



Audit Committee Meeting

December 2, 2016



Presented for Review and Approval

February 22, 2017

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**AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**December 2, 2016
ERS Board Room
ERS Building – 200 E. 18th Street
Austin, Texas 78701**

TRUSTEES PRESENT

I. Craig Hester, Chair
Doug Danzeiser, Vice-Chair
Ilesa Daniels, Member
Cydney Donnell, Member
Brian Ragland, Audit Committee Chair
Jeanie Wyatt, Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Catherine Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director and General Counsel
Shack Nail, Director of Governmental Relations
Tony Chavez, Director of Internal Audit
Robin Hardaway, Director of Customer Benefits
Robert Kukla, Director of Benefit Contracts
Machelle Pharr, Chief Financial Officer
DeeDee Sterns, Director of Human Resources
Gabrielle Stokes, Director of Procurement & Contract Oversight
Tom Tull, Chief Investments Officer
Chuck Turner, Chief Information Officer
Keith Yawn, Director of Strategic Initiatives
Nora Alvarado, Benefit Contracts
Lisa Caffarate, Office of Procurement & Contract Oversight
Kyla Cloutier, Benefit Contracts
Chloe Conner, Office of Procurement & Contract Oversight
Anthony Curtiss, Investments
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Brian Dowdy, Finance
Liz Geise, Benefits Communications
Beth Gilbert, Internal Audit
Ginger Grissom, Office of Procurement & Contract Oversight
Sharmila Kassam, Deputy Chief Investment Officer
Betty Martin, Investments
Karen Norman, Internal Audit
Jonathan Puckett, Internal Audit
Susie Ramirez, Executive Office
Carol Stueler, Office of Procurement & Contract Oversight
Ariana Whaley, Finance

ALSO PRESENT

Keith Barnes, Blue Cross Blue Shield of Texas
Amy Barrett, Teachers Retirement System of Texas
Kevin Cassidy, Blue Cross Blue Shield of Texas
Dan McCoy, Blue Cross Blue Shield of Texas

Rene Valadez, Office of the Governor
Cyrus Walker, Blue Cross Blue Shield of Texas

Meeting of the ERS Board of Trustees Audit Committee

Mr. Craig Hester, Chairman of the Board of Trustees of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order and read the following statement:

“A public notice of the Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 10:58 a.m. on Monday, November 21, 2016 as required by Chapter 551, Texas Government Code, referred to as “The Open Meetings Law.”

The Board of Trustees convened as a committee of the whole at 8:00 a.m. to consider Audit Committee agenda items.

X. REVIEW AND APPROVAL OF THE MINUTES TO THE AUGUST 16, 2016 ERS AUDIT COMMITTEE MEETING

Mr. Brian Ragland, Audit Committee Chair, opened the floor for a motion on the approval of the minutes from the Audit Committee Meeting held August 16, 2016.

MOTION made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser, and carried unanimously by the present members of the Audit Committee to approve the minutes from the Audit Committee Meeting held on August 16, 2016.

XI. PRESENTATION, DISCUSSION AND CONSIDERATION OF AUDIT COMMITTEE AGENDA ITEMS:

a. Internal Audit Reports – Mr. Tony Chavez, Director of Internal Audit, reported the objective of the Incentive Compensation Audit was to determine if recommended incentive compensation awards were in accordance with the ERS’ ICP plan. The overall assessment was satisfactory. Observation noted: continue to ensure sufficient and relevant information provided to executive management in a timely manner.

Mr. Hester clarified with Mr. Chavez that the Human Resources division is also part of the calculation/review process. Ms. Donnell asked that Internal Audit monitor the plan for unintended consequences and to monitor rewards. Mr. Wilson recognized Machel Pharr, Brian Dowdy and Ariana Whaley from the Finance Division and DeeDee Sterns, Human Resource Division for their work on the Incentive Compensation Plan. Mr. Chavez concluded that as the ICP process evolves, there will be continuous improvement.

Mr. Chavez introduced Mr. Jonathan Puckett, Internal Auditor to discuss Hedge Funds Audit. Mr. Chavez explained the State Auditor’s Office reviewed the valuation of Hedge funds so this audit did not focus on the valuation. Mr. Puckett reviewed the objective of internal audit was to determine whether the Hedge Fund Investment program is effectively designed and operating to meet ERS’ investment goals and objectives. The overall assessment was satisfactory. Observations noted in the audit were 1) monitoring of performance verses peer group hedge funds is not performed, and 2) certain information provided to key decision makers and stakeholders is not accurate.

Mr. Hester questioned the level of inaccuracies in reporting the performance numbers. Mr. Chavez, Mr. Puckett and Mr. Anthony Curtiss, Interim Hedge Fund Director, explained they did not find any material differences. Data was entered manually in a very complex Excel spreadsheet. Complex formularies and manual entries led to mistakes. Currently the hedge fund performance data goes into a

time-rated return calculation using estimates versus actual NAVs and is finally compared to actual end-of-the-month NAVs to ensure Investments can provide accurate data to the Board.

Mr. Danzeiser questioned the review of benchmarks. Mr. Puckett explained Internal Audit reviewed the benchmarking process as well as the appropriateness of the benchmarks. Albourne, ERS Internal Audit's third party consultant, assisted with setting up the benchmark. Ms. Sharmila Kassam, Deputy Chief Investment Officer, and Mr. Tom Tull, Chief Investment Officer reviewed hedge fund background as an asset class and their benchmarks. The Investment Division is constantly monitoring these benchmarks. Ms. Donnell commented on the hedge fund fee structure and the need to make sure fees can't be improved. Mr. Chavez thanked Ms. Caroline Cooley, IAC member, for providing her subject matter expert expertise during the audit.

Mr. Chavez introduced Ms. Karen Norman, Internal Auditor to discuss the HealthSelect Prescription Drug Program. The objective of the audit was to determine if contract administration and oversight ensures members' benefits are properly delivered. The overall assessment was needs improvement. Observations noted in the audit were 1) controls over the accuracy of key information used to manage and evaluate the PBM are not effective, 2) PBM performance results should be consistently maintained and communicated and 3) consider addition division control activities to enhance third-party review work.

Ms. Donnell asked about refining the use of heat maps as a performance measurement tool. Mr. Chavez clarified that the vendor self-reports and the contract and auditing standards are not always followed. Mr. Danzeiser asked about consequences. Mr. Rob Kukla, Director of Benefit Contracts, discussed consequences and the eligibility audit.

Mr. Danzeiser asked about oversight of contract compliance. Ms. Gabrielle Stokes, Director of Procurement and Contract Oversight (OPCO), explained both OPCO and division contract managers will provide oversight. Ms. Jeanne Wyatt questioned the total claims paid over the audited period. Mr. Kukla explained total claim costs including Medicare were \$800 million dollars over the past year. Mr. Chavez stated that Internal Audit determined the monthly impact of HealthSelect claims corresponding to our sample, since the controls were not in place. Mr. Danzeiser questioned the heat map measurements and medical management reviews on utilization and medical necessity. Mr. Danzeiser suggested that tracking appeals process outcomes on the heat map might provide feedback in that area.

Mr. Chavez discussed the Investment Compliance Agreed-Upon-Procedure report. Mr. Chavez stated the Securities Lending Program has been temporarily suspended since February, 2016. In April 2016, the Program was restricted to lending ETF's only. The Program has deliberately run at a low utilization rate, which caused audit flags for diversification limits through September, 2016. No other non-compliance was noted.

b. Internal Audit Administrative Items - Mr. Chavez, Director of Internal Audit, introduced Ms. Amy Barrett, Chief Audit Executive of the Teacher Retirement System of Texas, and Mr. Rene Valadez, Director Internal Audit at the Governor's Office who conducted an ERS Internal Audit Division peer review in accordance with the State Agency Internal Audit Forum Peer Review policies and procedures. Ms. Barrett said the Internal Audit Division received the highest rating "Generally Complies." The Internal Audit Division is complying with professional standards.

Peer Review Audit process recommendations for continuous improvement:

- Formally document threats to independence and safeguards in place to support Internal Audit's annual independence confirmation to the Board at the August Audit Committee meeting
- Report Quality Assurance Self-Review activity to the Board
- Explore opportunities for working in teams so that staff can serve as resource for each other, cross train, and develop supervisory skills
- Leverage specialists outside the organization as subject matter experts

- Consider whether an IT auditor would be beneficial
- Review internal requirements for evidencing completion and review of working papers

Ms. Barrett complimented Mr. Chavez and the dedicated professional audit staff on quality work. Ms. Barrett thanked Ms. Gilbert for her work during the peer review engagement.

Mr. Chavez and Ms. Gilbert presented Internal Audit Performance Measures for Fiscal Year 2016. Mr. Chavez stated the external peer review showed that we have our professional practices in place. This year will be focused on developing business acumen.

Mr. Chavez and Ms. Gilbert presented the Internal Audit Annual Report for Fiscal Year 2016. Mr. Chavez explained this report is required by the Texas Internal Auditing Act, Texas Government Code, Chapter 2012. The State Auditor's Office is charged with prescribing the form and content of the annual report which recaps the Internal Audit Division's previous year results and highlights Fiscal Year 2017 Annual Plan approved by the Board in August. Mr. Chavez noted that we have discussed the results during the External Peer Review and Internal Audit Performance Measures discussions today.

These agenda items are presented for discussion purposes only. No action is required.

XII. ADJOURNMENT OF THE ERS BOARD OF TRUSTEES AUDIT COMMITTEE – Following adjournment of the ERS Audit Committee, the Board of Trustees will take up the remaining agenda items.