

EXECUTIVE SUMMARY

Employees Retirement System of Texas

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As the administrator of state employee benefit programs, no agency has a more direct impact on state employees and retirees than the Employees Retirement System of Texas (ERS). Hundreds of thousands of employees, retirees, and their dependents rely on the pension, health insurance, and other benefits ERS administers for their economic security, and these benefits are a critical recruitment and retention tool for the state.

The 84th Legislature placed ERS under Sunset review after concerns about its procurement process came to light when the agency, in 2012, selected a new HealthSelect vendor for the first time in over 30 years and ended up on the receiving end of a critical state audit in 2014 regarding this contract. As such, evaluating the agency's procurement and contracting operations was a top priority for the review, which initially found the agency's decentralized approach to these functions resulted in numerous inconsistencies and inefficiencies. However, just prior to the publication of this report, ERS began consolidating its procurement and contracting functions into a new division. While centralizing these functions may address many of Sunset staff's concerns, further improvements, including developing agency-wide procurement and contracting policies and procedures, establishing appropriate contract term lengths, and implementing standard contract monitoring techniques are still needed to ensure ERS' contracts adhere to standard best practices and provide best value to the state.

These procurement and contracting functions support ERS' two main responsibilities — managing the retirement fund and administering the Group Benefits Program (GBP) for more than 500,000 state employees, retirees, and dependents.

On the retirement side of the house, the review found ERS strategically manages its investment program with a capable staff and an engaged board. The agency works to keep investment costs low and successfully worked with the Legislature in 2015 to put the retirement fund on a path to actuarial soundness. However, even though the review found no significant problems within the investment program, the agency could improve the transparency of costs related to alternative investments.

On the other side of the house is the Group Benefits Program, which Sunset staff found does not always get the attention it needs and deserves. From this vantage point, several issues emerged. ERS' unique status as a trust fund

The Group Benefits Program, with more than 500,000 participants, does not always get the attention it needs and deserves.

means the agency and its board members are legally bound to perform their duties solely in the interest of retirement fund participants and beneficiaries. While the importance of controlling costs cannot be overstated, this fiduciary duty, along with the fact that the Legislature ultimately controls the eligibility and funding aspects of the GBP, has created an entrenched culture that is heavily focused on the program's financial aspects, sometimes at the expense of members' needs and expectations. The review found ERS does not strategically manage the GBP to ensure the specific benefits within the program are meeting members' and employers' needs. As a key recruitment and retention tool, ERS should have an inclusive, forward-thinking approach for administering group benefits that is not focused solely on controlling costs. Further, ERS does not provide adequate information to help members make informed decisions about aspects of their insurance and other benefits.

Although the Sunset review did not identify any glaring issues or problems overall, thoroughly assessing the agency and its operations, especially its administration of the GBP, proved challenging. Having been over 20 years since Sunset last reviewed ERS, Sunset staff found the agency is not accustomed to having to justify its decisions and found a significant lack of formal policies, procedures, and other documentation necessary to determine whether ERS was doing what it claimed to be doing. And several times when documentation was available, it later changed or conflicted with previously provided information.

Despite these concerns, new agency leadership appears to be working to implement changes to remedy these problems. Overall, the recommendations in this report seek to ensure ERS' takes a more holistic approach to managing all of its important functions, advance some of the needed changes already in progress, and make sure agency processes and decisions are well documented, consistent, and transparent.

As a constitutionally created agency, ERS is not subject to abolishment under the Sunset Act, so the report does not contain a recommendation to continue its functions and duties. Further, the Sunset review did not delve into issues surrounding the pension plan design or eligibility, such as the debate around defined contribution versus defined benefit plans or the membership and accounting structure of the Law Enforcement and Custodial Officers Supplemental Retirement Fund. While important and worthy of discussion, these types of issues are currently being examined by interim committees or otherwise require value judgments that do not readily lend themselves to objective evaluation and analysis.

The following material summarizes Sunset staff recommendations on ERS.

Issues and Recommendations

Issue 1

ERS Needs to Make Additional Improvements to Ensure Its Contracts Adhere to Best Practices and Provide Best Value to the State.

ERS manages 128 major contracts, with a value of \$2.1 billion, to provide state employees, retirees, and their dependents with health and retirement benefits. Despite past procurement and contracting problems, ERS only recently began centralizing its contracting functions. The lack of a central point of coordination has allowed each division to procure and manage its contracts differently, contributing to operational inefficiencies, such as a lack of documented policies and procedures, inconsistent contract oversight, and questionable contract lengths. Although ERS cannot standardize all agency contracting overnight, having a division dedicated specifically to managing agency contracts would improve the quality of its procurements and promote consistency and fairness.

Key Recommendations

- Direct ERS to provide its new division clear authority over all of the agency's procurement and contracting functions, including contract oversight and enforcement.
- Direct ERS to further centralize and consolidate its procurement and contracting staff into the new division.
- Direct ERS to implement contract term dates in agency contracts, except in limited circumstances.

Issue 2

ERS Does Not Strategically Manage the Group Benefits Program to Ensure Its Effectiveness and Plan for the Future.

Employee benefits, especially health benefits, are a valuable recruiting and retention tool that employees highly value. However, unlike its retirement and investment programs, ERS does not strategically manage the GBP. The agency does not get formal, ongoing input from members or employers on the benefits offered; has no formal process by which to evaluate benefit changes to ensure they align with the agency's goals for the program; and does not provide comprehensive information about the GBP necessary to determine the program's overall effectiveness. Formalizing how ERS gets input on and makes changes to the GBP would provide the agency, members, and policymakers a better understanding of what is and isn't working in the GBP and what changes could be made to increase its continued effectiveness as a recruitment and retention tool. Further, providing more comprehensive information about the program would allow policymakers to better plan for its sustainability into the future.

Key Recommendations

- Require ERS to develop and regularly update a comprehensive annual report on the GBP.
- ERS should establish an advisory committee to obtain regular stakeholder and expert input on benefits.
- Direct ERS to develop a process and clear criteria for evaluating changes to the GBP.

Issue 3

ERS' Benefit Decision Processes Lack Balanced Treatment and Full Information for Members.

ERS has several different processes for members to apply for certain benefits and appeal denied insurance benefit claims. Although members appeal only a small percentage of insurance claims, the agency lacks balance in its treatment of members during the appeal process and tends to take a hard line that the reasons for most insurance claim appeals are due to member error. However, ERS does not provide enough information and resources to help members make more informed decisions about their benefits, and members are not allowed to participate directly in the appeal process. ERS also lacks certain management tools, like tracking aggregate appeals data and using established criteria and policies. Improving ERS' administration of the benefit appeal and application processes would lead to more consistent and fair treatment of members, allow ERS to identify problems and make improvements to the processes, and help members make more informed benefit decisions.

Key Recommendations

- Require ERS to develop and implement a process that allows members to participate directly in the insurance appeal process.
- Require ERS to establish a precedent or other type of manual for the insurance appeal process.
- Direct ERS to more effectively educate members about choices and decisions that can lead to unexpected health insurance charges.

Issue 4

ERS Does Not Adequately Track or Report All Costs Associated With Alternative Investments.

In recent years, ERS has begun to diversify its investment portfolio into alternative assets, which require ERS to contract with external investment fund managers. Payment to these fund managers is typically structured in two parts — a flat management fee and a profit-sharing component. The profit-sharing component incentivizes fund managers to maximize returns on these investments so they can receive a share of the profit. In fiscal year 2015, ERS' alternative investment fund managers received \$75.1 million in shared profits. However, ERS does not systematically track or publicly report the amount of profit shared with alternative investment fund managers. Having such information would ensure ERS fully assesses the costs of these investments and improve transparency to the Legislature, ERS members, stakeholders, and the general public.

Key Recommendation

- Require ERS to track and report profit-sharing in its alternative investments.

Issue 5

ERS' Statute Does Not Reflect Standard Elements of Sunset Reviews.

Among the standard elements considered in a Sunset review, the Sunset Commission adopts across-the-board recommendations as standards for state agencies to reflect criteria in the Texas Sunset Act designed to ensure open, responsive, and effective government. Because ERS has not undergone Sunset review recently, some of these provisions are missing entirely from the agency's statute and must be applied. Additionally, the Sunset Act directs the Sunset Commission to recommend the continuation or abolishment of each reporting requirement imposed on an agency under review. Sunset staff found all of ERS' required reports serve a useful purpose, but one has an inappropriate due date.

Key Recommendations

- Apply standard across-the-board recommendations to ERS.
- Change the due date for the *Cost Management and Fraud Report* and continue the agency's other reports.

Fiscal Implication Summary

These recommendations would not have a fiscal impact to the state since ERS' operating expenses are not appropriated. Establishing an advisory committee for the GBP would result in a small cost to ERS for travel reimbursement, but the amount would depend on the size of the committee. Other recommendations in this report direct ERS to develop policies and procedures, as well as track information and data, and could be accomplished within ERS' existing resources.

