SET DIRECTION AND THEN PRUDENTLY DELEGATE

By Rick Funston, CEO, Funston Advisory Services LLC, and Board Smart LLC and Jon Lukomnik, Managing Partner, Sinclair Capital

> *"There are risks and costs to action. But they are far less than the long-range risks of comfortable inaction."*
>
> - JOHN F. KENNEDY

This is the third in a series of articles about how to improve the effectiveness of public retirement system boards. Here we discuss seven steps to help both the board and management in direction setting and prudent delegation. Public retirement systems should be patient, and long-term investors. Organizationally, they also need to understand the key capabilities needed for the future to be both resilient and agile. Direction setting begins with identifying and constructively challenging conventional wisdom and overcoming potential entrenchment and inertia. As a starting point, the board should be asking how the external and internal environments may change and how the organization will need to change over the next five years or more. One of the fundamental powers reserved for a public retirement system board is to set direction and then prudently delegate its execution. This power covers a wide range of matters such as:

1. **Set planning horizon and assign responsibilities**
2. **Identify key issues/Gain situational awareness**
3. **Think strategically**
4. **Oversee the development of the strategic plan**
5. **Set goals, risk appetite, and tolerances**
6. **Align compensation and incentives**
7. **Prudently delegate authorities and resources to the executive and staff**

1. Set planning horizon and assign responsibilities

How should the board be engaged in the strategic planning process? The board (either as a whole or through its committees) should be involved in the initiation and finalization of three key steps of the process: 1) set strategic goals, 2) set strategies to meet the agreed-upon goals, and 3) set metrics and responsibilities for those strategies. The board should then prudently delegate the authority and resources to execute the strategy to the CEO or executive director. The CEO is the de facto chief strategy officer even if that responsibility is delegated further down into the organization.

The full Board should be engaged at key points in the strategic thinking and planning process to provide input, understand the issues and options available, and give its approval to proceed to the plan's execution. The board itself should decide how it wishes to participate in the strategic planning process. Will it be the full board or a committee? If a committee, which one? Standing or ad hoc? Does the board have the needed expertise? If not, how will it acquire it? Will the board retain third-party advice?

> Engage throughout.

2. Identify key issues/Gain situational awareness

Maintain Situational Awareness

In a changing and complex environment – the new normal – success and even survival depend on maintaining a high level of situational awareness. Situational awareness is knowing what is going on in your environment, what's important, what's changing (and how fast), and what it means for the organization. What are the key issues? What capabilities does the system require to be agile and resilient for the foreseeable future? What are the key decisions that must be made?

> Like radar, a scan is only useful if it is timely.

Maintain Constant Scanning

Situational awareness requires constant vigilance and environmental scanning, which is exhausting and impractical if dependent solely on human attention. Nevertheless, situational awareness is recognized as critical in a broad range of decision-making situations, "many of which involve the protection of human life and property, including law enforcement, aviation, air traffic control, ship navigation, health care, emergency response, military command and control operations, self-defense, and offshore oil and nuclear power plant management".[1] While public retirement systems aren't involved in physically life-threatening situations, they certainly do make decisions that affect the financial well-being of many people.

Because of the volume of information, the potential for contradiction, and the rate of change, weak signals may be missed, and strong signals may be ignored due to cognitive entrenchment, confirmation bias (the tendency to interpret new evidence as confirmation of one's existing beliefs or theories) and suppression of alternative views. Therefore, situational awareness is more than information gathering.

3. Think strategically

Understand the Options

Equipped with these insights, the board needs to consider the range of options available to it to address the key issues. The insight gained from being situationally aware and the advantages and disadvantages of each alternative need to be thoughtfully considered and evaluated.

Strategic thinking is the cornerstone of direction setting and strategic planning. The strategic thinking process allows the board to identify and address changes in the competitive and regulatory environment, anticipate challenges to the existing business model, and the risks and needs of the system. The goal should be improving organizational resilience to adversity and improving the agility to seize opportunities. Strategic thinking is fundamentally about problem-solving. It also involves challenging fundamental assumptions. For example, take the assumption that "people will come to work." What if they cannot or won't? This would have seemed absurd until it wasn't. Like radar, a scan is only useful if it is timely.

Conventional assessments and scans are typically annual and often subjective. In a rapidly changing environment, yearly may be insufficient. The frequency of scanning should match the velocity of change. Like radar, a scan is only useful if it is timely.

The best processes embrace a robust diversity of thought to avoid groupthink and to surface as many potential problems, opportunities, and potential situational changes as possible, but in a way that allows a consensus direction to develop. The development of common understanding, acceptance, and commitment between the executive and the board, and among the board members help make sure all aspects of the organization are working towards the same goals, from the same plan, over time.

"Expertise" is knowing what questions to ask and when to ask them.

Constructive Challenge

Constructive challenge – the informed, respectful questioning of management and others by the board – is a key to the effective discharge of the board's responsibilities, including the power of "Set." One of the characteristics of an "expert" is knowing what questions to ask and when to ask them.

To detect weak signals and to overcome confirmation bias, the organization needs to know what to look for when identifying opportunities and threats (especially disruptive or asymmetric risks). According to a 2018 survey by the US National Association of Corporate Directors, boards of directors tend to be diligent in overseeing risks that management has identified, but this focus can lead to blind spots and leave businesses vulnerable to disruptive risks. Less than 20% of the directors said they were extremely or very confident in management's ability to address disruptive risks.[2] The same can probably be said of public retirement systems.

Disruptive risks can be triggered by new technologies or social disruptions (such as those caused by the COVID pandemic) that change the way people do business as well as economic and political uncertainties, or major shifts in supply and demand. Strategic risk (i.e., risks related to the business model and caused by changes in the business environment) ought to be addressed within the overall strategic planning process. In addition, reputational risk is a consequence of failure in managing strategic and operational risk.

4. Oversee the development of the strategic plan[3]

Just what is a strategic plan? The one commonality of all good strategic plans is that they answer a simple, high-level question: What is the organization trying to accomplish and how? Below that, of course, there are typically many objectives, success metrics, accountability assignments, resourcing decisions, etc.

Many enterprises have so-called "strategic" plans which actually are tactical. These often are a collection of tactics, resources, opportunities, and threats cataloged on a business line basis or bounded by an operational area focus. For instance, there may be an annual plan for IT, service goals, staffing, etc. But they are developed in their silos, and not as an integrated, long-term plan that helps allocate resources and risk across the entire organization towards a longer-term goal.

Siloed plans, though they may verge on strategic for the various operating departments, are not a strategic plan for the organization overall. Equally insufficient in the other direction is a goal or aspirational statement, such as being "best," which may be a strategic objective, but there is no "plan" associated with it.

An effective strategic plan is both situationally aware and cross-functional, cutting across all the operations of the enterprise. What are the opportunities and risks of the strategy under consideration? What resources are needed? Leading practice is to perform a gap analysis of what is still needed. What do all departments have to achieve for the total enterprise to be successful in reaching its strategic goal? It may involve reallocating resources from one department to another, talent management, partnerships and alliances, and outsourcing versus insourcing.

Does the board have the appetite for the risks OF your strategy?

In sum, strategic planning allows the board to make informed choices about direction and resource allocation in the face of uncertainty, so as to increase resilience to adversity and the agility to seize opportunities.

Strategic plans also need to be long-term. Admittedly, "long-term" is a fuzzy time increment. It varies with the facts and circumstances of each specific situation. Longer periods are preferable; as true transformation takes time. Periodic reviews can be useful to see if the enterprise is progressing adequately towards the plan goals; to judge changes in the competitive environment and the enterprise's capabilities, resources, and opportunities; to provide opportunities to tweak the strategic plan; and/or to affirm that the plan remains the desired one.

5. Set goals, risk appetite, and tolerances

The power of the board to set direction includes the setting of strategies and the related performance goals and objectives that mark their achievement. This involves understanding and accepting the risks of the strategy, goal, or objective. This is often called an enterprise's risk appetite.

Every goal, objective, or strategy brings with it both the possibility of reward and risk. The board should clearly understand the nature and level of risk associated with the achievement of the goals themselves, not just with the risks to achieving them.

Risk appetite is distinct from the potential obstacles that may impede the execution of the strategy or the achievement of the goal or objective. Do you have the appetite for the strategy? In other words, if you are a mountain climber or an auto racer, you have decided to achieve a goal in a field that is traditionally considered "risky." If you don't want to accept the risks associated with the goal, then go no further. If you do, then you should understand the factors that may affect your ability to be successful.

Relationship Between Objectives and Tolerances

The board should set risk tolerances for vital enterprise functions / cross-functions. How much variability between actual and expected performance is acceptable? This is akin to quality as defined by specific requirements.

What is acceptable? What is cause for concern? What is completely unacceptable performance?

A retirement system is defined by the unique vital functions it performs, e.g., investment and benefits. There are also common functions such as HR, IT, Legal, and Finance. Each vital function is characterized by vital signs unique to that function i.e., the key indicators of the state of health of that function e.g., body temperature, pulse rate, respiration rate, blood pressure).[4] The choice of vital signs is strategic and dynamic and continues to evolve. Some are leading indicators while others are lagging.

The board needs to understand and approve these "norms" as they apply to their business. What constitutes "normal" performance for your system? These determinations will likely be an iterative process over time. The establishment of such norms or tolerances is a prerequisite for exception-based reporting. As vital signs begin to approach or exceed established tolerances, there should be escalation mechanisms to bring the "abnormal" performance to the attention of the board along with management's actions for mitigation and return to control. Escalation processes for when tolerances are or are about to be breeched are discussed in the article "Oversee Execution."

How much variability in performance is the board willing to tolerate?

6. Align compensation and incentives

Setting compensation for the CEO, as well as incentive compensation plans, is a key function of the board, generally led by a compensation committee. A full discussion of executive compensation is well beyond the scope of this article. However, we note that executive compensation should be aligned with the goals of the enterprise's strategic plan.

Unfortunately, that alignment is much more easily said than done. Many jurisdictions limit the ability of the retirement system board to set compensation, and this poses a significant source of risk to the ability of the system to attract and retain qualified personnel, and/or to align incentives with strategy.

As noted above, the final step of strategic planning is to develop metrics to measure progress towards the strategic goal. The board and/or its compensation committee ought to consider which, if any, of those metrics can also be used as compensation metrics. This emphasizes ways to create value for which the executive has direct responsibility and line of sight.

7. Prudently delegate authorities and resources to the executive and staff

The last step in setting direction is to prudently delegate authority, accountabilities, and resources to execute the board-approved direction within policy.

Some boards make only slightly qualified delegations, such as empowering the executive to carry out all lawful actions necessary to achieve a goal. Other boards place financial limitations around certain types of delegation (e.g., commitments of more than x dollars must be brought to the board for approval).

Whatever the delegation, the key is that the delegation to management should be both explicit and intentional, so both the board and management know the decisions which are reserved for the board, and those that can be made by executive management unilaterally.

Section 6 of the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) says: "A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances. The trustee or administrator shall exercise reasonable care, skill, and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program; and (3) periodically reviewing the agent's performance and compliance with the terms of the delegation."

The official Comments to Section 6 of UMPERSA explain, "If the trustee and administrator delegate effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee or administrator to delegate."

When delegating investment and similar functions, policies set by the board should address the due diligence process and quality standards. This is discussed further in the next article "Approve Key Decisions." Also, policy standards used for delegations should be consistent with fiduciary duties and other legal requirements.

Keith Johnson, formerly Head of Institutional Investor Legal Services at Reinhart Law, states:

> *"Given the complexity and time-consuming nature of management functions, prudent delegation of certain functions is required. Directors need assistance from experienced staff and outside experts. Demands on directors' time mandate that boards delegate certain functions.*
>
> *But delegation requires careful attention, too. As a practical matter, administrative and operational duties should be delegated through the CEO to staff and external service providers. However, when selecting advisors and the CEO, directors must carefully select, instruct, evaluate, and monitor them. This requires maintaining and following clear policies and processes."*[5]

Prudent delegation defines the standards and ensures that the functions overseen by the board are staffed by skilled practitioners and resourced appropriately. A very important part of prudent delegation is to ensure there are sufficient resources to carry out the agreed-upon direction.

Summary

In this article, we described seven leading practices to help the board improve its exercise of the power to set direction and then prudently delegate its execution.

In setting direction, the board is typically involved throughout the process. As we will see in the next article in this series "Approve Key Decisions," for certain key decisions, the board and/or committee may choose to be involved at the end of a process of due diligence. How can the board satisfy itself that the appropriate care has been taken by those making a recommendation for board approval? What was the process of due diligence? Who was involved? What factors were considered? In the next article, we describe six leading practices to improve the board's exercise of the power to approve key decisions.

For further information, contact
Rick Funston, CEO Board Smart LLC
rfunston@boardsmart.com

[1] Situation awareness - Wikipedia

[2] Adaptive Governance: Board Oversight of Disruptive Risks. 2018 NACD Blue Ribbon Commission Report

[3] https://getlucidity.com/strategy-resources/strategy-tools-for-strategic-options/

[4] https://www.hopkinsmedicine.org/health/conditions-and-diseases/vital-signs-body-temperature-pulse-rate-respiration-rate-blood-pressure

[5] Keith Johnson, The Prudent Fiduciary. Board Smart Talk