Audit Committee Meeting

December 11, 2018

ERS

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Presented for Review and Approval

March 6, 2019

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AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
December 11, 2018
TRS Board Room, E513
TRS Building – 1000 Red River Street
Austin, Texas 78701

TRUSTEES PRESENT

Catherine Melvin, Audit Chair
I. Craig Hester, Board Chair
Ilesa Daniels, Board Vice Chair
Doug Danzeiser, Member
Cydney Donnell, Member
Jeanie Wyatt, Member *(Via Video Conference)*

ERS STAFF PRESENT

Porter Wilson, Executive Director
Cathy Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director & General Counsel
William Nail, Special Projects & Policy Advisor
Jennifer Chambers, Director of Government Relations
Tony Chavez, Director of Internal Audit
Bernie Hajovsky, Director of Enterprise Planning Office
Robin Hardaway, Director of Customer Benefits
Sharmila Kassam, Deputy Chief Investment Officer
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director of Procurement and Contract Oversight
Chineque “DeeDee” Sterns, Director of Human Resources
Katherine Tesar, Director of Benefits Communications
Tom Tull, Chief Investment Officer
Keith Yawn, Director of Strategic Initiatives
Kelley Davenport, Executive Office
Juli Davila, Investments
Christi Davis, Customer Benefits
Pablo De la Sierra Perez, Investments
Tressie Landry, Internal Audit
Greg Magness, Internal Audit
Karen Norman, Internal Audit
Aris Oglesby, Investments
Jonathan Puckett, Internal Audit
Susie Ramirez, Executive Office
Tanna Ridgway, Investments
Mary Jane Wardlow, Executive Office

ALSO PRESENT

Janet Bezner, Group Benefits Advisory Committee
Kelly Bratton, State Auditor’s Office
Hillary Eckford, State Auditor’s Office
Nadine Phillpotts, Comptroller of Public Accounts
Sarah Puerto, State Auditor’s Office

Meeting of the ERS Board of Trustees Audit Committee

1. CALL TO ORDER

1.1 Call Meeting of the ERS Board of Trustees' Audit Committee to Order

Ms. Catherine Melvin, Chair of the Board of Trustees Audit Committee of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 8:59 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 3:53 p.m. on Monday, December 3, 2018, as is required by Chapter 551, Texas Government Code, referred to as the "Open meetings Law."

2. MINUTES

2.1 Review and Approval of the minutes to the August 29, 2018 ERS Audit Committee Meeting (ACTION)

Ms. Catherine Melvin, Audit Committee Chair, opened the floor for a motion on the approval of the minutes from the August 29, 2018 Audit Committee meeting.

The Board then took the following action:

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes for its meeting held on August 29, 2018.

Motion by Cydney Donnell, second by Doug Danzeiser.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

3. AUDIT ITEMS

3.1 Review of External Audit Reports

Mr. Tony Chavez, ERS Director of Internal Audit, introduced Ms. Hillary Eckford and Ms. Sarah Puerto with the State Auditor's Office (SAO) to present their annual Incentive Compensation Plan Audit of the Employees Retirement System of Texas for 2017. Ms. Puerto was the project manager for the audit and the objective was to determine whether ERS calculated and paid incentive compensation in accordance with its policies and procedures.

Ms. Puerto reported that the ERS generally calculated and paid incentive compensation in accordance with its plan and policies and procedures. The audit did find that ERS overpaid two employees a total of $3,593 in incentive compensation due to an error based on incorrectly calculating the number of years that the employees had participated in the plan. The SAO rated the finding (Chapter 3 of the audit report) as low, indicating the error does not significantly impact the agency's ability to effectively administer the program.

Mr. Porter Wilson verified that the incorrect payments were returned by the employees. No action was taken on this agenda item.

3.2 Review of Internal Audit Reports

Mr. Chavez introduced Mr. Greg Magness, Internal Auditor, to present the Investment Management Fees Audit to the Board. The objective of the audit was to attest to the accuracy of reported annual management fees. Mr. Magness reported that program staff developed a program objective to assist in assessing the processes and controls in place to ensure they are achieving those objectives. Audit staff found that management fees come in a variety of forms depending on the provided services and the asset class. For alternative investments (including private equity, private real estate and private infrastructure), management fees are intended to provide the general partner with resources to operate the partnership through the life of the investment. Mr. Magness stated that the fee agreements are designed so that the management fees are returned to ERS and are paid back prior to the distribution of profit share if the investment is profitable.

For public equity and hedge funds, management fees represent compensation to the general partner or the manager for management of assets. These fees are generally not returned to ERS.

Two departments - Investments Operations department within the Investment Division and the Investment Accounting department within Finance Division are responsible for the processing, accounting, and reporting of management fees.

Mr. Magness reported that the overall assessment for the audit was satisfactory, with two observations. This assessment was based on reviewing the control framework and determining that it included review and recalculation of management fees during the processing and then accurately accounting for the management fees across multiple accounting systems.

The first observation noted that partnership and organizational expenses were included in the amounts reported as management fees. These expenses did not have the same controls to verify their accuracy, and there were fewer limits in place. These expenses are generally not paid back to ERS upon liquidation of the partnership. These expenses are trending in an opposite direction as the management fees. From 2015 to 2017, management fees declined while these other expenses doubled. In 2015, the other fees made up 15% of the amount reported as management fees and by 2017, it was over 28%.

Audit staff recommended that the Finance Division review how these other expenses are reported to provide more transparency in the expenses related to alternative investments in ERS' annual financial reports. In response, the Finance Division will report these other expenses separately from the management fees starting in the 2018 Comprehensive Annual Financial Report (CAFR).

In the second observation, audit staff found two instances where the ERS investment custodian overstated expenses related to these alternative investments. These errors did not cause the value of the investments to be in error, but overstated the fees related to these alternative investments. A third instance was found where the investment advisory fees paid to a manager in the emerging manager program were not included in the amount reported for investment advisory fees in the 2017 CAFR. Audit staff recommended that Investment Operations and Investment Accounting should review procedures to ensure reconciliations are made at the appropriate level to capture mistakes by the investment custodian and develop a methodology to ensure that all management and advisory fees are included for reporting. As a result, Investment Operations is performing daily reconciliations of all directives to the Custodian to ensure the transaction is processed as intended. In addition, Investment Accounting has restructured a reconciliation to ensure prior period adjustments are captured. Both departments have worked together on a methodology to ensure that all fees that are paid are included in the notes to the CAFR.

Mr. Hester asked if the Custodian is recording management fees from the statements of the managers or from information received from ERS. Mr. Magness responded that process owners will create a "directive" that provides direction to the Custodian on how to record transactions, in this case someone miscoded a transaction and it was entered into the wrong account. Mr. Hester asked and Mr. Magness confirmed that the directive sent by ERS was accurate; it was an error on the part of the Custodian.

In response to a question from Ms. Melvin, Mr. Chavez stated that this is the first time that investment management fees have been reviewed by Internal Audit. The management fees are always included in the annual financial statement audit performed by the State Auditor's Office, but this is the first time that an audit has focused on the fees.

Mr. Chavez said that the fees were accurately reported and that Investment Operations recalculates management fees for reasonableness using the partnership agreements. Mr. Hester noted that there was a directive for more transparency, but it is especially important since the materiality of the other expenses has increased. Ms. Donnell agreed, noting the number of alternative investments has grown and each manager has their own method for recording expenses and negotiating agreement terms. She further noted that there is a movement to try to standardize this, but it is very hard to accomplish when each transaction is negotiated separately.

Mr. Chavez introduced Mr. Jonathan Puckett, Internal Auditor, to discuss the Real Assets - Infrastructure audit. Mr. Puckett informed the board that the objective of the audit was to determine if investments in infrastructure are in accordance with ERS' investment policy. For the audit sub-objectives, there were three scope areas: investment selection, ongoing operations and performance reporting. The scope covered private infrastructure investments made between August 2015 and December 2017.

The Private Infrastructure portfolio was created in FY14 and is a subset of the alternative investment class. The portfolio includes three legacy investments that were entered into prior to the creation of the infrastructure asset class. The asset allocation target for infrastructure was updated from 4% to 7% in 2017.

Mr. Puckett reported the overall audit results were rated as satisfactory with one scope area rated as needs improvement. He provided background on the infrastructure program, highlighting the importance of the Asset Class Investment Committee in reviewing and approving each investment.

He also explained that incentive compensation for infrastructure investments, as described by the 2016 Incentive Compensation Plan (ICP), differs from other asset classes and is a measurement of ERS private infrastructure portfolio blended economics against industry market economic fund terms. Beginning with the 2016 ICP, the discretionary goal award was capped at 25% weight, and a quantitative goal for cost savings was developed at 50% weight. This goal was a non-board approved benchmark as delegated by approved ICP.

Background on actual performance was provided by Mr. Puckett, noting that in Plan Years 2016 and 2017 about 200% of the goal was met for the one-year and three-year awards noting that PY15 was the last year the award was discretionary.

Mr. Puckett reviewed the incentive compensation calculation and reviewed each input of the calculation. There were two issues with the calculation methodology. The first observation noted that key information to validate the reasonableness of the benchmark fee was unavailable to support performance incentive benchmarks. Program staff said the decision to use 1.75% as the benchmark management fee rate was based on a market assessment for the fund management fee terms adjusted by ERS economics. Supporting documentation, including internal analysis of the ERS' economics that were considered, was not available for validation. Mr. Puckett reported that the consultant for the infrastructure asset class, Pavilion, did provide a memo to the infrastructure team stating that the 1.75% benchmark for the management fee was a reasonable benchmark based on fees reported in a database it had access to. However, it was not clear which economic factors, such as vintage years, geographies and investment strategies, were used to make that assertion and all those can impact the assessment. Mr. Puckett reviewed actual management fees from investments made during 2016-2017 (.75% - 1.60%). He noted that the audit does not find that that the 1.75% benchmark is wrong, just that there was not any documentation available to support the benchmark levels.

Mr. Hester asked if audit staff was able to go back and recreate the benchmark and Mr. Puckett replied that he was not able to recreate it because it is unclear what data was used to arrive at the selection. Without specific data identified, too many factors are inputs into that number (vintage years, geographies, or strategies).

Mr. Puckett also provided more detail on the target fee and reviewed the calculation methodology. He stated that direct or co-investments generally do not have management fees, which lowers average management fees for the [infrastructure investment] portfolio, which can significantly impact the incentive compensation calculation. The target fee calculation includes the portfolio's fund ratio target (fund investments to direct/co-investments because the long term goal of 70% fund investments was used instead of the actual percentage of fund investments of around 50%, the target fee was higher than it would have been had a ratio closer to the actual mix been used in the calculation. Just like the benchmark fee, the justification for using the inputs was not documented.

The second observation was that select investments included in the ICP goal calculation do not align with ERS' Incentive Compensation Plan objectives. Investments that were entered into before the infrastructure portfolio was created were included in Plan Years 2016 and 2017 ICP award calculations. The total commitment was over $150 million with no management fees since they were co-investments.

Mr. Puckett reported the ICP goal directive states that goals should be directly tied to a participant's actual performance and not applied retrospectively for performance. He also stated that in FY17, two investments with negative investment performance contributed positively to incentive compensation performance. The negative investment performance from these investments was not attributable to the normal investment life cycle. Other directives for the ICP include incentivizing achievement of the highest level of performance and asset class performance goals must include rationale so that it can be independently verified by Internal Audit and/or an external auditor.

Mr. Hester asked if the two investments with negative performance were legacy investments which Mr. Puckett confirmed they were.

Ms. Donnell asked how much longer ERS expects to use these goals. Ms. Donnell stated that she understood that is difficult to measure performance when alternative investments are in the J curve phase. Ms. Sharmila Kassam noted that ERS adjusted the benchmark for FY19 with the intent to move toward a more performance based goal, rather than relying on fee savings exclusively. Ms. Donnell asked if this portfolio was started after the establishment of the other performance goals and Ms. Kassam confirmed that the ICP program was started prior to the Infrastructure portfolio, but the incentives for those asset classes were based on discretionary awards.

Ms. Donnell noted that the investment committee acts as a control for investment decisions, which should serve as a deterrent to ignoring good investment deals based solely on the management fee, or selecting poor investments because of lower fees. All investment decisions are made with the approval of the investment committee, which would identify such a case. Ms. Kassam noted that co-investments only come when invested in the corresponding main fund.

Mr. Wilson noted that for FY19 ICP the goals have changed and there are actually two benchmarks, one based on fees and another based on performance of investments that have had capital deployed for more than five years.

Ms. Melvin asked if the actual performance of this asset class was typical compared to other asset classes. Mr. Chavez noted that the presentation was documenting the average ERS infrastructure management fee compared to the benchmark. Mr. Puckett added that employees cannot be paid more than 100% of their goal, even if the investment performance is greater than 100%. Ms. Melvin asked if that is an indication that the metric should be reviewed. Mr. Pablo De la Sierra Perez noted that it might also mean that the portfolio performance is good with half of the portfolio co-invested versus directly invested which exceeds what the infrastructure team has targeted. Ms. Kassam noted that they are constantly reviewing industry information for other benchmarks.

Ms. Melvin noted the challenge of trying to get a good metric that works and ensures that high performing staff are rewarded appropriately. She emphasized the need for the audit team to be able to audit the metrics, noting the high level of scrutiny associated with the ICP. Documenting how performance goals are established should be available for the audit team to review. She indicated that she was not sure from the management response if the needed documentation will be available to audit staff. Mr. Tull responded that every effort is being made to have more robust information from the marketplace and a lot more detail and work has been done to document the various pieces for the FY19 goals. Mr. Pablo De La Sierra Perez stated that the audit focus was on the 2016 fiscal year, and since then staff have been developing data to justify the benchmark. Ms. Sharmila Kassam also stated that staff have asked the consultant going forward to retain all their documentation.

Staff confirmed that the ICP calculations were accurate and there was no need to get any payments back Mr. Hester asked when the Investments staff expected to be on a more performance based measure and Mr. De la Sierra Perez responded that in FY19 part of the goal is performance based and as the portfolio matures the performance piece of the goal will increase. The goal is currently set at one-third performance and two-thirds cost basis. Ms. Kassam stated that they will be reporting annually to the Board on the status of the allocation between performance based and cost based allocation of the metric goals. Mr. Wilson also noted that the benchmark has changed and lowered over time. Mr. Hester agreed with Ms. Melvin's comment about keeping the documentation to justify the metrics.

Mr. Danzeiser asked what documentation the consultant is retaining to support their justification. Mr. De la Sierra Perez stated they are reviewing the market and creating their own database. Ms. Kassam noted the use of the Prequin database as well. Mr. Danzeiser asked if the consultant has documented their agreement with the reasonableness of the benchmark and Ms. Kassam stated that they have done it every year. In earlier years, they did not add enough detail, but they have had discussions with the consultant and more details will be added. Mr. Chavez noted that the consultant did document their agreement and that a Prequin database was referenced in their memo. However other than a stated affirmation of agreement, no additional analysis or reports were available. Audit staff subsequently tried to confirm the information in Prequin based on publicly available reports and that information is in the appendix of the audit report. Mr. Danzeiser asked if that they continue to support the benchmark and Ms. Kassam stated that they have attested to ERS staff that they still agree with the benchmark. She also noted that the Prequin database is difficult to recreate because it is based on the current time period.

There were no further discussion or questions and no action was taken on this agenda item.

3.3 Review of Internal Audit Administrative Items: Annual Audit Performance and Quality Review

Mr. Chavez provided the board with brief descriptions of the Annual Audit performance and Quality review exhibits. The Internal Audit Annual Report is a required report of internal audit plans, annual reports and any weaknesses or concerns resulting from audit activity. The Quality Assessment and Improvement Program Report is required monitoring, assessing and reporting of compliance of the internal activity with Audit Standards. Finally, the Internal Audit Performance Measures Report evaluates the effectiveness of audit processes and procedures.

The key takeaways are that staff has processes in place to ensure conformance with audit standards and improved collaboration with process owners to better align program objectives and associated risks. Mr. Chavez reported that staff would continue to improve and pursue opportunities to improve business acumen. Mr. Chavez then thanked the investment team for identifying certain trainings for the Internal Audit team to attend.

Audit efficiency was identified as needing improvement. Mr. Chavez walked the Board through areas of improvement and planned corrective action. This is the first fiscal year that staff levels were fully staffed and performing 3-4 audits concurrently, which led to longer times for review, since there was only one reviewer.

To improve timeliness of reviews a designated audit manager role has been established. Mr. Chavez provided an overview of the Audit Manager's duties, which involves the review of audit work papers to confirm sufficient evidence has been gathered and organized in accordance with audit standards and division policy to support audit results. The position also provides feedback and assists project leads in the completion of audit engagements. For the Audit Director, the role remains the same including second level review of milestone deliverables and key work papers that support audit findings, ensuring audit program and results align with ERS strategic/business goals and objectives and ensuring appropriate audit ratings are determined based on the level of risk and impact to ERS.

Mr. Chavez then introduced Ms. Tressie Landry, who recently started in the role as Audit Manager to provide some background information. Ms. Landry informed the board that she has 17 years of experience in and around all levels of government. Her experience includes a significant amount of time auditing Medicaid health care claims.

Mr. Chavez discussed the Fiscal Year 2019 action plan and restated the designation of the Audit Manager to assist with the efficiency of work paper review and timeliness of those reviews, which allows the Internal Audit Director to lead select engagements and have a greater focus on strategic activities. Another action plan is to have a formal audit talent assessment of the Internal Audit division that will help with staff development of training needs and performance plans, and identify skill gaps for individual audit engagements. The third action plan is to evaluate the current audit customer survey structure for continued viability. Mr. Chavez informed the Board that a customer survey is performed after every engagement, which is sent to the individuals that have been audited requesting their feedback. The team will also emphasize elements of audit work papers that promote critical thinking and analysis and ensure sufficiency of planned audit work.

Mr. Chavez told the Board that there is a total of 70 years of experience on the ERS internal audit team. Mr. Hester then stated that he applauds the efforts to continually focus on training and improving the staff.

Mr. Danzeiser presented Mr. Chavez with some general questions of how the audit plan is developed and asked if the number of audits is appropriate for the size of the agency. Mr. Chavez explained the audit plan has three different audit universes called audit units. Procedures identify/narrow down to 10 audit units for potential engagements. Mr. Chavez then assesses how many audit engagements can be performed based on available budget audit hours. A discussion ensued on Mr. Chavez's opinion on the number of hours and resources available for an agency of this size. Mr. Chavez noted that it is a balance between the impact to operations and the number of audits, but ultimately he feels that at this time the audit function is staffed appropriately.

Ms. Melvin commended Mr. Chavez on his ability to look inward and perform an assessment on the performance of his office. She also noted the importance of the development of business acumen in audit staff and commended him for making it a priority.

There were no further discussion or questions and no action was taken on this agenda item.

4. ADJOURNMENT/RECESS

4.1 Adjournment of the ERS Board of Trustees Audit Committee. Following adjournment of the Audit Committee, the Board of Trustees will take up the remaining Board agenda items.

There being no other items, the ERS Board of Trustees Audit Committee adjourned at 10:04 a.m. Following adjournment, the Board of Trustees took up the remaining agenda items. [See minutes to the Board of Trustees]