



Fiduciary Performance Audit of The Ohio Public Employees Retirement System Conducted on Behalf of The Ohio Retirement Study Council

Agenda

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Introduction of Presenters

Jeanna Cullins, Partner

- Jeanna leads the firm's Fiduciary Services Practice.
- She has worked with over 100 public fund boards, corporate pension funds, endowments and foundations to assist them in understanding their fiduciary responsibilities and enhancing their governance and management processes.
- Jeanna has over 33 years of industry experience. Prior to joining Aon, Jeanna was a Managing Director at Independent Fiduciary Services. She also served at the Executive Director and the General Counsel of the District of Columbia Retirement System.
- She is a National Association of Corporate Director's Governance Fellow.
- Jeanna joined the firm in 2008.

Rian Akey, Partner

- Rian leads the firm's Operational Due Diligence Practice, which routinely reviews the operational processes of investment entities, including selection and monitoring process, staffing adequacy, segregations of duties, middle and back office functions, technology and security.
- Rian has worked in the financial industry since 1997. Prior to joining Aon in 2015, Rian was a Principal at Mercer Investments working within the firm's specialty operational due diligence practice. Prior to Mercer, Rian served as the COO at Cole Partners, a Chicago-based hedge fund, where he developed and implemented the firm's research procedures, operations, and compliance.
- He has been published in a variety of journals and books and has presented to conferences and symposiums around the world.

Introduction of Presenters

Greg Korte, Partner

- Greg leads the firm's Trust/Custody and Securities Lending consulting practice.
- He has spent over 34 years working exclusively in the investment operations/custody industry and has extensive insight to the inner workings of custodian providers, with significant experience helping large investment plans with custodian evaluation.
- His operations background and significant years of experience managing global operations and industry vendors make him unique in the investment consulting field.
- Greg joined the firm in 2017.

Mike McCormick, Associate Partner

- Mike is a chartered financial analyst (CFA).
- He is a member of the firm's Client Advisory Group and a consulting team manager.
- Mike works with public retirement systems, endowments, foundations, and corporate retirement plans.
- He is a contributing author to the International Foundation Handbook.
- Mike joined the firm in 2007.

Overview of Purpose and Scope of Review

- The purpose of our work was to critically review and evaluate the organizational design, structure, and practices of OPERS in order to identify strengths and weakness, compare OPERS' operation with best practices of comparable public funds, and make recommendations for enhancements.
- The following six main areas were addressed in the scope of the review:
 - Board governance and administration;
 - Organizational structure and oversight;
 - Investment policy and oversight;
 - Legal compliance;
 - Risk management and controls; and
 - Information technology operations.
- The report addresses numerous topics within each of the six main areas. These topics were defined by the scope of work for the review. We caution that our findings and recommendations are limited to the topics defined by the scope of work. For each key topic within the report, background information is provided followed by findings and conclusions, and recommendations. A matrix listing each of the recommendations is provided at the end of the report.
- The majority of the 56 recommendations contained in the report can be characterized as fine-tuning.
- Today we will highlight key findings and recommendations for each of the six main sections of the report. Our presentation is intended as a high-level summary and is not intended as a replacement for the full report.

1. Board Governance and Administration

- The fiduciary standards governing OPERS are consistent with best practices.
- The OPERS Board composition, size, selection process and term lengths are appropriate.
 - There is an expertise requirement for appointed members. However, it is limited to investment expertise.
 - We **recommend** expanding the expertise requirement to require that one of the OPERS Board appointees have financial audit or internal controls expertise, or as an alternative, that OPERS retain a consultant that is a qualified “audit committee financial expert” to advise the OPERS Audit Committee.
- The current governing statutes include four statutory limitations which are not consistent with best practices and run contrary to OPERS’ ability to carry out its fiduciary duty to act in the sole interest of the beneficiaries and participants. These limitations are:
 - OPERS’ inability to select its legal advisers;
 - OPERS’ inability to select its financial auditor;
 - OPERS’ inability to select its custody bank(s); and
 - The requirement that the custody bank be in state.
- We **recommend** amending the governing statutes to grant OPERS exclusive authority and control over the selection of (1) its legal advisers and (2) its financial advisors.

1. Board Governance and Administration

- The inability to select its custody bank(s) and the requirement that the custody bank be in state are the most significant issues we found during our review.
- The current custody model is atypical and results in significantly higher fees.
 - Virtually all public retirement systems in the United States have exclusive authority and control and thus oversight of their custody banks.
 - Requiring the custody bank to be in state is also an atypical requirement and not in line with common or best practices.
 - Under Ohio law the Ohio Treasurer of State (TOS) selects the custody bank that OPERS must use.
 - OPERS receives and pays for the services but has no authority over the custody bank.
 - The designation of the TOS as the custodian and the in-state bank requirement hinders OPERS' efficiency, introduces additional risk, and necessitates the expenditure of millions of additional dollars to make the current requirements workable.

1. Board Governance and Administration

- The common and best practice, whether public or corporate, is to use a single custodian.
 - In order for OPERS to receive the custody services needed to support its operations, three different custody banks must be used.
 - Because multiple custodians are required, OPERS custody fees are millions more than peer public funds.
 - Total custody fees have nearly doubled since the custodian conversion in 2013. This increase is contrary to the current custody fee decline observed in the industry.
 - There is only one eligible in-state bank that is capable of supporting the consolidated custody model needed by OPERS. In most cases, the in-state bank still needs to subcontract with a non-state bank or entity to provide some of the services required by OPERS. This results in a non-competitive environment that does not align with best practices.
- We **recommend** amending Ohio law to:
 - Remove the TOS' custodian role and grant OPERS exclusive authority and control over the custodian relationship, including selection, negotiation of the contract's scope of services and fees, and terminations; and
 - Remove the requirement that the custodian bank must be located in Ohio.

1. Board Governance and Administration

- Overall, the breadth of OPERS' governance documentation and the tools used for communication are leading edge. Examples include:
 - OPERS' documentation of responsibilities and reporting lines;
 - OPERS' Financial Reporting Budget Policy and the reporting mechanisms used to ensure adherence;
 - The policies and processes OPERS has in place to facilitate compliance with the Ohio Ethics law; and
 - The newsletters, handbooks, and leaflets OPERS produces.
- During the review period, we found OPERS' education and total administrative costs to be reasonable.
 - Costs for OPERS' Board education and associated costs were de minimis compared to OPERS' total budget and the costs expended by comparable retirement systems.
 - OPERS' total administrative costs per member, inclusive of health costs, were much lower relative to the median and average administrative costs of comparable retirement systems.

2. Organizational Structure and Staffing

- Staffing levels should be based on the functions necessary to effectively and efficiently achieve the business of the retirement system. The need for staffing can increase due to the retirement system's complexity in relation to the required functions.
- We found OPERS' staffing and compensation levels to be reasonable.
 - Peer funds generally have between 300 and 700 employees. OPERS' overall staff size is within normal limits.
 - OPERS' compensation levels are conservative compared to peers.
- OPERS' hiring procedures are leading-edge and a model that can be used by other public retirement systems.
- OPERS also has a leading-edge employee performance evaluation process, excellent in-house training and development opportunities, and high engagement scores.
- OPERS' turnover increased during the review period.
 - High levels of turnover can negatively impact the effectiveness and efficiency of an organization.
 - We **recommend** OPERS explore ways to diminish turnover.

3. Investment Policy and Oversight

- OPERS' investment policy documentation is comprehensive and consistent with best practices.
- The controls and processes used by OPERS to regularly review and monitor investment performance and assess compliance by external and internal investment managers are sound.
- Investment fees are generally in line with those of peer public funds and in line with the level we would expect given the asset size, asset allocation, and implementation style.
 - An April 2018 a fee presentation was produced for the hedge fund portfolio. The fee presentation evaluated fees over time and across strategies and differentiated management fee and incentive fee. This type of analysis is an important component of ongoing oversight and assists OPERS in communicating how it thinks about, evaluates, and manages investment management fees. We **recommend** performing a fee analysis on each asset class as part of ongoing oversight and as a tool in communicating to stakeholders the underlying value proposition of each investment and why fees vary from one investment to the next.
- OPERS' investment manager selection processes are clearly defined in distinct documents for each asset class in which OPERS invests. Overall, the documentation aligns with industry best practices.
- The use of specialty consultants by OPERS is a common and best practice.

3. Investment Policy and Oversight

- OPERS should consider modifying its approach to operational due diligence.
 - OPERS' current risk-based investment managers review approach is used by many market participants in order to optimize resource allocation. However, we do not find this approach to be a best practice. We **recommend** that OPERS implement an investment manager review schedule to ensure all external managers for its external public markets programs are reviewed onsite on a periodic basis to update its operational due diligence.
 - The position responsible for OPERS' operational due diligence for external public markets is independent from the investment department, which aligns with best practices. However, the position responsible for OPERS' operational due diligence for private markets is embedded within its investment due diligence process. We **recommend** the OPERS Risk Management Team perform operational due diligence independently of the investment team for its private market program. Alternatively, we **recommend** OPERS engage its external consultant to conduct detailed operational due diligence for each mandate.

4. Legal Compliance

- During the review period, we found the policies and processes used by OPERS for purposes of legal compliance and adherence to United States Internal Revenue Services regulations to reflect best practices.
- The statutory designation of the Ohio Attorney General as the legal advisor to OPERS is consistent with common practice among public retirement system; however it is not a best practice.

5. Risk Management and Controls

- OPERS maintains an effective, comprehensive risk management framework.
 - Risk management and controls are an evolving trend among public retirement systems. OPERS is one of only a few public funds that has an enterprise risk management framework in place.
 - During the review period, OPERS was in the process of fully integrating its enterprise risk management framework.
- OPERS' approach to defining responsibilities, oversight, and procedures aligns with best practices.
 - The detailed documentation of OPERS' accounting procedure is consistent with best practice and, in some cases, represents leading-edge practice.
 - External audit procedures appear to be adequate.
- Oversight of financial reporting and internal controls are key responsibilities of the OPERS Audit Committee.
 - The ability of the OPERS Audit Committee to provide effective oversight and controls would be enhanced if it were comprised of members with strong accounting and audit experience.
 - We **recommend** expanding the expertise requirement to require that one of the OPERS Board appointees have financial audit or internal controls expertise, or as an alternative, that OPERS retain a consultant that is a qualified “audit committee financial expert” to advise the OPERS Audit Committee.

6. Information Technology Operations

- OPERS' information technology policies, processes, and oversight generally align with best practices.
 - Physical security surrounding the office building and access to the location were found to be in line with expectations.
 - Annually, an external vendor is selected to conduct penetration testing of OPERS' information technology network.
 - An annual risk assessment focusing on information technology is also performed.
 - OPERS' recovery time objective for priority one incidents is inside 24 hours.
 - OPERS has developed a helpdesk that is in place to record, prioritize, and dispatch appropriate personnel through a supporting incident response system.
- OPERS has business continuity and disaster recovery policies and processes in place that are in line with industry best practices.

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