

Presentation to the South Carolina Joint Committee on Pension Systems Review

October 26, 2016



Presenting Today

- Rick Funston, Managing Partner and former national practice leader for Deloitte's Governance and Risk Oversight Services. Created concept of Risk Intelligence. Principal author of "Surviving and Thriving in Uncertainty" (2010). Editor of "One Size Fits One: A Handbook for Public Pension Trustees" (2017).
- Randy Miller, Principal, former senior Deloitte consulting partner. Project leader.
- Keith Johnson, attorney and Chair of the Institutional Investor Legal Services team at Reinhart Boerner Van Deuren S.C. and former legal counsel to the State of Wisconsin Investment board (SWIB) for more than 21 years.

Overview

- The State Inspector General's Fiduciary Audits
- Purpose of Fiduciary Audits
- Scope
- RSIC Specific Conclusions and Recommendations
- PEBA Specific Conclusions and Recommendations
- Attachments
 - A - Bios of Team Members
 - B – Review Process
 - C – Recommendations to Stakeholders

The State Inspector General's Fiduciary Audits

Two independent fiduciary performance audits were commissioned by the State Inspector General

- Retirement System Investment Commission (RSIC)
 - Completed April 18, 2014
- Public Employee Benefit Authority (PEBA)
 - Completed December 22, 2014

Purpose of the Fiduciary Audits

1. A critical evaluation the fiduciary roles and responsibilities of the Commissioners and staff, the relationship with other fiduciaries of the Retirement System, and operational policies and practices
2. Identify areas of strengths and weaknesses, provide comparison with leading practices of other public pension plans, and make improvement recommendations

A fiduciary audit is NOT a financial statement audit, an evaluation of investment or benefit delivery performance or an assessment of the causes of unfunded liabilities.

Scope

RSIC

1. Governance
 2. Policy Review and Development
 3. Organizational Structure
 4. Investment Administration
 5. Legal Compliance
 6. Information Technology
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PEBA

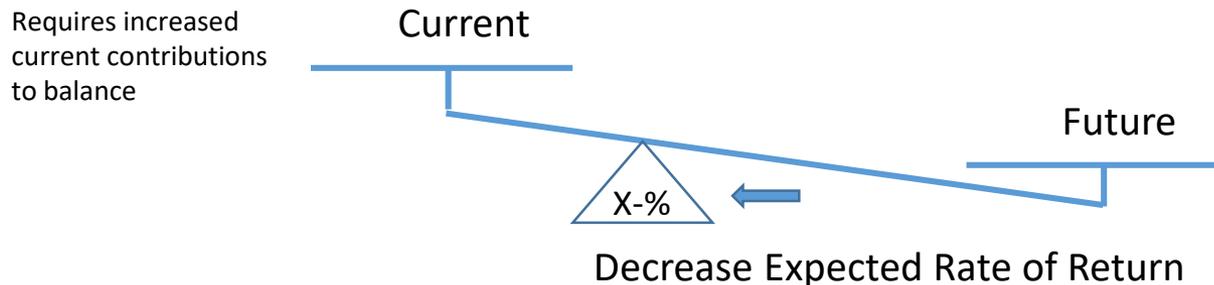
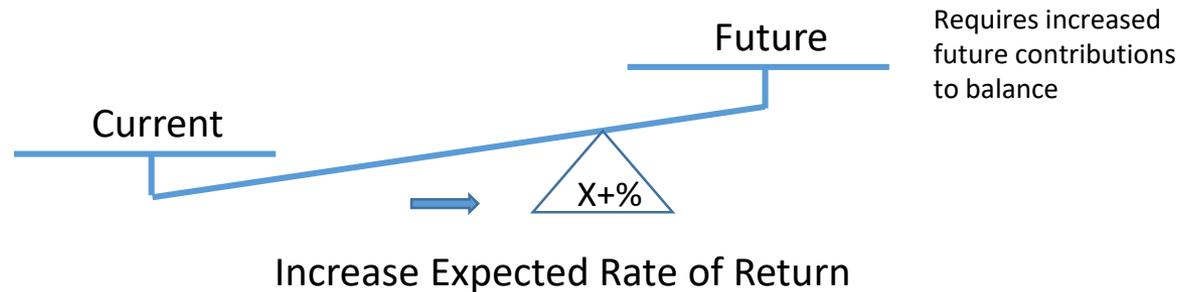
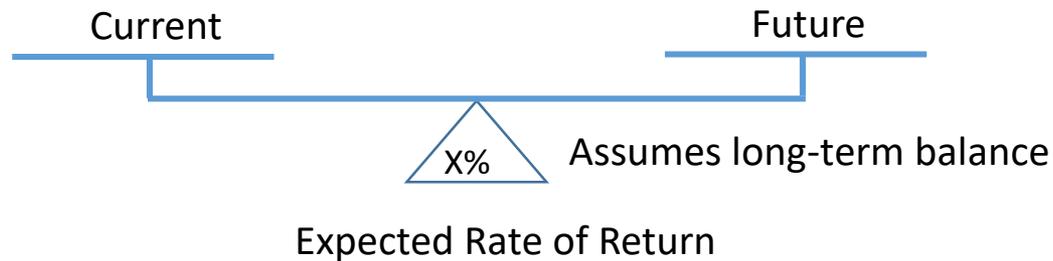
1. Governance
2. Policy Review and Development
3. Organization Structure
4. Benefits Administration
5. Legal Compliance
6. Information Technology Systems
7. Communications with Stakeholders
8. Actuarial Matters
9. Customer Service
10. Record Keeping and Security of Information
11. Cost of Operations

Key Governance Questions

While the unfunded liability was not part of our scope, it does raise a number of key governance questions that were within our scope:

- What are the key decisions?
- Who has the authority to make them?
- Are the decisions coordinated?
- What information do decision-makers need to make the best decisions under the circumstances?
- Who is accountable?

Example: Balancing Contributions



Involves a high degree of uncertainty. The future consequences depend on whether the assumptions are met – i.e., if the increased return assumption is actually met, then future contributions will not increase; if the lower assumption proves accurate, then the current and future contributions will be relatively stable.

Governance Decisions Affecting Pension Soundness

Pension Soundness

LONG-TERM ASSETS

=

LONG-TERM LIABILITIES

CONTRIBUTIONS

+

INVESTMENTS

=

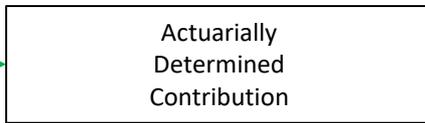
BENEFITS

+

EXPENSES



Actuarial Assumptions



Capacity / Willingness to Pay?

Classes (1-3)

Budget re: Staffing, Compensation & Infrastructure

Plan Design: Current & Future

Budget re: Staffing, Compensation & Infrastructure

Custodian

COLA/TERI

Assumed Rate of Return

Retroactive Increases?

Purchasing Policy (RSIC & PEBA)

Default Insurance

Investment Beliefs

Increased Longevity

Accounting

Fairness / Intergenerational Equity

Risk Appetite

Fairness / Intergenerational equity

External Audit

Current & Future Members (Growth/Decline)

Asset Allocation

Administer retirement / health benefits & services

Actuaries

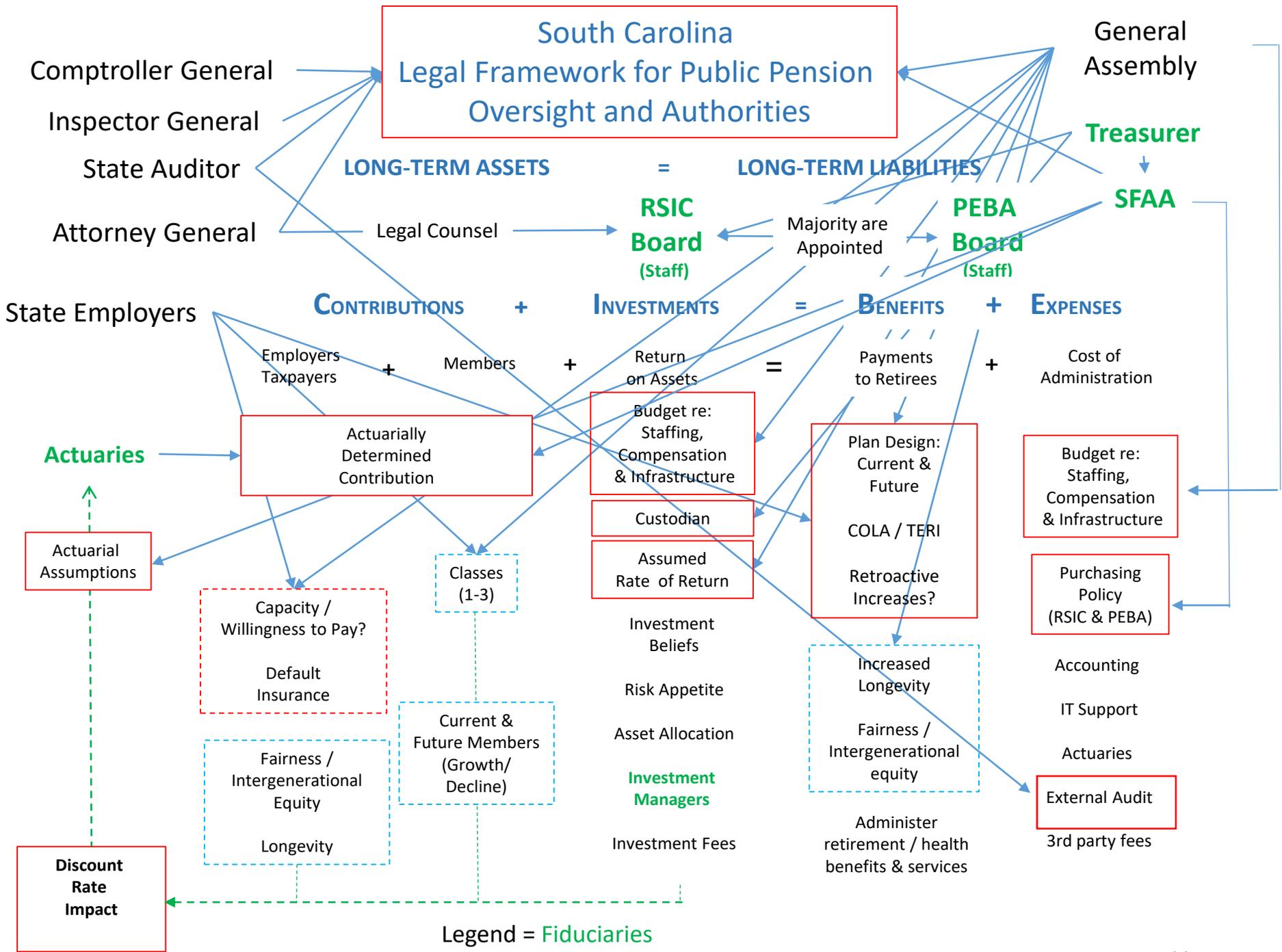
Longevity

Investment Managers

Investment Fees

3rd party fees

Discount Rate Impact



Fiduciary Duty, Structure and Accountability

- RSIC and PEBA have the responsibility to keep the promises made by others
- Many of the key decisions affecting unfunded liability are made by others
- Given this governance structure, who is accountable?
- The recommendations of our reviews were designed to streamline and align governance authorities and improve accountability

Retirement System Investment Commission (RSIC)

As of April 8, 2014

Composition of the RSIC Board

- There are seven members who are either appointed, elected or ex officio.
- Four members are appointed:
 - Governor
 - State Comptroller General
 - Senate Finance Committee Chairman
 - House Ways and Means Committee Chairman
- One member is elected by the Commission
- The State Treasurer is an ex officio member
- The seventh, non-voting commissioner, is the Executive Director of PEBA as an ex officio member.

RSIC Specific Context

- Less than ten years old at the time of review (2013).
- Continuing to develop its capabilities.
- In 2005, there were six commissioners and an Administrative Director/ General Counsel.
- A new Chief Investment Officer (CIO) came on board in April 2006, roughly six months later, and three full-time employees joined him in January 2007.
- The new Commission was charged with investing and managing \$25 billion in retirement assets.
- A key feature of the new statute was to mandate the Commission with diversifying the fund's assets unless "the Commission determines that, because of special circumstances, it is clearly not prudent to do so".

RSIC Key Conclusions

- RSIC has one of the most complex and fragmented governance structures among U.S. public pension funds.
- No red flag indicators of malfeasance or misfeasance.
- Investment fee transparency, policies and controls have improved significantly and disclosure of fees is the most complete in the industry.
- Although RSIC has selected a high cost strategy, fees to external managers are normal for its asset allocation and are not excessive.
- RSIC has been implementing a number of strategies which should result in lower external manager costs.
- RSIC's lack of infrastructure results in growing operational risks, and ultimately financial risk. There are several contributing factors including:
 - The annual legislative budget approval process;
 - Existing state procurement laws and policies relating to acquisition of investment systems and support; and,
 - The indirect relationship RSIC has with the custodial bank.
- RSIC had already implemented many improvement initiatives over the past two years and continues to track and report on implementation of our recommendations.

Pervasive RSIC Themes

Synthesizing the findings across the six categories of the audit, there were five overall themes for improvement:

1. Improve assurance and independent reassurance to build trust and confidence.
2. Build capabilities across the organization (including HR, IT, Accounting, etc.).
3. Reset Commissioners' focus on strategy and oversight.
4. Align fiduciary duties and responsibilities.
5. Improve the custodian relationships.

Specific recommendations to the Legislature are found in the fourth and fifth themes.

4. Align fiduciary duties and responsibilities.

- The Commission has the authority to invest \$27 billion and commit hundreds of millions of dollars in manager fees annually.
- However, RSIC’s internal annual spending budget of \$12-14 million, as well as staffing and compensation levels, must be approved annually.
- It has been difficult for RSIC to build out the infrastructure required to control risks and reduce overall costs due to this one-year budget horizon and lack of certainty of approval.
- Leading practice at other state investment boards is to delegate budget and staffing headcount and compensation to the trustee board.

Do the fund trustees have the final authority to approve:	Investment Board Responses (N=6)		
	Yes	No	RSIC
The overall fund operating budget	6	0	No
The fund headcount	6	0	No
Investment staff base compensation	4	2	Yes
Investment staff bonus pool	5	1	No*
Major purchases of investment-related services (e.g., systems, administrative services)	4	2	No*

* RSIC has authority to recommend only.

Roles of the Treasurer

The three fiduciary roles, authorities and responsibilities of the Treasurer have inherent conflicts:

- 1. *Member of Budget and Control Board (BCB):*** The Treasurer is in the position of having oversight of himself as a Commissioner. The Commission, in turn, must objectively evaluate the custody services it receives from a fellow Commissioner, who is also an overseer on the BCB.
- 2. *Commissioner on Retirement System Investment Council (RSIC):*** The Treasurer is faced with the challenge of resolving potentially conflicting fiduciary duties between his role as one of several commissioners on the RSIC and his separate obligations as Custodian.
- 3. *Custodian of the funds:*** When the statutes vested exclusive investment authority in RSIC, it seemed to preclude subsequent exercise of a de facto veto by one of the commissioners, regardless of the role (in this case as Custodian) in which that fiduciary is acting.

5. Improve the custodian relationships

- **Ensure the RSIC has the custodial services it needs to do its job.**
- **Align responsibilities to facilitate efficient and effective custody operations.**

1. The Legislature should:

- a. Consider options to improve the custodial relationship.
- b. Delegate selection of the custodial bank to RSIC.

2. Until the custodial relationship is changed, the Treasurer should:

- a. Review positions required to sign for release of cash transfers.
- b. Instruct the custodial bank to accept signatory changes from RSIC.
- c. Continue to allow standing instructions for the custodial bank to receive incoming funds and sweep cash.
- d. Allow electronic payment authorization.

3. The Commission should determine the future of Securities Lending.

5. Improve the custodian relationships

- There are four potential options to consider regarding custodial duties.
- We believe only Options 3 and 4 would solve the problem.
- In any case, RSIC should select the custodial bank and manage the relationship.

Option	Description
Status Quo: Custodian: Treasurer Relationship: Treasurer	<ul style="list-style-type: none"> • No significant changes • The Treasurer remains the custodian • STO implements its new Custody Officer role • RSIC proceeds to implement its investment administrator role • This structure is unique to South Carolina among U.S. state investment boards with an independent investment staff
Option 1: Improved Status Quo Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • The Treasurer remains the custodian • The Treasurer delegates authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds • Authorization processes are streamlined to not require STO signatures and utilize electronic payment authorization • Service level agreement and performance feedback are implemented by RSIC • The internal accounting system is updated (not related to custodian) • Similar to Washington State Investment Board (WSIB) structure
Option 2: RSIC Custody Relationship Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • The Treasurer retains the title of Custodian • Legislative change provides for delegation of authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds • Similar to the Illinois State Board of Investments (ISBI) and New Mexico ERB structure
Option 3: PEBA as Custodian Custodian: PEBA Relationship: RSIC	<ul style="list-style-type: none"> • Legislative change provides for: <ul style="list-style-type: none"> – PEBA to become the custodian of record – RSIC to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds • Similar to the Minnesota State Board of Investments (SBI) structure
Option 4: RSIC as Custodian Custodian: RSIC Relationship: RSIC	<ul style="list-style-type: none"> • Legislative change provides for RSIC to become the custodian of record and to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds • Similar to Florida SBA, Massachusetts PRIM, West Virginia IMB, and SWIB structure

Summary of RSIC Recommendations for the Legislature

The Legislature should:

- Delegate operating budget, staffing and compensation approval to the Commission.
- Extend RSIC's authorities for procurement to include investment-related services and systems.
- Eliminate the inherent conflicts in the role of the Treasurer by:
 - Designating PEBA as the custodian of all retirement funds; and,
 - Delegating selection of the custodial bank to RSIC.
- Revise Commissioner qualifications to recognize experience.
- Revise legislation to allow an Executive Director and change CIO reporting.
- Authorize an external audit or agreed upon procedures review of fund valuations, procedures and/or controls.
- Add 1 to 3 additional voting Commission members and increase beneficiary representation.
- Consider term limits for Commissioners.
- Regularly review the assumed rate of return and underlying assumptions every five years, or delegate the function to PEBA or RSIC.

BCB should allow a modified information systems procurement process.

The Attorney General should set high level criteria and delegate sourcing of external counsel to RSIC.

Status of Recommendation Implementation

RSIC reports that as of September 2016, 95 of 110 (86%) recommendations within the control of RSIC have been implemented. Examples of changes implemented since 2014 include:

- Re-focused Commissioners' role to one of strategic guidance and oversight and conducted a thorough review of and revisions to the strategic asset allocation
- Developed a set of investment beliefs as a basis for strategic direction of the portfolio
- Adopted an annual investment risk plan and added a member of the investment risk management team as a voting member of Internal Investment Committee
- Enhanced and streamlined due diligence practices
- Collaborated with CEM Benchmarking to review private equity fee reporting and initiate a national focus on standardized fee reporting
- Engaged an independent consultant to assess RSIC staff compensation and developed a new evaluation and compensation plan and process
- Created new policies and practices in a number of areas, including securities lending, risk tolerance, investment decision-making, and broker-dealers

Public Employee Benefit Administration (PEBA)

As of December 22, 2014

Composition of the PEBA Board

- PEBA's Board of Directors is composed of 11 appointed members. Board members are either representative, meaning they belong to a class of employees or retirees they represent, or non-representative, meaning they do not belong to a class of employees or retirees. Appointments are made by the following positions:
 - Governor
 - President Pro Tempore of the Senate
 - Chairman of the Senate Finance Committee
 - Speaker of the House of Representatives
 - Chairman of the House Ways and Means Committee
- Members of the PEBA Board serve for terms of two years at the pleasure of their appointing authority. Terms commence on the first of July in even numbered years. Learn more about the qualification requirements of PEBA Board Members in the [S.C. Code of Laws, Title 9, Chapter 4](#).

PEBA Specific Context

- PEBA was only two years old at the time of our review (2014), created through the merger of the South Carolina Retirement Systems and the Employee Insurance Program.
- Each program had established, stable and mature organizations, with capable staffing, processes and systems and to our knowledge delivered high quality services.
- PEBA and the BCB/SFAA are fiduciary stewards of the following funds and trust funds:
 - PEBA Insurance Benefits
 - PEBA Retiree Health Insurance Trust Fund
 - PEBA Long-Term Disability Insurance Trust Fund
 - South Carolina Retirement Systems
- PEBA is also responsible for the State Optional Retirement Program and the South Carolina Deferred Compensation Program.
- PEBA had several Executive Directors during its first two years of existence.

PEBA Key Conclusions

1. PEBA staff are competent, dedicated and service-oriented.
2. The administrative processes used by PEBA to deliver services to members appear to function well and consistently at low cost.
3. However, a transformation is needed for several key reasons and, fortunately, it has already begun.
 - Many processes are not well documented and rely extensively on the institutional knowledge and experience of long-time employees.
 - Up to 45% of employees are eligible for retirement within five years.
 - The ability to adapt to new requirements is limited due to aging information systems and lean staffing.
4. The Board needs to become more strategic and less tactical and delegate more to the Executive Director.
5. The organization should continue to evolve; the recent reorganization is a good step forward.
6. With support from the General Assembly, alignment of fiduciary responsibilities and authorities could be significantly improved.

Recommendations

- Synthesizing the findings across the eleven categories we reviewed, we organized the recommendations into nine topical areas:
 - Actuarial (6 recommendations)
 - Board (19 recommendations)
 - ***Legislation (11 recommendations) – Our focus today***
 - Organization (14 recommendations)
 - Planning (15 recommendations)
 - Policy (7 recommendations)
 - Process (27 recommendations)
 - Risk (8 recommendations)
 - Systems (6 recommendations)
- Specific recommendations are organized by each of these topical areas on the following slides.

Status of Recommendation Implementation

Since our report was submitted, as of October 12, 2016, PEBA reports it has completed 81% of the recommendations within its control. For example:

- Updated the Board of Directors' Bylaws and Committee Charters to include expanding fiduciary and ethics training;
- Developed new Board member orientation materials;
- Created an Employer Services unit to better serve the needs of our employers and enhance services in the future;
- Conducted annual network and security vulnerability tests to ensure networks and other IT security processes are working as intended;
- Enhanced PEBA's ability to communicate with members via email;
- Launched a consolidated agency website;
- Procured and deployed a new Customer Contact Center call management system;
- Assessed existing and trending threats to information and network security; and
- Completed a comprehensive assessment of existing IT infrastructure and business systems.

Legislative Recommendations

- The General Assembly should simplify and clarify the system of fiduciary governance for the Retirement System and insurance programs by reducing the multiple conflicts and overlapping fiduciary authority of the Treasurer and BCB (and its successors) with PEBA.
- The General Assembly should transfer investment responsibility for insurance trust fund assets to the Retirement System Investment Commission as the most qualified State entity to provide those services.
- The General Assembly should transfer approval of Deferred Compensation investment options from the State Treasurer to the PEBA Board of Trustees.
- The General Assembly should allow PEBA greater flexibility to reduce the number of ORP vendors in order to obtain lower fees and make other improvements without materially affecting program quality.

Legislative Recommendations

- The General Assembly should update the PEBA Board Member appointment process to be more consistent with peer practices.
 - Four- or five-year staggered terms, subject only to early removal for cause.
 - Consideration of changes in the appointment process to improve engagement with participant groups and the PEBA Board by establishing a process for them to submit qualified candidates for consideration by the appointing authorities.
- The General Assembly should give the PEBA Board of Trustees greater independence for budget and headcount decisions to ensure that they are consistent with the strict fiduciary standards to which it is bound.
- The General Assembly should eliminate the requirement for a Retirement and Pre-Retirement Advisory Panel, in the context of an improved PEBA Board communications and engagement plan that covers a broad range of stakeholder groups.

Legislative Recommendations

- The statutory requirement that the PEBA Board meet monthly throughout the year should be repealed.
- The General Assembly should include a provision in future legislation that replaces references to the BCB, or its successor, in S.C. Code Ann. §§ 9-1-1310 and 9-4-45 with specific references to the SFAA, in order to more explicitly effectuate transfer of the BCB's co-trustee functions to new State Fiscal Accountability Authority.
- The General Assembly should eliminate the notarization requirement for a member death by amending the appropriate statutes to delete the requirement for a “duly acknowledged” written notification to PEBA.

Attachments

Attachment A: Funston Advisory Services Team

RSIC

- Keith Bozarth
- Virginia Brizendine
- Marv Damsma
- Rick Funston*
- Keith Johnson
- Ken Johnson
- Jon Lukomnik
- Randy Miller*

PEBA

- Keith Bozarth
- Rose Hewig
- Rick Funston*
- Keith Johnson
- Todd McGowan
- Randy Miller*
- Dave Stella

* Team leaders

See also Attachment A for brief bios of each team member

RSIC Team Bios

- Rick Funston, Managing Partner and former national practice leader for Deloitte's Governance and Risk Oversight Services. Created concept of Risk Intelligence. Principal author of "Surviving and Thriving in Uncertainty".
- Randy Miller, Principal, former senior Deloitte consulting partner. Project leader.
- Keith Johnson, attorney and Chair of the Institutional Investor Legal Services team at Reinhart Boerner Van Deuren S.C. and former legal counsel to the State of Wisconsin Investment board (SWIB) for more than 21 years.
- Keith Bozarth, retired Executive Director of the State of Wisconsin Investment Board (SWIB) (June 2012) (9th largest public pension fund in the United States) and prior CEO of the Orange County Employees Retirement System in California.
- Virginia Brizendine, Chief Financial Officer for the School Employees Retirement System (SERS) of Ohio from 1999 until 2010.
- Marv Damsma, former Chief Investment Officer for BP America, The Kellogg Company and the New York City Retirement Systems.
- Ken Johnson, former Chief Operating Officer and Chief Financial Officer for the State of Wisconsin Investment Board (SWIB) (retired in 2010).
- Jon Lukomnik, former Deputy Comptroller for pensions for the City of New York, currently serves on three investment committees, is a trustee for the Van Eck mutual fund complex and a member of their Audit Committee.

PEBA Team Bios

- Rick Funston – former leader of Deloitte’s Governance and Risk practice and Managing Partner of Funston Advisory Services for five years
- Randy Miller – former Deloitte Consulting partner and Principal with Funston Advisory Services for five years
- Keith Johnson – fiduciary and institutional investor legal expert, former General Counsel for the State of Wisconsin Investment Board
- Dave Stella and Keith Bozarth – formerly Executive Directors of the Wisconsin agencies equivalent to PEBA and RSIC
- Rose Hewig – former Assistant General Counsel for New York State Teachers’ Retirement System and highly experienced in retirement operations
- Todd McGowan – former banking chief risk and compliance officer and Deloitte audit and IT security partner

Attachment B: Review Process

RSIC

- Reviewed 800 documents
- Interviewed 50 people
- Benchmarking survey
- Comments and feedback

PEBA

- Reviewed 400 documents
- Interviewed 50 people
- Benchmarking survey
- Comments and feedback

Attachment C: Recommendations to Stakeholders

RSIC

- 124 recommendations were identified
- 108 to be addressed directly by the RSIC
- 38 of these required the direct involvement of the Commissioners
- 12 require action by the Legislature
- 4 require action by the State Treasurer's Office

PEBA

- 113 recommendations were identified
- 102 to be addressed directly by PEBA
- 40 of these required the direct involvement of the Board of Trustees
- 11 require legislative changes by the General Assembly
- 3 more require budgetary support from the General Assembly

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