

Fiduciary Performance Audit of the Ohio Police & Fire Pension Fund

Conducted on Behalf of the
Ohio Retirement Study Council

September 8, 2022



Introductions

Presenting today:

- Randy Miller, project manager
- Steve Case, investment expert

Other FAS team members:

- Rick Funston, FAS founder and governance and risk expert
- Michael Gold, former head of investment operations at TIAA-CREF
- Steve Harding, accounting and controls expert
- Lisa Morris, former Executive Director of SERS of Ohio
- Tiffany Reeves, legal counsel, partner with Faegre Drinker
- Steve Ross, information technology and information security expert

Overview

- The Funston Advisory Services (FAS) team was selected to conduct the fiduciary performance audit of OP&F through a competitive RFP process in September 2021; the final report was submitted in August 2022.
- We reviewed six major areas, as specified in the RFP:
 1. Board Governance and Administration;
 2. Organizational Structure and Staffing;
 3. Investment Policy and Oversight;
 4. Legal Compliance;
 5. Risk Management and Controls; and
 6. IT Operations.

Process

- Our fiduciary audit approach and activities included:
 - Review of OP&F policies, procedures, reports, and a sample of investment transactions;
 - Interviews with all 9 trustees and 12 OP&F executives, 10 outside service providers, and 5 employee, retiree, and employer stakeholder groups;
 - Board Fiduciary Priorities Survey with participation by all 9 trustees and 9 OP&F executives;
 - Use of our proprietary InGov[®] public retirement system peer benchmarking data;
 - Numerous follow-up interviews and discussions with executives; and
 - Periodic status discussions with ORSC staff.

Overall Findings

- The OP&F Board of Trustees appears to be satisfactorily fulfilling its fiduciary duties (loyalty, prudence, staying informed, diversifying assets, controlling costs, compliance with laws and co-fiduciary duties).
- The OP&F Board has the powers or authorities needed to fulfill its fiduciary duties with two exceptions: lack of authority to select outside legal counsel and the custodian (to be discussed later).
- Overall, OP&F is generally well-run operationally.
- Many of the member services processes are manual, but function reliably; a new pension administration system is being implemented that will significantly automate many processes and increase the level of member self-service.
- OP&F's investment program is non-traditional, but the Board has a good understanding of the strategies; the fund has outperformed peers over the past 10 years, according to RVK and other investment consultant reports.

Overall Findings

- Although OP&F is generally well run, as with any organization, improvements can always be made.
- We made over 150 recommendations across the six areas in scope.
- The following slides highlight:
 - The most important conclusions and opportunities for improvement in each area; and
 - Those recommendations that require legislative support.

1. Board Governance and Administration

- We recommend that OP&F:
 - Adopt a formal policy setting forth the Board’s powers reserved and parameters for delegated staff authority and lines of reporting (R1.2.1).
 - Establish policy guideline parameters for greater delegation of investment authority to the Chief Investment Officer and investment staff (R1.2.2).
 - Allow non-elected trustees to be elected as Board chair (R1.2.4); consider a policy or informal practice that favors re-election of the Board Chair and Chair-Elect for two or three consecutive one-year terms if they have satisfactory performance (R1.2.5).
 - Continue to pursue legislation that provides for fully staggered Board member terms in the case of vacancies (R1.3.1); also pursue authority to select external legal counsel for investment and fund management matters (R1.3.2).
 - Develop additional trustee disclosure policies (R1.6.2) and collect all significant policies, statutes, and rules within a Governance Manual (R1.3.3).
- The OP&F Board and its committees should livestream the public sessions of their meetings to allow easy access for stakeholders (R1.4.1)

2. Organizational Structure and Staffing

- OP&F has an effective organization with a structured approach to performance management and an effective succession planning process.
- Over a fifth of OP&F staff are currently eligible to retire, and almost half of the organization will be retirement eligible within the next five years; it will be important to strengthen recruiting efforts (R2.1.2)
- OP&F should separate responsibility for investment accounting and performance reporting from within the investment management organization (R2.1.3).
- OP&F should improve monitoring of member satisfaction and benefits administration performance as it implements a new pension administration system (R2.2.1-3)

3. Investment Policy and Oversight

- OP&F has a small, but highly qualified in-house investment staff that invests the portfolio with extensive use of external advisors and investment managers.
- OP&F is among a very small number of major institutional investors to have adopted a risk parity investment approach across the Plan's entire investment structure.
- OP&F 10-year performance is in the top quartile (14th percentile) among peer public pensions, and over 135 basis points annualized performance above the policy benchmark on an after-fee basis.
- OP&F investment policies and practices are at prevailing practice levels in most areas.
- OP&F's external manager fees, when adjusted for its investment strategy, are comparable to peers; fee reporting transparency could be improved (R.3.2.4.3).

4. Legal Compliance

- OP&F legal staff appear to be well qualified; outside counsel firms are also experienced legal advisors to public pension funds in their respective areas of expertise.
- OP&F should establish a policy regarding periodic receipt of written tax compliance assurances from tax counsel (R.4.1.1).
- OP&F should consider establishing an independent compliance function and compile a compliance manual as the repository for compliance policies, processes and assigned responsibilities (R4.4.2).
- Either the legislature should allow the OP&F Board to hire external legal counsel, or the Attorney General and OP&F should formalize a standing process that recognizes OP&F's fiduciary obligation to use outside counsel with required expertise (R4.2.1).

5. Risk Management and Controls

- OP&F has implemented a conventional approach to enterprise risk management but would benefit from a simpler approach built upon enterprise performance and risk management with exception-based reporting (R5.1.1-8; R5.2.1-3).
- The essential components of the OP&F financial control structure are consistent with prevailing peer pension and benefit systems, with one exception; the Investment Accounting function should be moved from the Investment Office to Finance to improve segregation of duties (R5.3.2).
- OP&F financial reporting, financial statements, and procurement policies and processes are sound and consistent with prevailing practices.
- The OP&F Finance and Accounting function is capable, and the accounting systems appear to be effective.
- OP&F has a substantive policy for keeping, retaining, and destroying important records and preserving a trail when records are moved to storage, scanned or destroyed.

6. IT Operations

- The IT function at OP&F is in a period of significant change, with a recent upgrade to its financial systems and a pension system replacement (Lifeworks Ariel) currently underway.
- The Board should review the Lifeworks Ariel implementation progress at least quarterly and be apprised of any budget or timing issues encountered (R6.2.1-2).
- OP&F should expand project sponsorship of the Lifeworks Ariel project to include the heads of Finance and Member Services as the primary beneficiaries of the project (R6.2.3).
- OP&F needs to evaluate its IT resource needs, considering the balance of internal IT staff vis-à-vis its use of external resources (R6.1.2).
- IT should update its disaster recovery and business continuity plans (R6.8.1-2).
- OP&F should contract with a third-party managed security service provider (MSSP) to perform day-to-day information security tasks (R6.7.4).
- The Board of Trustees should ensure its understanding of the risks to the System involved in information technology, in particular, cyberattacks including ransomware (R6.1.1, R6.10.1).

Custody Model

- The Ohio custodian policy, with the Treasurer of State selecting custodial banks, and the requirement for an international sub-custodian, has over time resulted in OP&F following an in-house strategy, with support from other third-party providers, and minimizing services from the custody banks.
- The relationship and operating environment between OP&F and its two custodial banks can be summarized as an “optimization of the suboptimal”.
- Although the Ohio custodial services model is a lagging practice, the Treasurer of State’s office has improved custody bank selection and oversight processes.
- Consistent with our recommendations in the STRS report we recommend:
 - The OP&F Board of Trustees should be given authority to select its custodial bank (R3.4.5.1).
 - The law in Ohio Revised Code 135.03, “Institutions eligible as public depositories”, and its interpretation, severely restricts the selection of potential custodial banks which can serve OP&F; the legislature should modify this requirement to allow for a single global custodial bank to serve OP&F to reduce costs and complexity (R3.4.5.2).

Summary

- Overall, OP&F operates effectively, and staff are capable.
- OP&F Board oversight appears prudent, and delegations are functioning well.
- The ongoing pension benefit system (Lifeworks Ariel) implementation will be a major initiative for the next several years; the Board should provide periodic oversight, and user functions need to be more involved.
- OP&F leadership has been receptive to our recommendations and has already begun to implement some of them.
- The legislature should consider changes to statutes related to:
 - Hiring of external legal counsel (R4.2.1);
 - Selection and oversight of custodial banks (R3.4.5.1); and
 - Limitations on qualified custodial banks (R3.4.5.2).

Reasonable Reassurance

- This evaluation was a fiduciary review and not a forensic investigation, a comprehensive compliance audit nor an audit of financial statements.
- Our review was intended to provide reasonable, but not absolute, reassurance on matters within scope of the project as addressed in the final report; however, a review of this nature cannot serve as a guarantee regarding past, current or future instances of fraud, malfeasance, compliance or performance.
- Our work product is subject to the accuracy of data and information in the public domain or provided by the client and its agents, including information received in interviews and due diligence activities.
- The scope of the project did not include independent verification or background checks of employees, service providers, third parties or accuracy of such data or information.