



## Audit Committee Meeting

May 20, 2020

# ERS

EMPLOYEES  RETIREMENT  
SYSTEM OF TEXAS

**Presented for Review and Approval**

**August 19, 2020**

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
May 20, 2020**

*The May 20, 2020 meeting of the ERS Board of Trustees was held by video conference call as authorized under Section 551.127 of the Texas Government Code.* This meeting was conducted by videoconference in accordance with the governor's authorization concerning suspension of certain open meeting law requirements in response to the covid-19 (coronavirus) disaster. A quorum of members of the Board participated in the meeting remotely and could be heard and seen online by members of the public.

**TRUSTEES PRESENT**

Ilesa Daniels, Board Chair  
I. Craig Hester, Board Vice Chair  
Brian Barth, Member  
Dr. James Kee, Member  
Catherine Melvin, Member

**ERS DIRECTORS PRESENT**

Porter Wilson, Executive Director  
Cathy Terrell, Deputy Executive Director  
Paula A. Jones, Deputy Executive Director & General Counsel  
Tony Chavez, Director of Internal Audit  
Bernie Hajovsky, Director of Enterprise Planning Office  
Dee Dee Sterns, Director of Human Resources

**ERS STAFF PRESENT**

Kelley Davenport, Executive Office  
Tressie Landry, Internal Audit  
Greg Magness, Internal Audit  
Bruce Marton, Information Systems  
Roger Nooner, Benefits Communications  
Jamey Pauley, Executive Office  
Susie Ramirez, Executive Office

**ALSO PRESENT**

Phil Dial, Rudd and Wisdom, Inc.  
Mehdi Riazzi, Gabriel Roeder Smith and Company  
Dana Woolfrey, Gabriel Roeder Smith and Company

## **Meeting of the ERS Board of Trustees Audit Committee**

### **1. Call Meeting of the ERS Board of Trustees Audit Committee to Order**

Ms. Catherine Melvin, Chair of the Audit Committee of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 8:03 a.m. and read the following statement:

“A public notice of the ERS Board of Trustees Audit Committee meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 12:01 p.m. on Tuesday, May 12, 2020, as required by Chapter 551 Texas Government Code, referred to as the Open Meetings Law.”

### **2. Review and Approval of the Minutes to the March 11, 2020 ERS Audit Committee Meeting – (ACTION)**

Chair Catherine Melvin opened the floor for a motion on the approval of the minutes from the March 11, 2020 ERS Audit Committee meeting.

**Move** that the Audit Committee of the Employees Retirement System of Texas approve the minutes to the meeting held on March 11, 2020.

**Motion** by Craig Hester second by Jim Kee

Final Resolution: Motion Carries

Aye: Craig Hester, Brian Barth, Ilesa Daniels, Jim Kee, Catherine Melvin

### **3. Review of External Audit Reports**

Mr. Tony Chavez, Director of Internal Audit, introduced Dana Woolfrey and Mehdi Riazi with Gabriel Roeder Smith and Company (GRS) to present results from the actuarial audit of the ERS insurance actuary, Rudd and Wisdom. Mr. Chavez said Phil Dial with Rudd and Wisdom was also available to answer any questions. The Government Financial Officers Association recommends an actuarial audit be performed at least every five years to review the quality of services performed by the contracted actuary. The last insurance actuary audit was performed in 2016.

Ms. Woolfrey explained the findings of the actuarial valuation audit are of the state offered Other Post Employment Benefits (OPEB), which for Texas are post-retirement health care benefits. The audit was based on data as of August 31, 2019. Ms. Woolfrey said the conclusion of the audit was that the valuations are reasonable and represent a fair assessment of the state's obligations as measured by the Governmental Accounting Standards Board (GASB) standards. Ms. Woolfrey then explained the methodology used to support the conclusion:

- Review of Inputs – data, assumptions, initial age rated medical and prescription costs
- Review of Model – review individual liability projections (test life review) and overall actual cash flows are consistent with projected benefit payments
- Review of Report – inclusion of necessary disclosures

Ms. Woolfrey reiterated that, in their opinion, the obligations are being measured and reported appropriately, and that it was a clean audit without qualification. There were minor findings, but these items were not significant and did not cause any qualification to their opinion.

Ms. Woolfrey reviewed the purpose of actuary measurement of obligations. They are used for an accounting valuation to fulfill the GASB 74 requirements, and GASB 74 is specifically for OPEB. These benefits are largely unfunded and while the estimations are not used to make funding decisions, they are included in the financial statements and the purpose of the audit is to ensure accurate reporting of the obligations for these benefits.

Ms. Woolfrey reviewed the audit methodology used to validate the estimations made by Rudd and Wisdom in detail:

- Review of Inputs – Data
  - Ensure actuary is using the correct population and that data integrity is maintained throughout the estimation process. Other key data such as service time was accurate. GRS found that Rudd and Wisdom used input data correctly.
- Review of Inputs – Demographic Assumptions
  - The demographic assumptions used were essentially the same used in ERS' pension benefit estimations, which is very typical in an OPEB valuation since the pension actuary performs experience studies.
  - For ERS there is an extra assumption regarding whether people who terminate prior to retirement will stay in the system, and if they will wait for their annuity pension benefit and retain their health care eligibility or if they will take a refund for their contribution.
- Review of Inputs – Economic Assumptions
  - Economic assumptions are mandated by GASB. Since the GBP is unfunded, the discount rate used is based on a 20-year bond index as of the measurement date, making the results volatile from year to year, because the bond rate floats based on the economic conditions at the time.

Ms. Woolfrey introduced Mehdi Riazhi as their health care expert to discuss the process of reviewing health care related assumptions and the health care pieces of the model. Mr. Riazhi stated that as Ms. Woolfrey mentioned, many of the assumptions are the same as the pension plan, but additional information is required for retiree medical evaluations. These include estimating how much and what kinds of claims they will generate. The benefit is basically a health plan, requiring an estimate to the underlying costs, and then estimating how those costs will increase in the future and even what percentage of retirees will choose to participate. Mr. Riazhi noted that Rudd and Wisdom's evaluation was excellent and, in his opinion, the report was well done. He then continued the detailed methodology review:

- Review of Inputs – Health Care Cost Trend Rates
  - Health care trending is a macroeconomic issue and there are several opinions on what trends will look like in the future. Mr. Riazhi prefers to look at health care costs as a percentage of the economy. It has moved from 5% from the 1960's to currently 18%. Rudd and Wisdom assumed a 4.5% ultimate trend rate assumption and that health care costs would be 23% of the economy by 2040 and he thinks this assumption is very reasonable. While there are minor recommendations in this area, the trend assumption is valid.
- Review if Inputs – Healthcare-Related Assumptions
  - Participation and dependent participation are easier to study since ERS has current experience data on participants. Participation by members is high for ERS and the assumptions used by Rudd and Wisdom tie to the plan's experience.
- Review of Inputs – Initial Per Capita Costs
  - Rudd and Wisdom used the 2018 claims to predict the 2020 costs and claims were analyzed by plan, gender, relationship to member and all of this aligns with best practice.
  - Prescription drug plans generate revenue through rebates and discounts and all of that revenue was factored into the underlying costs.
  - Taxes and other expenses and fees were properly included in the valuation.

Ms. Woolfrey continued the presentation with a detailed review of the model:

- Review of Model – Test Life Review
  - This was a limited scope audit, which means not all participants were run through the valuation system and GRS did not recreate the total liabilities. A sample of participants was selected to verify the overall model was working. The test lives were selected to maximize coverage of the population and maximize assurance provided by the sample. Ms. Woolfrey said Rudd and Wisdom provided full detail, so when results did not match perfectly, GRS was able to identify differences and be confident that when considered in total, liabilities would not be significant. Ms. Woolfrey said Rudd and Wisdom should be

- commended. The staff and Board of Trustees should find tremendous reassurance that Rudd and Wisdom provided that level of detail and transparency.
- The results of the testing was that GRS was able to validate the Rudd and Wisdom valuations within 5%.
  - Review of Model – Test Life Review Findings
    - Based on the test lives, GRS can validate that Rudd and Wisdom is valuing the benefits correctly.
    - There were places where additional disclosures are needed in the assumption section and need to be in next year’s report.
  - Review Model – Test Life Review Findings, Application of forfeiture assumption
    - Assumption for members that terminate before retirement and whether they take the pension annuity and health care benefits or take a refund – the assumption that Rudd and Wisdom is using is reasonable
  - Review Model – Test Life Review Findings, Application of decrement timing
    - The retirement and termination probabilities are not applied consistently with pension assumptions. GRS recommends that Rudd and Wisdom match the pension assumptions or at least disclose the methodology in the report.
  - Review Model – Cash Flow Checks
    - One validation test of the aggregate output of the model is to compare the past actuary assumptions with actual costs. Mr. Riazi illustrated three different valuation years. Actual 2017 and 2019 costs were very close to projected costs and 2018 had actual costs lower than projections. Mr. Riazi explained that the difference in 2018 is expected due to a change in vendor.

Ms. Woolfrey summarized that based on the audit results, ERS is not over or under reporting OPEB liabilities on its financial statements.

Mr. Hester asked for a clarification on ultimate trend assumption. Mr. Riazi said the number includes the margin, long term nominal GDP growth estimates are usually between 3.5% and 4.0% and while Rudd and Wisdom used a rate slightly higher than that range, it is reasonable since the estimation includes the next 30 years.

Ms. Melvin asked if the auditors had full and free access to records of people, resources and anything needed to conduct the audit. Ms. Woolfrey responded they did have access to everything needed. They were given full detail of the valuation system and appreciated the cooperation.

Ms. Melvin remarked about the importance of the audit and that the work performed by Rudd and Wisdom is critical. She asked if there is anything not in the report that is important for the board to know, to which Ms. Woolfrey responded that she did not have anything further to add. Ms. Melvin then asked for comments from Machel Pharr, CFO and Phil Dial from Rudd and Wisdom. Ms. Pharr had nothing further. Mr. Dial said GRS was very professional, thorough and courteous. Based on the results, Rudd and Wisdom has ideas on how to improve disclosures in reports, and will consider decrement timing and forfeitures report disclosures going forward.

This agenda item was presented for information and discussion purposes only. There was no further discussion or questions and no action was taken.

#### **4. Review of Internal Reports**

Mr. Tony Chavez, Director of Internal Audit, introduced Greg Magness, project lead, and Tressie Landry, audit manager, to present the incentive compensation audit. An incentive compensation audit has been performed annually since 2015.

Mr. Magness began his presentation by reviewing the relevant strategic objective identified that aligns audit work with the mission and strategic objectives of ERS. During planning, these principles were identified in the incentive compensation plan (ICP) and investment policy, and were used throughout the audit to guide the review process.

Mr. Magness explained the Plan Year 2019 total maximum award available decreased from Plan Year 2018. This was primarily a result of the departure of nine participants, including three senior members, in the investment division. This accounted for most of the reduction in the maximum award available, with changes in positions, goals and salaries accounting for the remaining. The total realization of awards earned was 59%, down from 70% realization in Plan Year 2018. The one year global composite or total trust fund goal dropped from 100% realization in 2018 to 0% in 2019, and was the biggest contributor to the decrease, accounting for over \$870,000 of reduced earned awards. Mr. Magness explained these two factors decreased earned awards by \$1.2 million in Plan Year 2019, and noted that additional information related to award analysis can be found in the appendix of the report.

The audit's objective was to determine if incentive compensation awards were in accordance with the ERS incentive compensation plan. The overall assessment was satisfactory with one observation included in the report.

Key stakeholders and process owners made improvements to the control framework of the incentive compensation plan program. Program improvements resulted from the implementation of management action plans from prior audit observations and others were identified by process owners as areas that needed improvement.

- The ICP goal memo was revised. This was a suggestion of prior audits from internal audit and the State Auditor's Office, but could not be addressed in the Plan Year 2019 goal memo. In comparing the Plan Year 2019 memo to Plan Year 2020's, auditors found the document had been significantly improved, including well-defined goals by asset class and explicitly stated goal benchmarks. Other enhancements to the goal memo were all changes in goals from previous years and were highlighted with explanations provided for the changes and a list of affected participants. Generally, in the auditor's opinion, the document provided better information for the executive director's review and approval.
- Qualitative, or discretionary, awards are calculated within the ICP database. Previously, they were calculated offline and the results entered into the database. Beginning in Plan Year 2019, once the discretionary realization percentage was reviewed and approved, it was entered into the database and the calculation became part of the automated process.
- A change log was implemented to track adjustments to ICP award payments after being calculated, reviewed, and approved. When adjustments must be made to awards, the log maintains both the original approved award and the adjustment. The log includes the payout schedule for participants so that adjustments are applied at the same payout schedule as the original award.
- The eligibility date was added to goals when assessed, which delineates when the participant is eligible for the goals, specifically the one, three and five year goals, making it clear when being reviewed.

While stakeholders and process owners continue to improve the incentive compensation program, some previously recommended improvements from prior audits were partially implemented.

- Process owners developed a detailed task list to use as procedures when administering the incentive compensation program. It is a good project management tool with deadlines and responsibility for many tasks. However, it did not define all procedures, including some key controls required in program administration. Controls should be defined as to their objective, how they will be applied and how it will be documented to ensure program objectives are met. Included in this is the change log. While the log is an excellent tool, how and in what instances the log should be used should be defined. This was confirmed when four adjustments to the February ICP award payments were not applied. These adjustments are currently being tracked and are scheduled to be adjusted with the 2021 ICP award payments.
- Documentation of the database is not complete. As the team becomes more reliant on the ICP database for administering the program, including object descriptions and definitions

within the database and associated relationships, the structure should be documented. In addition, the database should be protected from accidental or malicious changes with a formal change management process. Currently, only one team member has complete knowledge of the database structure.

Mr. Hester noted the ICP is a critical component for investment staff retention and is important in ERS' ability to not only retain, but attract talented people because of the responsibility managing the trust fund for active and retired members. He asked if benchmarks were reviewed as they relate to private equity and alternative parts of the portfolio, and if Mr. Magness felt comfortable with those benchmarks and how the ICP related to those. Mr. Magness stated that for this engagement, goals were reviewed to ensure they were defined ahead of time, but assessing appropriateness was not performed in this engagement. The scope of this audit ensured that the goals were justified for the Plan Year 2020 and were clearly described in the goal memo.

Mr. Chavez added that an audit of private equity is currently finalizing, and will be addressing the appropriateness of the private equity benchmark and components of the private equity ICP methodology. They have an established methodology and are ensuring the methodology was followed, and whether it is a reasonable methodology with reasonable benchmarks and components. Mr. Chavez noted that the engagement will be presented to the audit committee at the August meeting. In addition, going forward, any asset class review will include an ICP component.

Mr. Hester asked if there were any clawbacks of awards. Mr. Magness state clawbacks were not necessary because there were no overpayments. Participants forego any future payments for awards earned when they separate employment with ERS. Award payments are schedule where the award is paid 50% the first year, 25% in the next year and 25% the following year. Therefore, clawbacks are not necessary.

Ms. Melvin asked Mr. Magness and Mrs. Landry if they received full and free access to do the work that was needed for this audit. Mr. Magness said certainly, and when working with human resources they provided everything requested.

Ms. Melvin then asked Mr. Magness if there was anything not in the report that he believed was important for the trustees to know. Mr. Magness said everything was included. There was not a lot found that was in error, just a few minor observations that were included in the report.

Ms. Melvin asked if Ms. Sterns, Human Resources Director, wanted to add any comments. Ms. Sterns said she appreciated all of the effort and each time this audit is performed, it is an opportunity to help find key controls. Ms. Sterns appreciates the support from leadership and the audit team in moving forward to make this an effective and efficient program.

This agenda item was presented for information and discussion purposes only. There was no further discussion or questions and no action was taken.

#### **5. Adjournment of the Board of Trustees Audit Committee Meeting**

The Audit Committee meeting adjourned at 8:47 a.m. on Wednesday, May 20, 2020.