# How Can Trustees Learn to Trust?

*Achieving the Right Balance in Decision-Making between the Board and Executive Management*

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*"Trust, like reputation, is gained in inches per year and lost in feet per second"*

**The Challenge**

Many boards of trustees struggle to achieve an appropriate balance between a focus on setting strategy and policy and providing operational oversight vs. over-involvement in operational and transactional details and decisions. This article describes the challenges faced by a growing number of boards of trustees and executives of public retirement systems. It offers some potential solutions so trustees can learn to trust each other and their executives' advice and oversee executives' ability to execute agreed policies and directions.

Most trustees are regularly reminded of the nature and extent of their fiduciary duties. First and foremost, trustees owe a duty of loyalty to the fund's beneficiaries. They may take into account the wishes of their appointers, constituents, electorates, taxpayers, etc. but those views cannot override their duty of loyalty to the beneficiaries. While they are collectively responsible for board duties, individual trustees are subject to a stricter duty of loyalty than are corporate directors.

Trustees are not only accountable for their own behavior but may also be exposed to liability for their co-fiduciaries' misconduct. Trustees are responsible for supervision of the fund's performance, its governance, strategy and oversight, as well as for organizational and individual behavior and outcomes.

The board can delegate authority to executives but cannot avoid its own fiduciary responsibilities to carefully select, instruct, incent and monitor those executives. The board must hold executives accountable but practically speaking, where does the board draw the line between oversight and management? What constitutes effective board oversight and what insights are needed to provide effective operational oversight? How can trustees add the most value? How can the board enable management to achieve its mission? How can the board know whether the executives and their performance reports can be relied upon?

Trustees immediately assume full responsibility of fiduciary duties upon taking office. Like corporate directors, trustees are part-time but have full-time responsibilities. Tough decisions need to be made despite high complexity, high uncertainty, rapid shifts, polarized and conflicting opinions, pressures from special interests and inter-generational differences amongst beneficiaries.

Given open meeting laws, discussions must take place with a very high degree of transparency. However, this often makes it difficult to have a free exchange of ideas given the immediacy of stakeholder feedback on matters they may perceive as counter to their interests. Different states also have different limitations on the topics for which closed executive meetings may be held.

Trust is critical and yet still fresh memories of governance scandals involving pay to play, ethics breaches and other self-dealings in public retirement systems have heightened trustees' awareness of what can go wrong with the board and the executive. When things go wrong, boards have been criticized for not having paid enough attention. Thus, it should come as no surprise that trustees want to delve into operational and transactional details to satisfy themselves that the organization is performing as it should. How else can trustees be assured and then reassured that they can trust their executives and each other?

Individual trustees also interpret and exercise their responsibilities in different ways. Some are passive, some are aggressive. Some challenge every executive proposal, some accept every recommendation. Some demand extraordinary detail. Others just want the big picture.

How does a board and its executive management come to an appropriate balance in a constructive relationship? Trust is essential but trust must be earned. Building and maintaining trust requires constant care and attention and multiple approaches. Each approach is necessary but not sufficient unto itself. Some of these include, for the board:

- Establishing clear criteria for selecting the Executive Director (ED), conducting performance evaluations, and providing regular board feedback;
- Clearly defining the powers reserved for the board and the delegations to the ED and others;
- Developing an explicit strategic policy agenda so that the board can spend its time focused on understanding and gaining insight into key policy issues, strategic risks and strategic options;
- Aligning board self-development and education programs with the strategic policy agenda and improving on-boarding processes;
- Utilizing a decision-making framework for staff recommendations to the board which includes analysis of alternatives considered, discussion of risks , and pros and cons of each alternative;
- Improving operational oversight tools;
- Using self-assessment to help the board improve its policy and oversight roles; and,
- Obtaining its own source of independent reassurance for the board so that information provided by the ED and staff can be relied upon.

***Selecting and evaluating the Chief Executive.*** One of, if not, the most important decisions made by the board is the selection of the Executive Director (ED). If trust cannot be developed, then the board likely has the wrong ED in place. The board should establish clear criteria for selection and performance evaluation. They should also give the ED regular feedback, e.g., quarterly, not just annually, to maintain a clear mutual understanding of expectations compared to actual performance. This will allow time for correction.

***Defining Powers Reserved.*** The board can and should delegate operational authority to the ED and, clearly, the ED should be held responsible and accountable for organizational performance while the board still retains its overall fiduciary responsibilities. The powers reserved for the board and their delegations should be clearly defined.

What must come to the attention of the board and how big does it need to be (financial and/or investment, legal, operational, reputational and strategic)? What decisions must be made by the board? What activities does the board actually perform such as selecting the ED, approving the asset allocation policy, establishing standards for investment manager selection and retention and overseeing operations?

Trustees need understanding and insight into the system's strategies, policies, operations and transactions necessary for responsible and intelligent oversight. Executives, in turn, need sufficient authority and latitude to execute agreed upon strategies, policies and directions. Executives also typically identify and frame emerging policy issues and develop strategies subject to review and approval by the board. The board, however, needs to be actively involved in setting the strategic policy agenda.

***Setting the Strategic Policy Agenda*****.** The range of strategic policy issues facing public retirement systems is broad, difficult, dynamic and rapidly shifting. This requires constant analysis and preparedness for adaptation. Boards need to understand the strategic policy issues which must be addressed for the foreseeable future, prioritizing those issues and making time for a thoughtful and coordinated response. Yet boards too often become overly involved in executive operational and transactional decisions. Too easily, boards find themselves enmeshed in operational decisions despite a formidable and growing strategic and policy agenda, the magnitude and velocity of which is unlikely to abate in the future.

Strategic policy agenda topics can range from legislative pension reform, unfunded liabilities, stakeholder engagement, hostile media and growing public antipathy toward public pensions, and asset allocation strategies to achieve expected rates of return, internal HR retirement cliffs, aging IT systems, etc.

Many public pension funds have a one- or two-year budgeting process but lack a robust longer-term strategic planning process. Because many aspects of pension fund governance are set by statute, it is easy to assume that there are few, if any, truly strategic choices. However, it is critical for the board to look to the longer term and provide strategic guidance for the organization. If the board can't control the causes, can it mitigate the effects?

Developing a strategic focus for the board is often hindered by lack of a meaningful strategic planning process and a strategic policy agenda for the foreseeable future. Strategic thinking is required to anticipate and prepare for uncertainty. It requires the identification of options in response to a range of scenarios to improve the organization's ability to adapt to changing conditions.

***Aligning Board Education and Self-Development with the Strategic Policy Agenda.*** Continuing education for trustees is essential to stay abreast of issues in a rapidly changing environment. In addition to in-house educational sessions, trustees should seek out external opportunities to gather new ideas and gain others' perspectives. Board education should be tied to the strategic policy agenda to provide perspectives and insights on the breadth and depth of the issues.

But before continuing education, on-boarding processes need to be improved to decrease the steepness of the trustee learning curve. As in the private sector, it takes about two years for a trustee or director to really begin to understand the key issues, gain insight and provide effective oversight. Operational matters are typically shorter term and easier to grasp and strategic issues are tougher and longer term.

By improving on-boarding processes, using tools such as decision-support frameworks, visual process maps (discussed further below), and process walk-throughs, trustees can much more quickly develop an understanding of the organization and build confidence in its processes and staff. This can free them up to focus more on strategic decision-making.

***Utilizing a Decision-Support Framework.*** As mentioned earlier, open meetings laws, while improving transparency, also inhibit candid discussion of tough strategic policy issues. How then do the tough strategic policy issues get raised? One way is to use a consistent but simple decision-support framework that describes for each strategic policy item:

- Issue
- Background
- Assumptions
- Risks of action vs. inaction
- Options available
- Pros and cons of each option
- Staff / Consultant Recommendation

Using a consistent decision-support framework brings discipline and repeatability to the process. It enables the board to understand the executive thought process in recommending a course of action rather than just presenting a “baked cake”. It also enables the surfacing of tough issues and the related pros and cons without requiring trustees to immediately take a position.

***Improving operational oversight tools.*** Public retirement systems are increasingly complex. One way to help trustees understand how the organization works and to improve operational oversight is to provide visual process maps for each major service area. For example, a fully integrated public retirement system may provide Pension, Health Services and Employer Services, Manage Investments, and Govern and Administer the overall system. By visualizing the services offered, oversight can be enhanced. Visual process maps can also be used as dashboards to indicate areas that are functioning well and those that need improvement.

***Using board self-assessments.*** Self-assessments can help a board improve its policy and oversight roles. By identifying, strengths and weaknesses, a board can review its own style, it operations, and its relationship with management. Improvements are often easier to implement when they come as the result of opportunities identified by the trustees themselves. Such self-assessments should be part of an on-going process of development and tied to the board’s continuing education plan and the strategic policy agenda.

***“Trust but verify” Ronald Reagan***

***Obtaining Independent Reassurance.*** There is no aspect of the organization or its operations into which trustees cannot legitimately inquire to satisfy themselves that the organization is being well-run. But is this the most effective way to manage the organization? Not enough trustee involvement may lead to laxity. Too much involvement may lead to organizational paralysis.

How can trustees obtain reasonable (but not absolute) assurances from executives that the organization is performing as expected? How can trustees get independent reassurance that executives’ reports are reliable? There are a number of sources of independent reassurance, i.e., independent of management:

- Internal Audit
- External Audit
- Risk Management / Compliance, and,
- Third Parties through independent reviews

Each of these may or may not provide independent reassurance that the reports the trustees receive from executives about operational performance are reliable.  These reassurances can help the board to stay focused on the strategic policy agenda.  Board oversight is enhanced by the knowledge that those who are deeply conversant with the subject matter have examined management's assurance in considerable detail.

**Conclusion**

It's hard to make a relationship work when times are good. When times are tough, as they are today, it's even harder to trust because the consequences of error are so high. But boards and trustees must delegate and must trust, otherwise, why have an executive?

Hire the best, give them the authority and resources to do their jobs and hold them accountable for performance that is within their control.  Focus the board on the strategic policy agenda. Get reasonable assurances from management that the organization is performing as expected and get independent reassurance that executive assurances are reliable. This will enable trustees to trust as they delegate operational matters to the executive while the board focuses on the strategic issues essential to the long term performance and success of the system.

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