investment performance
  - Systemic conflicts and trustee qualifications

Fiduciary Autonomy & Unclear Accountability



How Many Boards Can't Hire Their Own Staff?*

***Based on Cortex's client experience. Cortex did not perform a survey of the issue.**

Measure B:
A Key Development Since Prior Study

Potential for much greater alignment of interests if Measure B is upheld:

- Risk will be shared by the City and plan members and the effects of pension underperformance on plan members will become explicit.
- Creates conditions for the City to relinquish control of the systems and allow boards the necessary autonomy to run the systems effectively; i.e., control over staff, advisors, etc.

Summary of Recommendations from 2013 Cortex Report

Overarching Themes

True, joint administration of the pension plans:

1. Stakeholders to administer the city pension plans in *partnership*.
2. Stakeholder interests to be reflected in the governance of the plans via a *balance of power* on the boards.
3. The *retirement boards are the sole, accountable fiduciaries* and have full autonomy to administer the pension plans and pursue excellence in the administration of the plans and the funds.
4. *Stakeholders are confident their respective interests will be managed* by highly independent and qualified fiduciary boards.
5. Board's activities and performance to be *fully transparent* to stakeholders.

1. Autonomous & Accountable Fiduciary Boards

- City Charter to be amended to provide the retirement boards with the necessary authority they currently lack, which includes authority to:
  - Approve personnel position; and hire, direct, evaluate all personnel
  - Determine human resource policy including compensation policy
  - Select and appoint all advisors
- Mechanisms to remove board members for fiduciary cause.

2. Board Composition to Reflect Stakeholder Interests

- Composition of the retirement boards should continue to provide a balance of power between the City and members/ retirees.
  - 50% of the board members should be selected by the City
  - 50% of the board members should be selected by members/retirees
  - The above board members may continue to jointly select one additional member for each board
  - Mechanism to remove board members for *fiduciary* causes
- Above reflects that both members and taxpayers have a legitimate interest in the success of the two systems:
  - Measure B further clarifies the above alignment of interests

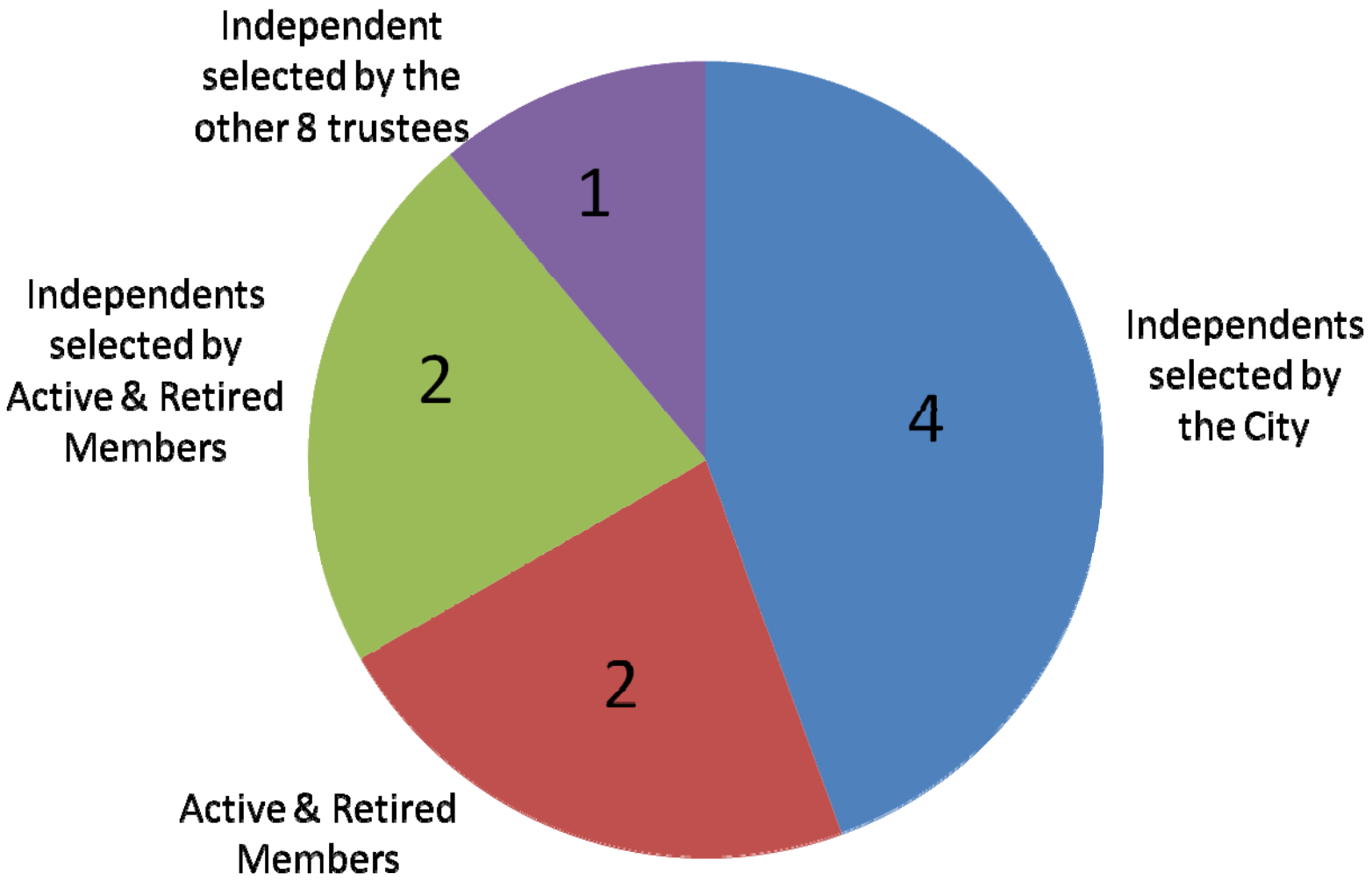
3. Independence of each Board to be Enhanced

- In 2010, it was decided city officials would no longer serve on either retirement board so as to enhance the independence of the boards.
- Cortex recommends that independence be further enhanced by decreasing the number of board members who may be active or retired members of the systems, *and replacing them with independent trustees selected by active and retired members*.
- Cortex also recommends that, if feasible, retirement system staff should not be members of the systems.

4. Qualifications of each Board to be Enhanced

- In 2010, board composition was changed to require that just over 50% of the board members must possess relevant expertise & experience.
- Cortex now recommends that board expertise be further enhanced by requiring that just over 75% of the board members must possess relevant expertise and experience.

Recommended Board Composition



Why Reduce Direct Stakeholder Presence on the Boards?

It enhances the independence and qualifications of the Boards and better enables the boards to administer the plans prudently and in the sole best interests of beneficiaries.

- A largely independent and qualified board benefits ***all*** stakeholders and should provide them enough comfort to allow board autonomy.

Why Reduce Direct Stakeholder Presence on the Boards? (cont'd)

While academic research is limited and mixed, it suggests:

- Presence of sponsor-trustees is associated with being under-funded.
- Presence of small proportion of member-trustees may be associated with improved performance.
- Presence of independent trustees may be associated with improved performance.

5. Secondary Safeguards

Added transparency and accountability:

- Creation of Stakeholder Committee (to replace non-voting board members)
- Mandatory annual general meeting for the public
- Enhanced performance reporting
- Social and ethical investment policy
- Audit Committee
- Fiduciary audit
- Expanded disclosures (e.g. senior executive salaries)
- Mechanisms to remove trustees for fiduciary cause

Potential Stakeholder Concerns

1. Why does the recommended model allow for 25% of trustees to be members/retirees, but not allow for any city officials to serve?
2. What kind of independent trustees would members/ retirees be expected to select to serve on the boards? What if they can't find appropriate individuals?
3. What if the Board or an individual trustee goes "rogue"?
4. What if staff salaries grow out-of-control?
5. Will the suggested model provide any real benefits to stakeholders?
6. How could retirement staff become employees of the boards?
7. Are there examples of the recommended model in place elsewhere in California?

Board Consolidation

Not strictly speaking a governance issue, but an organizational issue.

Advantages of Consolidation

1. Enhanced governance through clearer accountability and authority over staff (1 board/1 staff).
2. Lower costs by eliminating duplication of vendor services.
3. Enhanced efficiency at the staff level.
4. Less potential for conflicting investment policies.
5. Potential for marginal economies of scale.
6. Potential for improved *net* investment performance and better member service due to all of the above.

Consolidation: Cortex Recommendations

- From operational and governance perspectives, Cortex believes consolidation of the two retirement systems would support more efficient and cost-effective pension administration.
- Cortex recommends the two retirement systems be consolidated:
  - One board
  - One fund/master trust
  - Multiple plans

Questions

Thank you