

Public Agenda Item #3

Review of Internal Audit Reports

December 7, 2021

Tony Chavez, Director of Internal Audit

Private Real Estate Audit

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Jonathan Puckett, Audit Lead

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Strategic Alignment

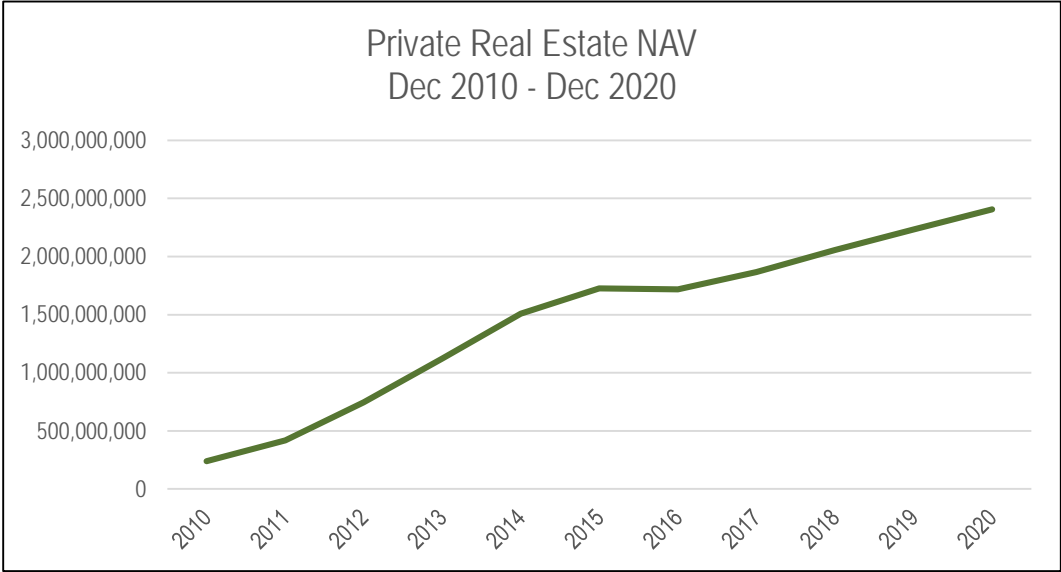


Audit Objective: To determine if investments in private real estate are in accordance with ERS Investment Policy

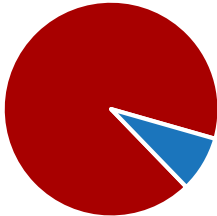
Program Objective: Generate maximum risk-adjusted return while maintaining prudent diversification of specific investments

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Background



**Total Trust Fund
as of 08/31/2021**



- All Other Asset Classes
- Private Real Estate

As of August 2021 - 90 investments with Commitments of \$5.7b

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Results



Overall Results: The system of internal controls provides reasonable assurance that key goals and objectives will be achieved. **(Satisfactory)**

Scope Area	Sub-Objectives	
Portfolio Management	<ul style="list-style-type: none">• Has the portfolio been adapted to meet investment objectives?• Are processes in place to manage and mitigate portfolio risk?	Satisfactory
Investments	<ul style="list-style-type: none">• Do investment recommendations communicate relevant information?• Is information validated?• Are investments properly authorized?	Satisfactory
Governance	<ul style="list-style-type: none">• Is information presented reliable to facilitate proper oversight?• Is portfolio performance and management explained to promote transparency?• Does performance incentive align with portfolio objectives?	Needs Improvement

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Observation 1 – Active Risk Management

Improve controls over active risk management



The risk a manager takes to outperform a benchmark and achieve higher returns for investors.

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Observation 1 – Active Risk Management



Private Real Estate Portfolio

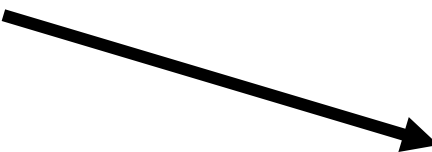
Diversification – managing active risks



Strategy:



Property Type:



Geography:



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Observation 1 – Active Risk Management

Program risk: Investment loss exposure may be greater than willing to endure.

Inherent risks:

- Risk tolerance (limits) is subjective (how much risk is acceptable?)
- Investment staff delegated authority to determine risk limits within the asset class
- No single quantitative measure to assess the level of active risk taken

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Observation 1 – Active Risk Management

Control Observations:

- Diversification guidelines (risk limits) need improved clarity
- Changes to limits not formally adopted/approved
- No process to formally review and update active diversification/concentration limits
- Policy compliance chart difficult to follow and had errors

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Observation 2 – Limited Performance Information

Observation: Limited information provided to facilitate discussion of long-term performance.



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Observation 2 – Limited Performance Information

Asset Class Overview



- **Presentation** – Highlights key information to facilitate discussion and Board oversight
- **Key Information** – Investment returns and risks
- **Investment Returns** – “Consistent positive performance over the long-term while not engaging in undue risk.”

ERS Strategic Goal: engage stakeholders for informed decision making

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Observation 2 – Limited Performance Information

2020 Investment Policy Statement

- Transparency in Reporting:
 - *Accurate, timely, and clear reporting to the Board of the Trust's assets, investment returns and risks, portfolio costs, and portfolio implementation decisions made by Staff.*
- Trust Performance Objectives:
 - *Private market investments are evaluated over rolling 10-year periods or other specified time periods using realized internal rates of return (IRR) and gross realized multiples.*

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Observation 2 – Limited Performance Information

Program risk:

- May not take corrective action when needed
- Stakeholders unaware of performance trends

Inherent risks:

- No single performance measure to evaluate all PRE investment objectives
- Reporting lag for current valuations (typically 3-6 months)
- Illiquid asset (investments held for 7-10 years and difficult to sell)
- Initial negative returns until investment matures (J-Curve effect)

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Observation 2 – Limited Performance Information

Control Observations:

- Long-term performance is not charted over time to provide improved context of investment performance
- Presentation in March 2021 annual asset class review included one bullet on long-term performance

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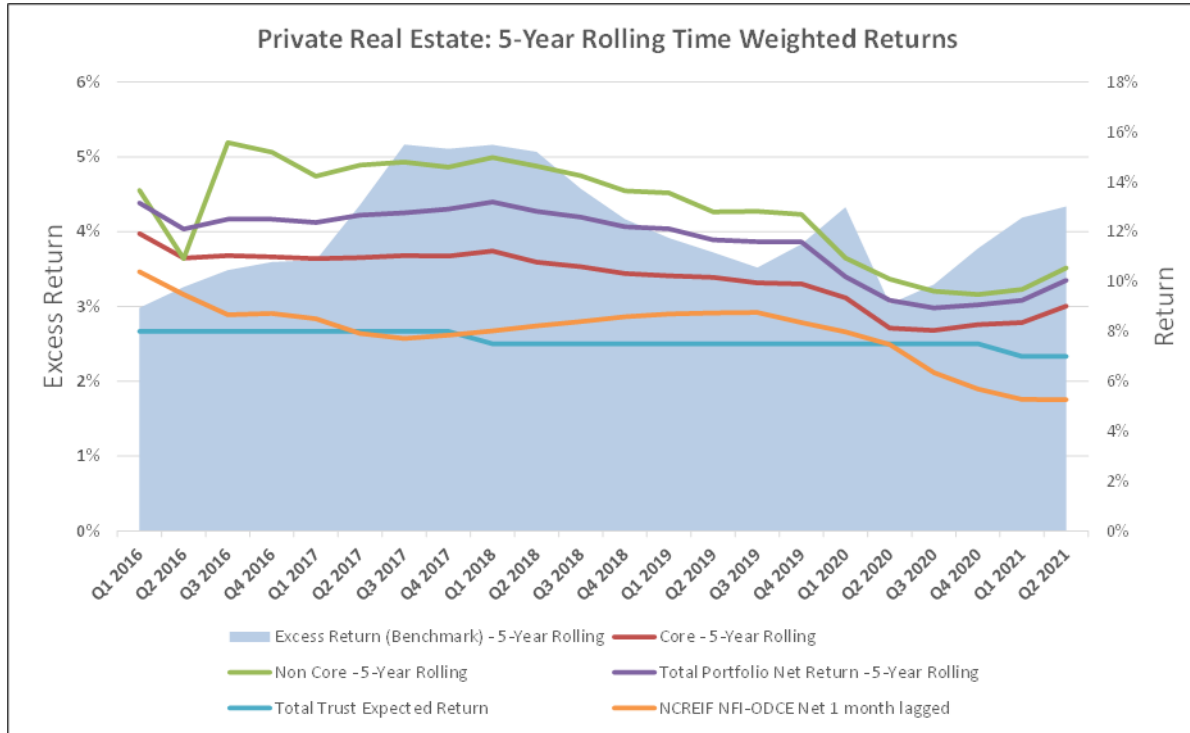
Observation 2 – Limited Performance Information

Performance Reporting Framework:

Question	Chart	Attribution Effect	Decision Owner
1. How did the asset class contribute to supporting member retirement income security?	Compare total private real estate return against adopted investment rate of return (7%)	Allocation	Chief Investment Officer
2. Was the decision to allocate capital to the private real estate class a good one?			
3. Did Private Real Estate meet its investment objective?	Relative Performance against benchmark over rolling 10-year period	Allocation & Selection	Private Real Estate Director
4. Did we make good allocation decisions across strategies, geographies, and property types?	Compare total return for strategy (core vs non-core), geography, and property types	Allocation	Private Real Estate Director

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Observation 2 – Limited Performance Information



Source: Reports from ERS' Investment Custodian and Real Estate Consultant

Questions?

Dental Insurance Audit

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Dental Insurance

Background – Dental Choice



- PPO Dental Insurance
- Costs paid entirely by participants (self-insured)
- > **350,000** participants in FY21
- **\$100 million** in total cost
- Beginning FY20 transition to new TPA after 10 years



Dental Insurance Audit

Objectives and Results



Overall Results: Contract management procedures ensure benefits are properly delivered.
(Satisfactory)

Scope Area	Sub-Objectives	
Member Benefits	<ul style="list-style-type: none">• Does provider network support delivery of dental services?• Does customer service assist in delivery of benefits?	Satisfactory
Cost Management	<ul style="list-style-type: none">• Are dental claims processed in accordance with plan design?• Are claims reimbursements and vendor fees remitted accurately?• Are cost savings through the provider network realized?• Are appropriate funding levels established to support program costs?	Satisfactory

Plan Benefits

Dental Care Cost Savings



May see any dentist, but receive higher benefit for using a network provider

Covered Service	In-Network	Out -of- Network
Diagnostic & Preventive	100%	90%
Basic Services	90%	70%
Major Services	50%	40%
Orthodontics	50%	50%

Network Charges	In-Network	Out -of- Network
Dentist usually charges	\$1,000	\$1,000
Cost Savings (In-network service discount)	\$310	\$0
Service unit cost	\$690	\$1,000 (no discount)
ERS plan pays	\$345	\$400
Member pays	\$345	\$600

Observation 1

**Establish controls to assess whether in-network service discounts are realized.
(Moderate)**

Program risks:

- Participants could pay more for dental care.
- Projected provider discount savings and associated reduced dental costs may not be realized by plan participants.

Inherent risks:

- New Third-party administrator (TPA) with significant projected provider discounts.
- TPA negotiated discounts, ERS has no involvement.

ERS Dental Insurance



Observation 1

Total Dental Cost = Dental care costs + TPA administration fee



Dental Care costs = Utilization x Service Unit-Cost



Service Unit-Cost = Amount dentist charges per procedures

Control observations:

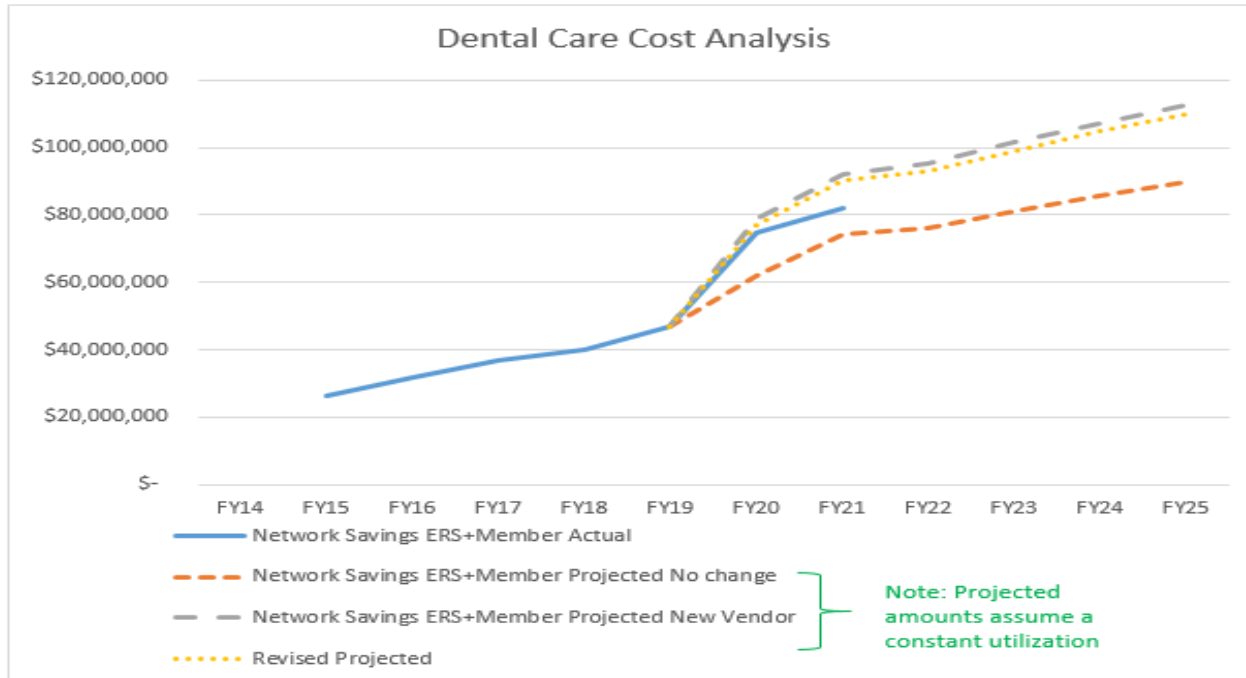
- No cost attribution analysis
- Cost analysis focused on setting rates
- Limited service cost information in TPA annual presentation (*First-year*)
- Prior TPA annual presentations included service unit-cost trends
- Program staff has since initiated a service unit-cost analysis

ERS Dental Insurance



Observation 1

Dental Care Cost = utilization + service unit-cost



ERS Dental Insurance



Observation 1 - Recommendation

To ensure maximum dental cost savings for participants are realized, the following actions should be taken:

- Continue to incorporate additional dental cost attribution analysis to evaluate both unit-cost and utilization impact on total dental care costs.
- Coordinate with TPA regarding additional cost trending analysis to include in Annual reports and presentations.

Questions?

ERS Performance Measure Management Audit

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Greg Magness, Audit Lead

Strategic Planning and Performance Budgeting

State of Texas's SPPB system require agencies to:

- Identify measures and calculation methodology
- Report measure results
- Explain variations from targets
- Revisit definitions during strategic planning

Performance measure reporting is used by policy-makers when allocating resources

Certification Audit



The State Auditor's Office may certify the accuracy of measures' reported results.

Certification Categories:

- Certified
- Certified With Qualification
- Inaccurate
- Factors Prevented Certification

Attributes:

- Policies & Procedures
- Review Controls
- Support Documentation
- Accuracy

Performance measures are considered reliable with a Certified or Certified with Qualification

Summary Classification Results



Description of Performance Measure	Fiscal Year	Results Reported	Targeted Performance	Certification Results	Justification
Percent of ERS Retirees Expressing Satisfaction with Member Services	FY21	98.01%	97.00%	Inaccurate	Methodology not aligned with approved definition; incomplete documentation of procedures; Variance > 5%
Investment Expense as Basis Points of Net Position	FY21	12.00	16.00	Certified	
Number of ERS Accounts Maintained	FY21	282,177	268,500	Certified	
Percent of HealthSelect SM Participants Satisfied with TPA Services	FY21	90.20%	85.00%	Certified with Qualification	Methodology not aligned with approved definition; incomplete documentation of procedures; Variance < 5%
Percent of Medical Claims Paid within 22 Business Days	FY21	98.23%	98.00%	Certified with Qualification	Methodology not aligned with approved definition; incomplete documentation of procedures
HealthSelect SM Admin Fees as Percent of Total HealthSelect Costs	FY21	2.42%	3.00%	Certified with Qualification	Incomplete documentation of procedures

Observation



Key Performance Measures	Policies & Procedures	Reporting & Review Controls	Support Documentation	Accurately Reported
% of Retirees Satisfied with Member Services				
Investment Expense as Basis Points of Net Position				
# of ERS Accounts Maintained				
% of HealthSelect SM Participants Satisfied w/TPA				
% of Medical Claims Processed within 22 Business Days				
HealthSelect SM Admin Fees as a % of Total Costs				

Questions?