

SUNSET ADVISORY COMMISSION

STAFF REPORT

Employees Retirement System of Texas



2016–2017
85TH LEGISLATURE

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Cover Photo: The iron perimeter fence was installed in the 1890s, a few years after the completion of the Texas State Capitol. The fence surrounds approximately 22 acres of the Capitol Grounds but only on the east, west, and south sides due to the addition of the Capitol Extension to the north in the early 1990s. Photo Credit: Janet Wood

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

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HOW TO READ SUNSET REPORTS

Each Sunset report is issued *three times*, at each of the three key phases of the Sunset process, to compile all recommendations and action into one, up-to-date document. Only the most recent version is posted to the website. (**The version in bold is the version you are reading.**)

1. SUNSET STAFF EVALUATION PHASE

Sunset staff performs extensive research and analysis to evaluate the need for, performance of, and improvements to the agency under review.

FIRST VERSION: The *Sunset Staff Report* identifies problem areas and makes specific recommendations for positive change, either to the laws governing an agency or in the form of management directives to agency leadership.

2. SUNSET COMMISSION DELIBERATION PHASE

The Sunset Commission conducts a public hearing to take testimony on the staff report and the agency overall. Later, the commission meets again to vote on which changes to recommend to the full Legislature.

SECOND VERSION: The *Sunset Staff Report with Commission Decisions*, issued after the decision meeting, documents the Sunset Commission's decisions on the original staff recommendations and any new issues raised during the hearing, forming the basis of the Sunset bills.

3. LEGISLATIVE ACTION PHASE

The full Legislature considers bills containing the Sunset Commission's recommendations on each agency and makes final determinations.

THIRD VERSION: The *Sunset Staff Report with Final Results*, published after the end of the legislative session, documents the ultimate outcome of the Sunset process for each agency, including the actions taken by the Legislature on each Sunset recommendation and any new provisions added to the Sunset bill.

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SUMMARY OF SUNSET STAFF RECOMMENDATIONS

SUMMARY

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.

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

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 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.

ERS AT A GLANCE

ERS AT A GLANCE

Created by a constitutional amendment in 1947, the Employees Retirement System of Texas (ERS) is a trust fund administered by a board of trustees. ERS' mission is to support the state employee workforce by offering competitive benefits at a reasonable cost. To achieve its mission, ERS carries out the following key activities:

- Administers retirement; deferred compensation; health and optional insurance coverage, including dental coverage; and other benefit programs for members, including state and higher education employees, retirees, and their dependents
- Invests trust funds on behalf of beneficiaries
- Provides information and educational counseling services regarding retirement, insurance, and other benefits

What Is a Trust Fund?

A fund comprised of assets, such as cash, stocks, bonds, and other financial instruments, intended to provide benefits to an individual or group of individuals called beneficiaries. A trustee or group of trustees manages the fund on behalf of the beneficiaries.

Key Facts

- **Board of Trustees.** The ERS Board of Trustees is the six-member body that oversees investment of the retirement fund and administration of state benefits. Three board members are appointed — one each by the governor, speaker of the Texas House, and the chief justice of the Texas Supreme Court. The remaining three members are active state employees elected by state employees and retirees. All board members serve staggered six-year terms.¹ The chart below provides information on the current board members. To help make investment decisions, the board relies on the advice of an eight-member Investment Advisory Committee composed of investment experts from the private sector and state universities.²

ERS Board of Trustees

Member	Position	Term Expires
I. Craig Hester, Chair	Appointed by the Supreme Court Chief Justice	2016
Doug Danzeiser, Vice Chair	Elected* (Texas Department of Insurance)	2019
Ilesa Daniels	Elected (Health and Human Services Commission)	2021
Cydney Donnell	Appointed by the Governor	2018
Brian D. Ragland	Elected (Texas Department of Transportation)	2017
Vacant**	Appointed by the Speaker of the Texas House	2020

* This is an elected position, but the current trustee was appointed to the position by the board upon the resignation of the previous elected trustee.

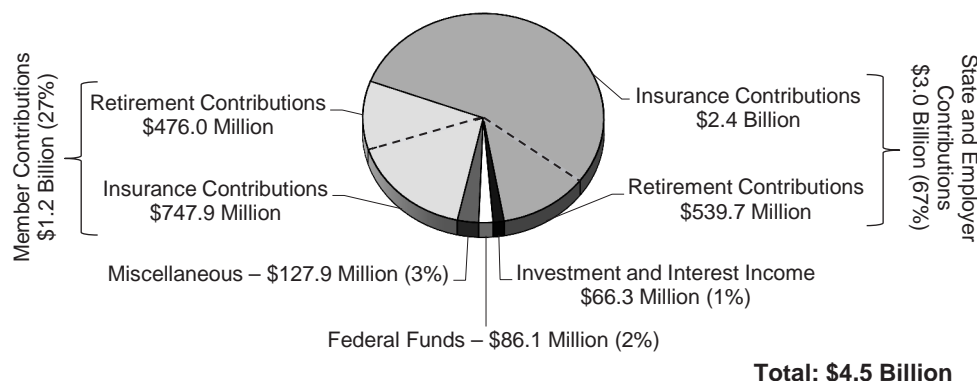
** Frederick (Shad) Rowe, Jr. resigned from the board in January 2016, but technically remains a member of the board until the speaker of the House makes a subsequent appointment.

- **Staffing.** In fiscal year 2015, ERS employed 350 staff at its headquarters in downtown Austin. In addition to its in-house call center, ERS contracts for call center services in Harlingen where 15 contract employees provide basic customer service support. ERS also uses outside consultants and

advisors to provide investment expertise and services. Appendix A, *Equal Employment Opportunity Statistics*, compares ERS' workforce composition to the percentage of minorities in the statewide civilian labor force for the past three fiscal years.

- Funding.** ERS is funded primarily through member and state contributions, and the interest and returns from investing these contributions. State contributions come primarily from general revenue. In fiscal year 2015, ERS received \$4.5 billion in revenue, detailed in the *ERS Revenue* pie chart.³ Due to poor market conditions, ERS' investment earnings only accounted for about 1 percent of total revenue in fiscal year 2015. By comparison, investment earnings accounted for 45 percent of revenue in the prior fiscal year. The agency's only direct appropriation was \$9.3 million to provide lump-sum retiree death benefits.

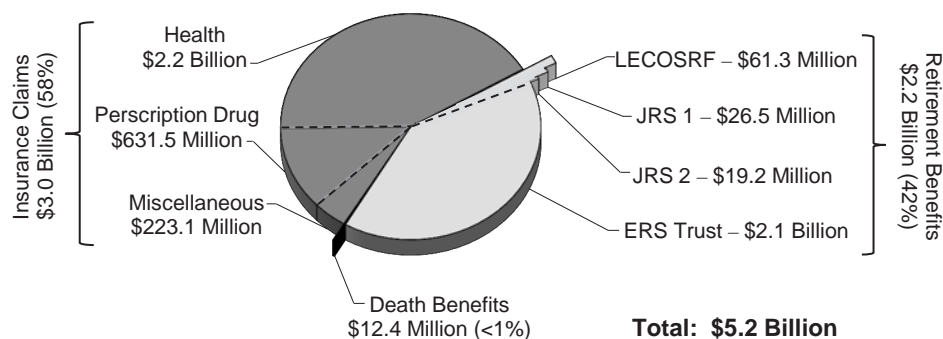
ERS Revenue – FY 2015



In fiscal year 2015, ERS' operating expenses totaled \$61.3 million, with roughly 62 percent going toward ERS employee salaries, benefits, and incentive compensation. Other significant expenses included costs related to information technology (11 percent); subscription and electronic communication services mostly for investment analytics tools (9 percent); and professional fees and services, including actuarial services and investment consultants (9 percent). In addition to these operating expenses, ERS paid about \$12 million in management fees to external investment advisors and \$28.8 million in Affordable Care Act fees.⁴ Appendix B, *Historically Underutilized Businesses Statistics*, describes ERS' use of historically underutilized businesses in purchasing goods and services for fiscal years 2013–2015.

Separate from its operating expenses, ERS paid out just over \$5 billion in fiscal year 2015 in insurance claims, retirement benefits, and other member benefit payments.⁵ The *ERS Benefit Payments* pie chart depicts the breakdown of payments by benefit type and retirement plan.

ERS Benefit Payments – FY 2015



- **Retirement benefits.** ERS administers four major retirement plans, each for a defined group of state employees or officials, as discussed below. The *Retirement Plan Populations* table provides a breakdown of the membership in each plan at the end of fiscal year 2015.

ERS Trust. The plan consists of two classes — the elected class and employee class. The elected class is for individuals holding statewide elected positions, members of the Legislature, and district attorneys. The employee class consists of three groups of state agency employees, based on the date they were hired. The ERS Trust is expected to be actuarially sound in 33 years based on fiscal year 2016 contribution rates and current actuarial assumptions.⁶

Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOSRF). In addition to the benefits under the ERS Trust plan, law enforcement and custodial officers of certain state agencies receive an extra benefit through the LECOSRF plan in recognition of their career services.⁷ All LECOSRF members are also members of the ERS Trust.

Judicial Retirement System – Plan 1 (JRS 1). ERS' only pay-as-you-go plan consists of judges, justices, and commissioners of the Texas Supreme Court, Court of Criminal Appeals, Court of Appeals, district courts, and certain commissioners courts in office before September 1, 1985. The Legislature closed this plan with the creation of JRS 2.

Judicial Retirement System – Plan 2 (JRS 2). The replacement for JRS 1, the plan includes all judicial officers taking office on or after September 1, 1985.

- **Health insurance and other benefits.** ERS administers the Group Benefits Program (GBP), which provides coverage for health, life, dental, short- and long-term disability, and voluntary accidental death and dismemberment to employees and family members of state agencies, universities, community colleges, as well as eligible retirees.⁸ Some insurance plans are self-insured (also known as self-funded), meaning the state and members — not an insurance company — assume the risk that the revenue for benefits will be enough to cover all costs. ERS pays the claims through contracted third parties, such as United Healthcare, Caremark, and Humana Dental Insurance Company. In fiscal year 2015, ERS paid third parties \$88.7 million in administrative fees to administer the self-insured insurance plans.

The *Healthcare Program Enrollment* table provides a breakdown of those enrolled in the GBP health plans. During 2015, ERS offered two types of health insurance plans for state employees and their families, and retirees under age 65: HealthSelect, a point-of-service (POS) plan, and two health maintenance organization (HMO) plans. ERS also offered two additional plans for Medicare-eligible retirees: an HMO and a preferred provider organization (PPO) plan.⁹ The table, *Health Insurance Plan Types*, on the following page highlights the key differences between the plan types.

Retirement Plan Populations – FY 2015

Retirement Plan	Contributing Members	Retirees and Beneficiaries
ERS	142,409*	100,003*
LECOSRF	38,526	10,845
JRS 1	10	391
JRS 2	563	322

* Includes LECOSRF members.

Healthcare Program Enrollment – FY 2015

Type	Members	Dependents
State Agency	137,378	104,360
Higher Education	68,295	54,322
Retirees	101,623	38,181
Other*	12,571	6,383
Total	319,867	203,246

* Includes survivors, individuals receiving coverage under COBRA, and other retirement systems statutorily authorized to participate.

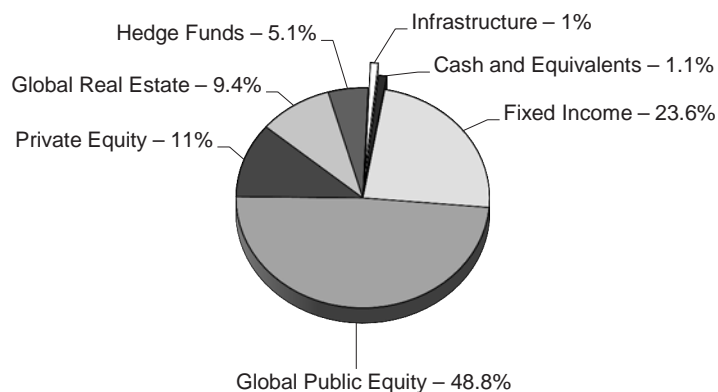
Health Insurance Plan Types – FY 2015

	Pays portion out-of-network expenses	Requires primary care physician referral or preauthorization	Limited to geographic areas	Self-insured by ERS
POS	✓	✓		✓
HMO		✓	✓	
PPO	✓			

In addition to retirement and GBP benefits, ERS administers other voluntary benefits that members can choose to use. These benefits include a flexible spending account (TexFlex), which allows members to use pre-tax dollars for out-of-pocket health and dependent care expenses; deferred compensation 401(k)/457 retirement savings plan (Texa\$aver); and discount purchase program (Beneplace), which provides employees, retirees, and their families access to discounts on certain products and services.

- **Investments.** ERS invests all of the system's trust funds and at the end of fiscal year 2015, managed an investment portfolio valued at about \$25 billion.¹⁰ As shown in the *Asset Allocation* pie chart, ERS invests in a diverse set of asset classes, but the majority of funds are invested in more traditional asset classes of public equity and fixed income. For the 10 years ending August 31, 2015, the portfolio returned an average annual rate of 6.04 percent, outperforming the investment policy benchmark of 5.58 percent.¹¹

**Asset Allocation
As of August 31, 2015**



- **Customer Service.** To help members navigate the various benefit options and stay up-to-date on plan changes, ERS performs a variety of marketing and customer-service activities, including publishing newsletters, pamphlets, and other informational materials, and offering webinars and presentations on specific benefits. ERS handles approximately 500,000 customer calls and emails, and 5,000 in-person visits annually.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Sections 815.001–815.003, Texas Government Code.

² Section 815.5091, Texas Government Code.

³ The amount for member insurance contributions includes \$83.5 million in TexFlex contributions.

⁴ The costliest Affordable Care Act fee is the Transitional Reinsurance Program Fee, which is designed to spread financial risk across insurers to assist plans that attract individuals at risk for high claims costs. The fee terminates after December 31, 2016.

⁵ The total excludes \$457,148 paid from the Excess Benefit Arrangement, which pays for retirement benefits otherwise payable by ERS that exceed limitations on benefits imposed by the Internal Revenue Service.

⁶ Gabriel Roeder Smith & Company, “Employees Retirement System of Texas Annual Actuarial Valuation — Funding,” in *Actuarial Valuation Reports* (Austin: Employees Retirement System of Texas, 2015), 3.

⁷ LECOSRF covers custodial officers employed by the Texas Department of Criminal Justice and Board of Pardons and Paroles, as well as law enforcement officers commissioned by the Texas Department of Public Safety, Texas Alcoholic Beverage Commission, Texas Parks and Wildlife Department, and the Office of Inspector General at the Texas Youth Commission, and who are recognized as commissioned law enforcement officers by the Texas Commission on Law Enforcement.

⁸ GBP coverage also extends to community supervision and corrections departments; Texas County and District Retirement System staff; Texas Municipal Retirement System staff; and Windham School District employees. Retirees are eligible for coverage if they have at least 10 years of eligible service credit and are age 65 or older, or meet the Rule of 80.

⁹ For plan year 2016, ERS added a third HMO to the GBP.

¹⁰ Employees Retirement System of Texas, *2015 Comprehensive Annual Financial Report* (Austin: Employees Retirement System of Texas, 2015), 86.

¹¹ Ibid.

ISSUES

ISSUE 1

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

Background

The Employees Retirement System of Texas (ERS) administers and manages contracts for the agency's benefit programs, investment advisors, and other internal operational services to meet ERS' overall purpose of providing retirement and health insurance benefits. As of December 2015, the agency managed 128 major contracts, with a total contract value of \$2.1 billion, as shown in the table *Contracts per Division*.

Although ERS' Information Systems Division procures the most contracts, the Benefit Contracts and Investments divisions manage the agency's highest dollar contracts. The table below contains 10 select contracts in these divisions and their contracted expenditures in fiscal year 2015.

Contracts per Division

Division	Total Contracts
Information Systems	45
Investments	31
Benefit Contracts	23
Other*	21
Customer Benefits	6
Benefit Communications	2
Grand Total	128

* Includes contracts in the Legal, Finance, Human Resources, Operations, Internal Audit, Executive Office, and Enterprise Planning Office divisions.

Select ERS Contracts

Contracted Service	Vendor	FY15 Expenditure (in millions)
Benefit Contracts Division*		
HealthSelect	United Healthcare	\$55.4
	Caremark	\$5.0
HMOs	Scott & White	\$106.3
	Community First Health Plan	\$23.8
Dental	Humana (HMO)	\$15.0
	Humana (PPO)	\$2.9
Short / Long Term Disability	Aon Hewitt	\$6.2
Investments Division		
Investment Analytics Tools	FactSet	\$1.8
Investment Software Subscriptions	Bloomberg	\$1.6
Custodian Bank	Bank of New York Mellon	\$0.9

* Contracts reflect some of those most familiar to members and include both fully-insured and self-insured products.

Key SAO Findings

- ERS did not include purchasing staff throughout the HealthSelect procurement.
- ERS did not define best value or how best value was determined in the HealthSelect request for proposal.
- ERS did not define all evaluation criteria used to evaluate submitted proposals.
- ERS did not develop an evaluation tool consistent with the HealthSelect request for proposal.
- ERS did not have a process to monitor whether claim reimbursement payments matched processed claims.
- ERS needs to improve the timeliness of its contract monitoring activities.

After ERS changed vendors for its HealthSelect contract in 2012, the Legislature expressed concern with ERS' contracting processes, resulting in the House State Affairs Committee suggesting an audit of the contract.¹ In 2014, the State Auditor's Office (SAO) completed an audit of the HealthSelect contract, identifying a number of problems with ERS' procurement and contracting processes, summarized in the textbox, *Key SAO Findings*.²

Based on SAO's recommendations and Senate Bill 20, 84th Legislature, ERS has been making changes to improve the agency's procurement and contracting processes. In 2015, ERS established a director of procurement position to oversee all the agency's procurement functions and update its contracting policies and procedures. Most recently, the agency has begun centralizing its procurement and contracting functions into a new division.

Findings

ERS' procurement and contracting processes do not fully conform with best practices, contributing to inconsistencies in contract management and other operational inefficiencies.

When evaluating an agency's contracting operations, Sunset uses the general framework established in the *State of Texas Contract Management Guide* (CMG), as well as documented standards and best practices compiled by Sunset. Although Sunset recognizes ERS has begun making improvements to its procurement and contracting operations, the agency needs to ensure its improvements address the issues described below.

- **New centralized structure.** Just before the publication of this report, ERS announced it was consolidating its procurement and contracting functions into a new division. Prior to this, Sunset staff had evaluated ERS' decentralized procurement and contracting operations and found significant inconsistencies and inefficiencies resulting from different divisions performing similar functions differently. While centralizing these functions should address many of these concerns, the agency has not yet completed the consolidation, including placing all its certified purchasers into the new division. Therefore, Sunset staff was unable to evaluate and determine the impact of any changes due to their newness.
- **No clear delineation of contract management responsibilities.** In agencies with significant contracting functions, like ERS, separating the activities of staff responsible for day-to-day interactions with vendors from the contract enforcement activities is important to ensure objectivity of contracting staff in correcting problems and deficiencies. ERS has not separated these responsibilities, resulting in inconsistent contract enforcement as discussed

ERS has not yet completed the consolidation of its new procurement and contracting division.

later in this issue, and whether these functions will be separated in the newly established division is unclear.

- **No agency-wide contract management policies and procedures.** While the CMG provides an excellent framework for state contracting, an agency should have policies and procedures that both complement the CMG and address agency-specific needs. Having standard contracting policies and procedures promotes consistency and ensures accountability throughout procurement and contracting functions. ERS lacks systematic, agency-wide policies and procedures for managing its procurements and contracts, and where policies do exist, some are outdated and do not always adequately document procedures. For example, ERS does not have detailed agency-wide procedures for monitoring contractor performance and enforcing contract requirements, which has resulted in inconsistent enforcement and vendors with recurring problems, as discussed below.

ERS does not have detailed procedures for monitoring contractor performance.

Inconsistent contract oversight limits ERS' ability to ensure successful contracting outcomes.

- **Questionable performance guarantees.** ERS monitors most vendors using performance guarantees, such as ensuring a vendor answers member phone calls quickly and processes insurance claims in a timely manner. Each ERS division establishes the performance guarantees for its individual contracts. However, some of these performance guarantees do not seem to ensure a proper balance between contract compliance and adequate service.

While ERS' vendors typically meet performance guarantees, some seem impossible to meet consistently, while others appear to allow for continued noncompliance. For example, ERS' customer-service call center vendor missed its service quality standard 17 times over a four-year period, but only missed it by an average of 1 percent each time. Having a vendor slimly miss a performance guarantee continually may indicate it is unachievable. On the other hand, some of ERS' health insurance vendor contracts have performance guarantees that reset annually giving poor performing vendors a clean slate every fiscal year regardless of the vendor's performance in the prior year. Although having a set timeframe for measuring and documenting a vendor's performance is prudent, ERS should also consider a vendor's performance across years to avoid a potential revolving door of poor performance.

Some performance guarantees seem impossible for vendors to meet.

- **Lack of consistent contract monitoring and enforcement procedures.** ERS does not have adequate agency-wide contract oversight procedures that provide consistent monitoring and enforcement of vendors to ensure problems are identified and resolved quickly. Although ERS has not had significant problems with most vendors, Sunset staff encountered multiple inconsistent oversight procedures and a lack of or conflicting monitoring and enforcement information throughout the agency. Corrective action plans were not consistent within or between divisions, and penalty amounts did not always match assessment letters. Overall, ERS' lack of

standard monitoring and enforcement procedures presents the potential for overspending, contract mismanagement, and a decline in the quality of member services.

Corrective action plans. ERS does not have agency-wide policies explicitly outlining when, why, or how to apply corrective action plans for continually poor performing vendors. Each division uses its own discretion to determine when or if corrective action plans are necessary. For example, the Benefit Contracts Division documented poor performance from its disability insurance vendor for nine months before applying a corrective action plan, while the Customer Benefits Division allowed seven months of poor performance from its call center vendor before implementing a corrective action plan. Such inconsistencies do not guarantee quality service or fair vendor treatment.

Penalties. ERS does not have agency-wide procedures on how to assess performance penalties to ensure the agency treats vendors fairly and consistently. Instead, each division has discretion to determine when and under what circumstances to apply, waive, reduce, or negotiate penalties for missed performance. Some ERS divisions, like Customer Benefits, adhere strictly to their contracted performance guarantees, but others, like Benefit Contracts, routinely waive or reduce penalties. For example, after United Healthcare reported inaccurate claims data for 17 months, ERS applied a \$1.4 million performance penalty that the Benefit Contracts Division eventually negotiated down to \$970,320. While having the flexibility to waive and reduce penalties can be beneficial to managing the vendor relationship, the division's policy does not clearly identify the conditions necessary to do so, or outline what type of documentation the vendor must provide to be eligible for a reduction or waiver.

Each division has discretion to waive or reduce vendor penalties for missed performance.

ERS' approach to establishing contract term lengths does not guarantee best value for the state.

ERS has several contracts with either open-ended terms or unlimited renewal options that allow the agency to use the same vendor for an extended period of time without rebidding the contract. Further, ERS does not have an agency-wide policy outlining the review and approval procedures for contract term lengths, or the documentation needed to justify extended-term or sole source contracts. For example, the agency's health actuary contract with the same vendor has been renewed every four years for the last 32 years and is only being rebid for the first time in 2016. The contract with Beneplace, ERS' discount purchase program vendor, has no end date. In both cases, Sunset staff found insufficient documentation justifying the contracts' extended lengths or how ERS guarantees the products and services for either remain best value to the state and members. The CMG recommends a maximum four-year term, but ERS does have to consider the services and impact on members when determining contract lengths. Some of the agency's investment-related contracts, such as for investment analytics tools, may necessitate different contract lengths outside the recommended four years.

The agency's health actuary contract has not been rebid in 32 years.

Recommendations

Management Action

As previously discussed, ERS has begun to consolidate its procurement and contracting functions into a new division that is in the process of improving these functions. The recommendations below are designed to ensure continuation and completion of the agency's efforts to meet contracting best practices.

1.1 Direct ERS to provide its new division clear authority over all of the agency's procurement and contracting functions, including contract oversight and enforcement.

ERS should ensure the new division is responsible for the management and oversight of all of the agency's procurement and contracting functions. ERS should also clearly define the responsibilities of the new contracting division by delineating the responsibilities between it and the other agency divisions. Specifically, the new division should carry out the following functions:

- Develop, maintain, and update standard agency-wide procurement and contracting policies and procedures
- Develop, maintain, and update the agency's standard procurement and contracting resources, such as request for proposal and contract templates, and a master evaluation summary sheet
- Coordinate any meetings or sessions that occur throughout the procurement process, such as best value discussions, evaluator trainings, and vendor interviews
- Track procurement and contract manager training and certification
- Assist division staff in developing appropriate contract terms, including performance guarantees
- Manage agency contract enforcement efforts by reviewing, approving, and overseeing contract enforcement measures, discussed further in Recommendation 1.2
- Coordinate with all agency divisions to ensure divisions are implementing consistent contract monitoring techniques

Establishing a centralized division responsible for the agency's procurement and contracting functions would strengthen the consistency and accountability of ERS' contracting function. The division would establish a more consistent and fair contracting process that follows established best practices so vendors are treated fairly and members continue receiving quality benefits and services.

1.2 Direct ERS to further centralize and consolidate its procurement and contracting staff into the new division.

In establishing its new division, ERS should consider consolidating all agency purchasers into the new division to ensure all agency contracts are procured in a consistent and fair manner, and to take advantage of operational efficiencies that could be gained by housing procurement staff in one division. Consolidating all agency purchasers into a single division would help standardize and streamline request for proposal development, proposal evaluations, defining best value, processing purchase orders and payments, and Legislative Budget Board contract reporting.

ERS should also include some certified contract managers in the new division to perform contract enforcement functions, including reviewing vendor performance reports, assessing penalties, and approving corrective action plans. The contract managers remaining in the agency's other divisions would continue to manage their contracts on a day-to-day basis, including coordinating operational meetings, reviewing source documentation, and managing monthly administrative performance reports. Separating the staff responsible for day-to-day interactions with vendors from those that enforce the contracts would better ensure ERS manages its contracts objectively and consistently.

1.3 Direct ERS to implement contract term dates in agency contracts, except in limited circumstances.

To ensure contracts are providing best value to the state and ERS is meeting its fiduciary duty, the agency should set specific term lengths in its contracts, including extensions, except in very limited circumstances. ERS should only consider open-ended contracts or those with automatic renewals in cases where terms that are more restrictive would hinder ERS' ability to obtain services or are industry standards, such as subscriptions ERS has with MSCI and Bloomberg, which are investment analytics tools used throughout the industry.

Further, the agency's new division should develop a policy for standard contract lengths, including extensions, and formally document justification for any contracts with terms outside the policy. The policy should also require sole source contracts to be reevaluated at regular intervals to ensure the current vendor remains the only eligible provider. ERS could consider adopting a policy similar to that of the Teachers Retirement System of Texas, which specifies that unless otherwise expressly authorized by the board, contracts should have an initial term not more than five years, with one or more extensions not to exceed a total of two years.

Fiscal Implication

These recommendations would not have a fiscal impact to the state since ERS' operating expenses are not appropriated. Centralizing the procurement and contracting staff should not have a fiscal impact since the agency already employs a sufficient number of certified procurement and contract management staff that could be reassigned to the new division.

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¹ Texas House Committee of State Affairs, *Interim Report to the 84th Legislature*, accessed March 22, 2016, http://www.house.state.tx.us/_media/pdf/committees/reports/83interim/House-Committee-on-State-Affairs-Interim-Report-2014.pdf.

² Texas State Auditor's Office, *An Audit Report on the HealthSelect Contract at the Employees Retirement System*, accessed March 22, 2016, <http://www.sao.texas.gov/reports/main/15-007.pdf>.

ISSUE 2

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

Background

The Employees Retirement System of Texas (ERS) designs and administers the state's Group Benefits Program (GBP), which provides health, life, and disability insurance, as well as other optional benefits to employees and family members of state agencies, universities, and community colleges, as well as eligible retirees and their dependents. The chart below, *GBP Benefits*, lists the different insurance and non-insurance benefits within the GBP, and the number of participants in each plan in fiscal year 2015.

GBP Benefits – As of August 31, 2015

Benefit Type	Plan	Vendor	Participants
Health Coverage (includes prescription drug coverage)	HealthSelect Point-of-Service Plan	United Healthcare	436,432
	Health Maintenance Organization Plan	Scott & White	18,827
	Health Maintenance Organization Plan	Community First Health Plan	5,132
	Statewide Medicare Advantage Preferred Provider Organization Plan	Humana	61,535
	Regional Medicare Advantage Health Maintenance Organization Plan	KelseyCare	1,187
Basic Term Life		Minnesota Life	317,033
Optional Dental Coverage	Dental Choice Preferred Provider Organization Plan	Humana	282,274
	Dental Health Maintenance Organization Plan	Humana	133,042
	Dental Discount Plan	Careington	9,245
Optional Term Life Insurance	Optional Life	Minnesota Life	209,299
	Optional Dependent Life	Minnesota Life	312,962
Optional Accidental Death and Dismemberment Insurance		Minnesota Life	130,637
Optional Short-Term and Long-Term Disability Insurance – Texas Income Protection Plan		Aon Hewitt	132,149
TexFlex Flexible Spending Account	Health Care Reimbursement Account	ADP	51,760
	Dependent Care Reimbursement Account	ADP	4,404
Employee Discount Purchase Program		Beneplace	over 20,000 website hits

The Legislature determines who is eligible for benefits, sets a basic level of health insurance coverage, and decides the amount of funding for the GBP through the appropriations process. Benefits are not guaranteed and subject to change based on appropriations. The Legislature also sets the overall policy for how cost is shared between employers and employees by setting the contribution amounts for each.

The state pays 100 percent of the health insurance costs for full-time employees and eligible retirees, and 50 percent of dependent coverage, while members pay the other half of dependent coverage. The state also funds limited basic life and accidental death and dismemberment coverage for active employees. Optional insurance coverage, such as for dental insurance, is funded entirely by members.

Findings

State benefits are an important recruitment and retention tool, and highly valued by employees and retirees.

Research shows public sector employees value their retirement, health, and optional benefits. According to MetLife's 2014 *Employee Benefit Trends Study*, public sector employees, especially those at larger employers like state governments, place higher importance on benefits compared to other employees.¹ According to the study, 61 percent of public sector employees surveyed agreed benefits are an important reason they remain with their employer, compared to only 48 percent of non-public sector employees.²

Although all types of benefits are important to current and prospective employees, health insurance is particularly valued since it directly affects them throughout their working career and in retirement. In 2012, ERS' own research confirmed the importance of state benefits, as members ranked health insurance as their most valued benefit and employers, such as state agencies and institutions of higher education, indicated benefits play a key role in recruitment and retention.³

ERS surveys are focused on changing benefits to reduce costs, not improving the program as a whole.

ERS does not get comprehensive stakeholder input or expert advice on the benefits offered through the GBP on a regular, ongoing basis.

ERS does not formally request and receive feedback from its members to know whether benefits are meeting their needs, how they view the quality of existing benefits, or what benefit changes they would like to see. ERS also does not systematically get input from state agencies and other employers to know what benefits are most useful in recruiting and retaining employees. Without regular input from members and employers, ERS and the state lack a full 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.

ERS Member Surveys

2006 – Assess members' knowledge and beliefs about benefits in anticipation of future benefit changes/reductions

2010 – Obtain member and employer opinions about how to shift healthcare costs to cover a \$142 million funding shortfall

2014 – Assess the adequacy and affordability of dependent coverage in response to legislative requirement

While ERS surveys members and employers about their benefits, it is usually on an ad-hoc basis, at legislative direction, or in reaction to funding shortfalls. As such, these surveys and their results are focused on changing benefits to reduce costs, not improving the GBP as a whole. As described in the textbox, *ERS Member Surveys*, ERS has only conducted three comprehensive member surveys in the last 10 years, and initiated these either because of funding gaps or legislative direction. Other ERS surveys focus on specific aspects of the GBP, not the program overall. For example, ERS conducts an

annual customer satisfaction survey, but the survey only inquires about ERS personnel and the customer service provided. ERS also requires its vendors to conduct their own customer service and benefit satisfaction surveys, but they only survey members who have had recent claims.

When the Legislature originally established the GBP in 1975, it saw the need for ERS to get regular input on the program overall and created an advisory committee of employees from state agencies and institutions of higher education, as well as a retiree and private sector expert in employee benefits.⁴ However, the advisory committee was abolished in 2001 as part of an omnibus retirement bill and ERS has not used its existing statutory authority to replace the input.⁵

ERS does not formally or consistently evaluate, justify, and document changes to the GBP to ensure benefits are meeting members' and employers' needs and align with agency goals.

According to its strategic plan and as described in the accompanying textbox, ERS has several goals related to the GBP, with an overall objective to provide the best benefits for the most members.⁶ However, ERS does not consider or evaluate changes to the GBP in a consistent or fair manner. ERS has no formal process or criteria by which to evaluate benefit changes to ensure they align with the agency's stated goals for the program. For example, ERS gets ideas for new benefits and services in many different ways, including staff looking at industry trends, board member suggestions, and potential vendors proposing ideas. ERS schedules some of these ideas for a "solution session," a forum where potential vendors present ideas to ERS staff for consideration. However, ERS has no policies for determining which ideas merit a solution session, how those that do are evaluated, or clear procedures for pursuing a suggested new benefit or service.

Group Benefits Program Goals

- Provide competitive benefits at a reasonable cost
- Align benefits with member and employer needs
- Provide members with additional choices when opportunities exist to add value
- Provide benefits consistent with, and complementary to, regulatory environment and market trends
- Align incentives with health risks to encourage appropriate healthcare use and risk sharing
- Establish a comprehensive wellness program that complements existing initiatives
- Increase awareness and participation in wellness and condition management programs
- Provide policy makers with relevant information about the GBP for informed decision making

Further, ERS does not adequately document or communicate the reasons the agency does or does not make changes to the GBP. For example, members have expressed interest in having vision insurance for many years, but this benefit has never been offered. Without documentation or communication of the agency's considerations and decisions, members had no way of knowing ERS had evaluated vision insurance options over the years before finally deciding to move forward with one that will be offered for the first time in the upcoming plan year. Not only do members not know what benefits ERS has considered or why it makes changes, but the agency also lacks any comprehensive record of its benefit evaluations and decisions.

ERS does not provide comprehensive information about the GBP necessary to determine the program's overall effectiveness and best plan for its future.

Statute gives ERS broad authority over the GBP, including developing specific plan coverage; providing optional benefits; and studying the program's costs, benefits, use of benefits, and claims administration.⁷ However, the Legislature controls the most important aspects of the GBP — eligibility and funding — and as such, needs ongoing, comprehensive information about the program to be able to evaluate its overall effectiveness and plan for its sustainability into the future.

GBP reports focus almost exclusively on costs and do not address other important aspects of the program.

Statute requires ERS to submit an annual report related to GBP plans and services, but only requires the agency to specifically report on the effectiveness and efficiency of its managed care cost containment practices and fraud prevention procedures.⁸ Although the information ERS provides in this report is useful, it focuses primarily on the HealthSelect insurance plan and cost considerations; it does not provide a comprehensive analysis and evaluation of the GBP as a whole or the program's effectiveness in meeting agency goals. At the Legislature's direction, ERS also published a sustainability report in 2012 and a resulting follow-up interim report on dependent coverage in 2014.⁹ While valuable, these reports focus almost exclusively on costs of the health insurance benefits within the GBP and do not address other important aspects of the program, including optional benefits and employee attitudes. Without comprehensive information about the GBP, policymakers cannot determine or prioritize the GBP's long-range needs and make decisions accordingly.

ERS uses a more strategic approach in managing its retirement and investment functions.

Unlike the GBP, ERS has several tools — described in the accompanying textbox — to help strategically guide and manage the agency's retirement and investment functions. Together, these tools provide ERS with a deliberate, long-

term approach that has resulted in the agency proactively developing its Investment Division over the last 15 years to diversify its investments and manage more investments internally. These tools not only govern all aspects of the agency's investment decisions, but inform policymakers, members, and other stakeholders about the investment program, and give the Legislature a clearer understanding of the status and implications of changes to the retirement plans.

***Retirement and Investment
Planning and Reporting Tools***

- **Experience Study:** An investigation of the mortality, service, and compensation experience of ERS members and beneficiaries.
- **Investment Policy:** Adopted by the board annually, the policy defines ERS' investment objectives and governs all investment activities.
- **Asset Allocation:** The asset mix for ERS' investment portfolio to meet the board's investment objectives.
- **Investment Summary:** An annual summary of the market value of the trust fund, asset allocations, and investment performance.
- **Actuarial Valuation:** Report describes the assets and liabilities of ERS to determine the effect of investment, salary, and payroll experience on the trust funds.

The ERS Board of Trustees also uses an Investment Advisory Committee that provides independent, expert advice and assists in the board's investment duties. The eight-member body, appointed by the board and consisting of experts in the investment field, works closely with the board to help set the agency's investment policy and asset allocation, meets together with the full board, and votes in advance of the board on all investment-related items.

Recommendations

Change in Statute

2.1 Require ERS to develop and regularly update a comprehensive annual report on the GBP.

This recommendation would modify ERS' existing annual report to include more comprehensive information about the GBP. In addition to the cost containment and fraud detection and prevention measures already required, the report would

- include basic information about each benefit program, such as the number of participants, claims expenses, and administrative fees;
- summarize recent benefit additions and changes, and highlight any key benefits ERS evaluated, but did not implement;
- discuss trends in claims and other areas of interest ERS identifies;
- recommend any statutory changes needed to help ERS achieve its goals for the program; and
- include any other information ERS determines appropriate.

Although ERS must ultimately adapt the GBP to the Legislature's direction and appropriation, this recommendation would help ensure the agency has a forward-thinking, strategic approach for the GBP. ERS would consider and communicate to the Legislature not only ideas for controlling costs, but also what level of benefits will continue to attract workers and how to ensure the program's sustainability over time.

Management Action

2.2 ERS should establish an advisory committee to obtain regular stakeholder and expert input on benefits.

The ERS Board of Trustees should use its existing statutory authority to appoint a GBP advisory committee to get formal, ongoing input from members, employers, and industry experts on health insurance and other non-retirement benefits. ERS would have the flexibility to determine the committee's appropriate makeup, but it should include active and retired ERS members, at least one employee from an institution of higher education, and individuals with expertise in the insurance field. This recommendation would ensure ERS consults regularly with members and employers before considering benefit changes, give members and employers a more active role in helping determine benefits, and ensure ERS gets advice from individuals with insurance expertise.

2.3 Direct ERS to develop a process and clear criteria for evaluating changes to the GBP.

This recommendation would ensure ERS consistently evaluates potential changes to existing benefits and any new benefits to ensure they align with the agency's goals and priorities for the GBP. ERS would develop evaluation criteria based on ERS' goals for the program, as outlined in the agency's strategic plan, and include considerations of costs, member expectations, employer needs, industry and market trends, and other factors ERS determines are necessary. ERS should also formally document its evaluation, decisions, and justification for all benefit changes the agency considers, and as described in Recommendation 2.1, summarize key changes in its annual report.

Fiscal Implication

Establishing an advisory committee for the GBP would result in a small cost to ERS, but the amount would depend on the size of the committee. Based on ERS' eight-member Investment Advisory Committee, travel reimbursement for the new advisory committee would cost less than \$9,000 per year. Publishing a more comprehensive annual report could be done within ERS' existing resources, as the agency already has the required information.

¹ MetLife, *Adapting Benefits to New Public Sector Realities: How to manage costs while sustaining satisfaction and talent*, accessed March 8, 2016, https://www.metlife.com/assets/cao/publicsector/Public_Sector_EBTS_Rprt_FINAL.pdf.

² Ibid., 3.

³ Employees Retirement System of Texas (ERS), *Sustainability of the State of Texas Group Insurance Program Report to the 82nd Legislature*, (Austin: ERS, 2012).

⁴ S.B. 18, 64th Texas Legislature, Regular Session, 1975.

⁵ S.B. 292, 77th Texas Legislature, Regular Session, 2001.

⁶ ERS, *Strategic Plan: Fiscal Years 2015–2019*, (Austin: ERS, 2014), 8–9.

⁷ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 1551.055, Texas Insurance Code.

⁸ Section 1551.061, Texas Insurance Code.

⁹ ERS, *Sustainability*; ERS, *Interim Report to the 83rd Texas Legislature: The Impact of Offering Alternative Health Insurance Options to State Employees Enrolled in the Texas Employees Group Benefits Program*, (Austin: ERS, 2014).

ISSUE 3

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

Background

The Employees Retirement System of Texas (ERS) provides insurance and retirement benefits to state employees, retirees, dependents, and other members through several programs. These benefits are important to members and when they are denied, ERS provides for an appeals process.

- **Insurance appeals.** ERS members can appeal an insurance company's denial of a claim to ERS for certain insurance programs, described in the *Insurance Appeals* chart. During ERS' insurance appeal process, ERS staff review each denied claim based upon its facts, the requirements of the plan's governing documents, relevant statutes, and ERS rules, and determines whether the vendor correctly denied the claim.¹ ERS members appeal a relatively low number of insurance claims. Of the millions of claims members file every year, they appealed 283 to ERS in fiscal year 2015.

Insurance Appeals

Program	Insurance Benefit Types	Members Can Appeal When:
Insurance Claims ²	<p>ERS members can participate in the following insurance programs:</p> <ul style="list-style-type: none"> • HealthSelect • HealthSelect prescription drug program • State of Texas Dental Choice Plan preferred provider organization insurance • Life insurance • Voluntary accidental death and dismemberment insurance • Texas Income Protection Plan (disability insurance) 	A health and other insurance benefit claim has been denied or paid incorrectly. ³ A member can also appeal a denied evidence of insurability application for life or disability insurance.

- **Other benefit applications.** ERS members must apply for other types of benefits, including disability retirement, insurance for over-age dependents, and Chapter 615 survivor benefits. These applications, described further in the *Benefit Applications* chart on the following page, are reviewed to determine whether the member meets program requirements and should be granted benefits. In certain situations, a group of contracted physicians, called the Medical Board, also reviews these cases. In 2015, ERS reviewed 176 over-age dependent applications, 77 disability retirement applications, and 25 Chapter 615 survivor benefit applications.

Benefit Applications

Program	Benefits	Members Can Appeal When:
Insurance for Over-Age Dependents ⁴	ERS members can apply for insurance for dependents that have a disability and are over age 26. Over-age dependents are eligible for the same insurance coverage as all other qualifying dependents.	An application for insurance for over-age dependents has been denied.
Disability Retirement ⁵	ERS members apply for disability retirement when they suffer from a permanent disability preventing them from working at a job with similar pay to their current income.	An application for disability retirement has been denied.
Chapter 615 Survivor Benefits ⁶	The state guarantees benefits for the survivors of certain members, such as peace officers and emergency responders, who die in the line of duty.	An application for survivor benefits has been denied.

Findings

ERS does not provide enough information and resources to help members make more informed healthcare decisions and avoid unnecessary appeals.

Insurance benefits within ERS are complex and expensive. ERS members need to know about concepts like networks, deductibles, coinsurance, premiums, and out-of-pocket expenses. While members have a responsibility to be educated about their insurance benefits, ERS, as the agency tasked with overseeing members' benefits, also has a responsibility to help educate members about the specifics of the network, including covered expenses and the impact of using providers within the network versus going out of network for services.

Many members, however, may not be aware all physicians, medical equipment, and tests are considered either in or out of network, regardless of whether they are using an in-network facility, their primary care physician, or other in-network physician. ERS, with the help of state agency benefit coordinators, does a good job marketing the health insurance benefit plans available to members and highlighting the differences between plans, as well as generally emphasizing the importance of finding a primary care physician, getting referrals for procedures from that physician, and staying in network for services. However, ERS' website and printed informational materials do not specifically warn members that using any out-of-network services, or those that are not covered under the insurance plan, may result in increased costs at any stage of the treatment process.

The bottom line is that ERS expects members to know for every treatment or test whether all services are in network and covered, but does not effectively communicate this expectation to members. ERS frequently refers members to the master benefit plan documents, medical and drug policies, and coverage guidelines, so they can determine for themselves which services are covered. However, these documents are very complex and do not provide real world examples or other clear guidance to members. For example, the *2016 HealthSelect Master Benefit Plan* is 166 pages and *United's Medical & Drug Policies and*

ERS expects members to know whether all healthcare services are in network and covered.

Coverage Determination Guidelines is an online database of 176 treatments.⁷ Both resources use advanced insurance, legal, and medical terminology, and ERS should not rely on members understanding these documents.

ERS lacks balance in its treatment of members during the agency's insurance appeals process.

ERS members may need to appeal their insurance claims from time to time. However, ERS tends to take a hard line that the reasons for most appeals are due to member error. Through observing appeals processes, reviewing documentation, interviewing ERS staff, and surveying ERS members, Sunset staff concluded ERS has a culture that places unreasonably high expectations on members to fully understand their insurance coverage and does not give adequate consideration to the member's situation or the circumstances under which a claim was denied. As an example, if a doctor orders a series of tests, such as blood work, ERS expects the member to know whether their plan covers every individual test ordered and if not, to contact the insurance company or ERS before receiving services to verify they are covered. This expectation is simply unreasonable. Members may not know all the tests ordered or to question those orders, and even if they do, may not have the time or ability to call the vendor or ERS while at the doctor's office. While ERS must sustain the benefits program and follow plan documents, the agency also has a responsibility to its members and should have a more appropriate balance between ensuring claims are paid correctly and presuming the member is wrong, or should have checked regardless of circumstances.

ERS tends to take a hard line that the reasons for most appeals are due to member error.

During ERS' insurance appeal process, the member and their interests are not directly represented. To appeal an insurance claim that has been denied, ERS instructs members to submit a written explanation of their position and any relevant documentation. Beyond filing their appeal, members do not have an opportunity to participate directly in the appeals process. Instead, the ERS Grievance Administrator reviews the justification provided by both the member and the vendor, pitting the less experienced member against the vendor's insurance expertise. The administrator then presents the appeal to the Grievance Review Committee, a group of seven ERS staff who review insurance claim appeals. Neither the member nor the vendor appears before the Grievance Review Committee. However, of the seven ERS staff members who make up the Grievance Review Committee, only two have a member-oriented perspective since they work in the Customer Benefits Division that works with members regarding the benefit programs offered by ERS. The other five committee members are contract and legal staff who work mainly with vendors and interpret issues more from the programs' contractual perspective.

Members do not have an opportunity to participate directly in the appeals process.

In comparison, some of ERS' contracted Health Maintenance Organization (HMO) vendors allow members to present their case directly to the panel of decision makers during the HMO's internal appeal process. Other agencies that administer state benefit programs also allow members to participate directly in their appeal processes, including the Texas Department of Insurance, which allows individuals disputing a decision regarding their workers' compensation

claim to directly participate in and present their case in each of the dispute resolution proceedings.⁸

ERS lacks certain management tools to help ensure consistent and fair treatment of members during the benefit application and appeal processes.

Because the benefit application and appeal processes differ depending on the coverage sought or benefit being offered, several different individuals and entities are involved in deciding whether members receive the coverage. As discussed below, ERS lacks certain tools and data to help identify problems in the different processes, implement improvements when necessary, and ensure the processes in this fragmented system are administered consistently and fairly for members.

ERS does not know about HMO vendors' internal appeal processes.

- **No comprehensive data.** ERS does not track or receive comprehensive information about all the different decisions being made by various entities in the appeal process, or information about the final outcomes related to these decisions. For example, HMOs providing health insurance services to ERS members are contractually required to provide insurance claim appeal processes to members. However, ERS does not know about the vendors' internal appeal processes or receive aggregate information about appeal decisions. While ERS is not directly taking on the financial risk associated with HMO programs, nearly 24,000 ERS members use the HMO health plans and the agency spends approximately \$130 million to contract for their services. ERS needs data and information about the HMO appeals to actively manage the contracts with vendors, analyze the reasons for appeals, understand resulting outcomes, and ensure members enrolled in the programs are being treated fairly.

Similarly, the HealthSelect vendor reviews applications from members seeking health insurance coverage for their over-age dependents with disabilities. Although ERS receives the vendor's final decision to approve or deny each application, ERS does not track aggregate information about reasons behind the vendor's decisions. Without this information, ERS cannot identify trends, inefficiencies, or problems that need attention, and ensure members are being treated fairly and consistently in this fragmented system.

- **Lack of guidelines.** Although ERS uses plan documents and medical standards to make appeal decisions, the agency does not have a precedent manual or other guidelines for the Grievance Review Committee to use to help ensure consistent treatment of members and decisions on appeals that are not clear-cut. Such guidelines would allow ERS to document specific circumstances where insurance claim denials have been reversed, providing useful information to the committee and members going through the appeal process. Other state agencies develop and use precedent or other types of manuals to help make consistent decisions. For example, the Texas Workforce Commission publishes a precedent manual of previous

commission and court decisions to guide staff and hearing officers in handling unemployment cases, and the Texas Department of Insurance has an Appeals Panel Decision Manual to help the panel achieve consistency in its decisions and inform its customers about how the panel reaches those decisions.⁹

- **Insufficient survivor benefit policies.** Chapter 615 survivor benefit applications are reviewed to determine if certain members, such as a law enforcement officer, died in the line of duty or if their deaths were caused by risk factors associated with the job.¹⁰ By informal practice, ERS typically refers these survivor benefit applications to the agency's Medical Board if the cause of death involved a medical condition, like heart attack, stroke, or cancer, while ERS staff analyze all other applications. However, ERS lacks formal policies and procedures related to the agency's review of applications to ensure consistent and fair results. Further, during the review, Sunset staff received conflicting information about the application review processes, such as who reviews the applications and how. Without sufficient policies governing the survivor benefit review process or clear procedures to carry out the policies, Sunset staff could not thoroughly analyze or fully evaluate the process.

Sunset staff received conflicting information about survivor benefit application review processes.

Recommendations

Change in Statute

3.1 Require ERS to develop and implement a process that allows members to participate directly in the insurance appeal process.

ERS should allow members to take a more active role in presenting their case and hearing opposing points during the insurance appeal process. ERS could ask members for more specific information about the situation that led to the appeal or allow members to directly address the group of ERS staff making insurance appeal decisions, either in person or by phone, to fully explain their situation and answer any questions ERS staff may have. This recommendation, along with others below, would help begin to change ERS' culture regarding member appeals, and help agency staff identify and solve issues that lead to insurance appeals.

3.2 Require ERS to establish a precedent or other type of manual for the insurance appeal process.

Under this recommendation, ERS would create and use a manual to help document and guide the agency's insurance appeal decisions. This manual should provide examples of previous decisions that were made in line with insurance plan requirements to provide useful comparable information to both the Grievance Review Committee and other ERS staff involved in the insurance appeal process. A precedent manual would help achieve more consistent decisions at each level of the appeal process and inform members about ERS' appeal decisions. The manual would not bind ERS to these or any decisions, but rather provide guidance to agency staff and participants in the process on how ERS has considered similar facts in previous appeals.

Management Action

3.3 Direct ERS to more effectively educate members about choices and decisions that can lead to unexpected health insurance charges.

This recommendation would direct ERS to provide members with more information about the types of health insurance choices and decisions throughout the medical treatment process that can lead to appeals, including how to find out if healthcare services are out-of-network, over the allowable amount, or otherwise not covered. If the expectation is that members know this level of information before agreeing to a medical test or procedure, ERS should make the information more readily available and understandable to members. ERS staff should also identify member education needs through its call center, member complaints, appeals, and meetings with vendors, and use this information to develop educational materials. This recommendation is not intended to have ERS reverse more denied appeals, but instead, reduce the number of denied claims by educating members on how to avoid out-of-network charges and costs not covered by their health insurance plans.

The information should be written in plain language and be easy to understand and find on the ERS website. For example, ERS should post examples of common decisions that can lead to unexpected charges on the insurance section of its frequently asked questions web page, as well as on its *Find a Doctor or Provider in Your Network* web page, and HealthSelect's *Find a Doctor, Hospital, or other Facility* web page. ERS should add this information to existing print materials, like the enrollment guides, *Medical Benefits Member Guide*, and the *New Employees Benefit Guide for State Employees*. ERS should also provide members with real life examples illustrating decisions that often lead to insurance appeals on its website and direct members to those online examples in the print materials. Finally, ERS should work with agency benefit coordinators to disseminate this information to active state employees.

3.4 Direct ERS to ensure balanced representation on the Grievance Review Committee of customer service and other staff.

To ensure the committee members adequately balance the member's interest with those of the agency and insurance vendors, ERS should increase the proportion of customer service staff on the Grievance Review Committee. Changing the committee's membership should help improve ERS' culture around the claims appeal process and provide balance to a process that tends to view issues more from the vendor's perspective. This approach is not intended to skew appeal results in favor of members. The contracts are appropriately intended to keep costs in check while providing members necessary and quality healthcare. But the expectations of member knowledge and ability regarding coverage must be part of a balanced approach to decision making in the appeals process.

3.5 Direct ERS to develop policies and procedures to govern reviews of Chapter 615 survivor benefit applications.

To make the Chapter 615 review process more consistent, ERS should develop formal policies and procedures related to the agency's review of Chapter 615 survivor benefit applications. The policies should clearly indicate under what circumstances the Medical Board and ERS staff review survivor benefit applications. ERS should train all staff involved in the review of Chapter 615 applications on the new policies and procedures, and ensure staff have a full understanding of the entire review process.

3.6 Direct ERS staff to comprehensively track and analyze benefit application decision and appeals data.

This recommendation would direct ERS staff to consistently track appeal and application decisions at every level, including aggregate information related to HMO programs and applications for over-age dependent insurance coverage handled by the HealthSelect vendor, and use the data to identify trends and make changes to the process to address problems. Tracking this data would allow ERS to analyze the information to know whether outsourced appeal and application processes are working, better evaluate vendor performance, and help ensure consistency in these processes to ensure members are treated fairly.

Fiscal Implication

These recommendations would not have a fiscal impact to the state since ERS' operating expenses are not appropriated. Providing members with additional information about the choices leading to insurance and benefit appeals could reduce the number of appeals and ultimately result in savings to ERS and its members. While this and the other recommendations would involve staff time to develop materials, provide training, and develop methods for collecting data, they are all part of ERS' expected duties and thus can be performed within ERS' existing resources.

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¹ "Step-By-Step Guide to Insurance Appeals," Employees Retirement System of Texas, last modified March 11, 2016, https://www.ers.state.tx.us/Insurance/Step_by_Step_Guide_to_Insurance_Appeals/.

² All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 1551.002(1), Texas Insurance Code.

³ Section 1551.355, Texas Insurance Code.

⁴ Section 1551.004(a)(3), Texas Insurance Code.

⁵ Section 814.201, Texas Government Code.

⁶ Chapter 615, Texas Government Code.

⁷ Employees Retirement System of Texas, *Health Select Master Benefit Plan Document*, accessed March 22, 2016, <http://healthselectoftexas.welcometouhc.com/assets/pdf/HS%20In-Area%201-2016%20MBPD%20FINAL.pdf>; "Medical& Drug Policies and Coverage Determination Guidelines- Commercial," United Healthcare, last modified 2015, http://www.unitedhealthcareonline.com/b2c/CmaAction.do?channelId=016228193392b010VgnVCM100000c520_720a_____.

⁸ "Dispute Resolution for Injured Employees," Texas Department of Insurance, last updated March, 28, 2016, <http://www.tdi.texas.gov/wc/employee/dispute.html>.

⁹ "Unemployment Benefits Appeals Policy & Precedent Manual," Texas Workforce Commission, last verified February 24, 2015, <http://www.twc.state.tx.us/unemployment-benefits-appeals-policy-precedent-manual#precedent-Decisions>; "Appeals Panel Decision Manual - Table of Contents," Texas Department of Insurance, http://www.tdi.texas.gov/wc/idr/apdmanual_liability.html#C01.

¹⁰ "State of Texas Offers Special Benefits to Survivors of Those Killed in the Line of Duty," Employees Retirement System of Texas, last updated 2016, https://www.ers.state.tx.us/Life_Events/Death/Survivors_of_those_killed_in_the_line_of_duty/.

ISSUE 4

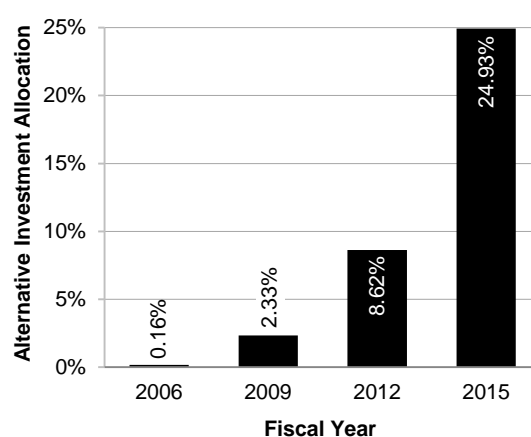
ERS Does Not Adequately Track or Report All Costs Associated With Alternative Investments.

Background

The Employees Retirement System of Texas (ERS) invests all available revenue and uses investment income to help pay for members' retirement and other benefits. The ERS Board of Trustees sets the agency's investment policies, including balancing the desired rate of return with a comfortable level of risk, and determining the mix of assets in which to invest the fund.

Historically, ERS has invested in traditional assets, such as stocks and bonds. However, in recent years, public pensions nationwide, including ERS, have begun investing in alternative assets, such as private equity, private real estate, hedge funds, and infrastructure to diversify their investment portfolios. The accompanying graph shows how, over the last decade, ERS' investment in these alternative investments has increased as a proportion of the overall asset allocation, and now makes up nearly one quarter of the trust fund's \$25 billion in assets.

Change in Alternative Investments



To invest in alternative assets, ERS partners with external investment fund managers in long-term contractual arrangements. Under these contracts, ERS provides money to fund managers who use the money, usually along with money from other investors, to make strategic investments in specific assets, like private real estate. These contractual agreements typically structure payment to the fund managers in two parts — a management fee and a profit-sharing component, sometimes referred to as carried interest, performance fees, incentives fees, or incentive allotments. See the textbox, *Alternative Investment Terms*, for a brief description of terms used in this type of payment arrangement.

Alternative Investment Terms

Fund manager: A private investment company that specializes in certain investment strategies in alternative markets.

Management Fee: A flat fee paid upfront by an investor (ERS) to a fund manager for investment services. The industry standard is 2 percent of the initial investment amount. This amount usually comes back to the investor prior to the fund manager receiving any profit-sharing.

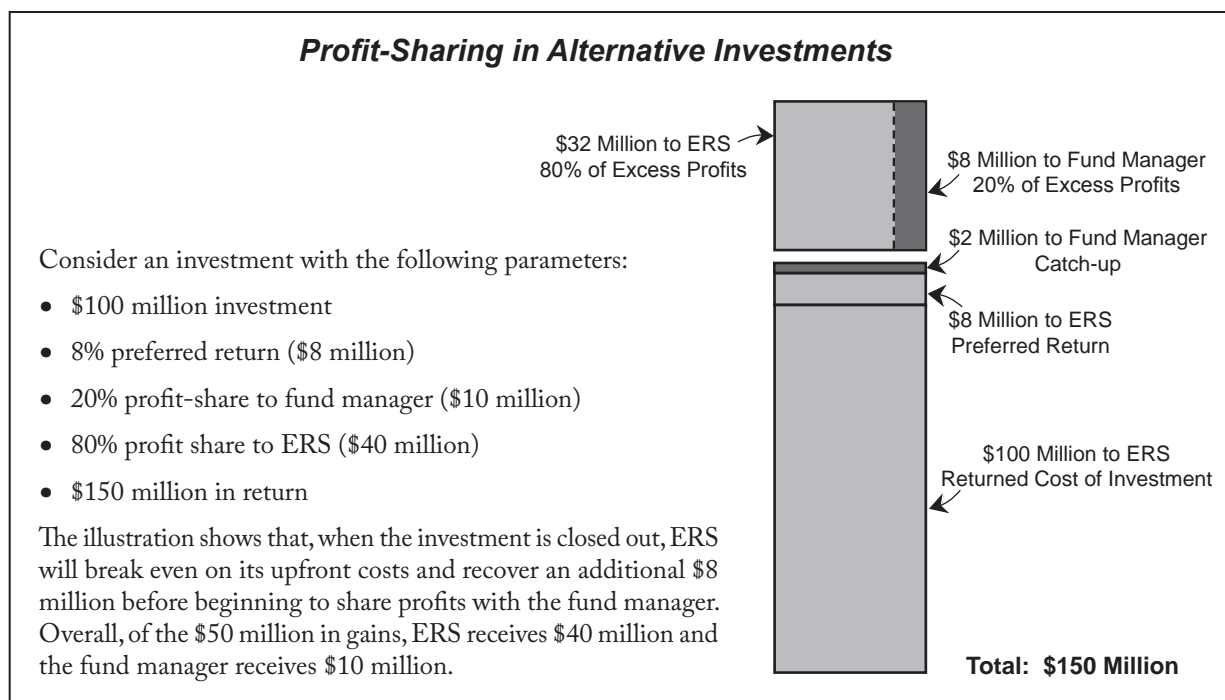
Preferred Return: A minimum investment target negotiated between an investor and the fund manager that must be paid to the investor prior to profit-sharing beginning. As an example, preferred returns in private equity are often around 8 percent of the original investment.

Profit-sharing: An agreement negotiated between investors and fund managers to share profits of an investment at a certain percentage. The industry standard is 80 percent of profits go to the investor and 20 percent to the fund manager. Profit-sharing does not begin until the investment meets its preferred return. Also called carried interest, performance fees, incentives fees, or incentive allotments.

Catch-up: A distribution made to the fund managers to allow them to “catch up” with the investor's returns. Because the investor gets 100 percent of the preferred return, the catch-up allows the fund manager to receive enough distributions to bring the ratio from 100/0 to the agreed 80/20 profit share. After this, each dollar is split 80/20.

The profit-sharing component incentivizes fund managers to maximize returns on these investments so they can receive a share of the profit and ensures investors, like ERS, only share profits if the investment exceeds its minimum target. Initially, 100 percent of returns on the investment will be returned to ERS. However, ERS and the fund manager negotiate an investment target, or “preferred return,” and once the investment meets this target and begins returning additional money beyond that, ERS and the fund manager share the additional profits. In fiscal year 2015, ERS’ alternative investment fund managers received \$75.1 million in shared profits, which was associated with \$478.9 million in gains to ERS. The illustration, *Profit-Sharing in Alternative Investments*, depicts a simplified example of how this complex profit-sharing arrangement might work.¹

Sunset staff did not evaluate ERS’ decisions on the wisdom of investing in alternative assets or the amount allocated to those assets. Instead, staff focused on the contracting and management processes in place to evaluate whether these decisions are executed in an effective manner that minimizes risk to the agency.



Findings

ERS does not consistently track or report the amount of profit shared with alternative investment fund managers, limiting transparency.

- **Limited tracking.** ERS does not have a complete picture of the cost of its alternative investments because the agency does not systematically track the amount of profits shared with alternative investment fund managers. To fulfill a Sunset request for this information, ERS staff had to hand-count the amounts in about 200 distribution letters from its various fund managers. In some cases, the letters did not explicitly include the amount of profit shared with the fund managers, requiring ERS staff to perform their own calculations to determine the amounts.

Because the amount of profit shared is likely to fluctuate over the life of the fund, and may decrease as the fund value changes, calculated numbers often only represent a point-in-time snapshot of the amount that has been shared so far. However, without sufficient data on these relatively new asset classes, ERS cannot fully assess the costs of investing in them, particularly relative to traditional asset classes with more minimal associated fees and expenses. As ERS approaches setting a new asset allocation within the next year, this data could help the board in determining whether and how to adjust the allocation of alternative investments.

- **No reporting.** ERS provides no publicly available information on its profit-sharing, which makes understanding the true costs of alternative investments impossible for the Legislature, members, stakeholders, and the general public. In its *Comprehensive Annual Financial Report* (CAFR), ERS generally reports other costs associated with its investments program, including fees and commissions paid in traditional asset classes and fees paid to investment consultants. However, the list of “Management Fees for Alternative Investments” does not include the full costs of the alternative investments. Initially, ERS was unable to identify whether this list includes profit-sharing for hedge funds. Staff later determined the list only reflects management fees and does not include profit-sharing amounts for any alternative investments.

ERS' annual financial report does not include the full costs of alternative investments.

The need for more transparency in public pensions' alternative investment costs has been recognized nationally and several states have begun to address this concern.

With more public pension systems investing in alternative assets, stakeholders have begun demanding additional transparency to help determine whether public pensions are really getting a good deal on their investments. The Pew Charitable Trusts recently released a report on transparency in state pension funds and alternative investment costs, and recommended several practices for improving public access to and understanding of the costs associated with alternative investments, such as adopting reporting standards and enhanced reporting.² Additionally, because fund managers have traditionally wielded more negotiating power in these profit-sharing arrangements, the Institutional Limited Partners Association, a trade association for institutional investors like ERS, has become more active in advocating for transparency and consistency on behalf of investors, including developing a set of best practices and standard reporting templates for fund managers to use when distributing investment returns.

Groups have begun developing best practices and standards for reporting profit-sharing.

In Texas, due to the lack of a clear definition of profit-sharing under the state's Public Information Act, most Texas public pension systems have considered such information confidential. However, “in the interest of greater transparency,” the Texas County and District Retirement System (TCDRS) reports the total amount of profit-sharing for each asset type.³ Further, other states, such as California, Rhode Island, and New Mexico have taken steps to increase

transparency associated with alternative investments, such as requiring pensions to explicitly disclose fees and expenses; prohibiting state pensions from doing business with fund managers who do not publicly disclose fees; and developing internal tools that account for fees and expenses when assessing fund manager performance.⁴ The South Carolina Retirement System has one of the more extensive and transparent cost reports for alternative investments in the country, itemizing all fees and profit-sharing separately by fund.⁵ Systems that have started reporting their profit-sharing generally acknowledge the difficulties in calculating these amounts and note values will fluctuate over the life of long-term alternative investments.

Recommendation

Change in Statute

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

This recommendation would require ERS to track internally and report publicly the amount of profit-sharing, also known as performance fees, incentive fees, or carried interest, for all its alternative investments. Staff should use this data to advise the ERS Board of Trustees on its future asset allocation determinations. With the additional information available, ERS staff and the board would be able to better assess the costs of alternative investments relative to other asset classes and make more informed decisions about the fund's asset allocation.

- **Tracking.** ERS should develop a consistent method for calculating profit-sharing amounts, guided by best practices and standards as they develop among investment professionals. Using this method, ERS should consistently track these amounts, along with the associated amount of realized gains from these alternative investments.
- **Reporting.** At a minimum, ERS should report the aggregate amount of profit-sharing, by asset type, in its CAFR and other investment reports and board presentations. ERS could qualify these amounts to explain any consideration necessary for understanding the information. This information would make the full costs of alternative investments more transparent and give members and policymakers a more complete understanding of the results and costs of ERS' different investment strategies. While state law and industry norms may influence ERS' options for how it reports these alternative investment costs, ERS should strive for the most transparent option. For example, the South Carolina Retirement System itemizes all fees and profit-sharing separately by fund, but ERS should determine if reporting this level of detail puts ERS at a disadvantage in negotiating contract terms with fund managers.⁶ However, as industry standards continue to change, and to the extent ERS is able to move toward clear and fully transparent reporting without affecting its ability to do business, it should do so.

Fiscal Implication

These recommendations would not result in additional costs to the state. Tracking and reporting data associated with alternative investments could be accomplished within ERS' existing resources.

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¹ Please note alternate investments are often contractual agreements lasting 10 or more years, and which investors do not expect to return profit within the first year. Additionally, assuming the investment is successful and makes money, the upfront management fee and expenses will normally be returned to the investor along with the return of the initial investment. This sample investment is extremely simplified and only provided for basic illustration purposes.

² Pew Charitable Trusts, *Making State Pension Investments More Transparent*, (Pew Charitable Trusts, 2016), accessed March 28, 2016, <http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/02/making-state-pension-investments-more-transparent>.

³ Texas County & District Retirement System, *Comprehensive Annual Financial Report* (Austin: Texas County & District Retirement System, 2014), 55–56, accessed March 28, 2016, <https://www.tcdrs.org/TCDRS%20Publications/2014CAFR.pdf>.

⁴ Corey Harris, “CA Legislation Would Require Pensions to Disclose Fees and Expenses of Alternative Investments,” *Lexology*, March 21, 2016, <http://www.lexology.com/library/detail.aspx?g=84148055-8242-44d0-b6d8-0b6802ecb8bc>; Office of General Treasurer Seth Magaziner, “Treasurer Magaziner Unveils ‘Transparent Treasury’ Initiative,” news release, May 26, 2015, <http://www.ri.gov/press/view/24905>; James Comtois, “Rhode Island takes transparency to new level” *Pensions & Investments*, June 29, 2015, <http://www.pionline.com/article/20150629/PRINT/306299974/rhode-island-takes-transparency-to-new-level>.

⁵ Pew Charitable Trusts, *State Pension Investments*, 4–5; Andrea Dang, David Dupont, and Mike Heale, *The Time Has Come for Standardized Total Cost Disclosure for Private Equity*, (Toronto: CEM Benchmarking Inc., 2015), 4–5, accessed March 28, 2016, http://www.cembenchmarking.com/Files/Documents/CEM_article_-_The_time_has_come_for_standardized_total_cost_disclosure_for_private_equity.pdf; South Carolina Public Employee Benefit Authority (PEBA), *Comprehensive Annual Financial Report* (Columbia, South Carolina: South Carolina Public Employee Benefit Authority, 2015), 48, accessed March 28, 2016, <https://www.peba.sc.gov/assets/cafr.pdf>.

⁶ PEBA, *Comprehensive Annual Financial Report*, 103–107.

ISSUE 5

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

Background

Over the years, Sunset reviews have included a number of standard elements either from direction traditionally provided by the Sunset Commission, or from statutory requirements added by the Legislature to the Criteria for Review in the Sunset Act, or from general law provisions generally imposed on state agencies. The following material highlights the changes needed to conform the Employees Retirement System of Texas' (ERS) statute to Sunset across-the-board recommendations (ATBs) and to address the need for the agency's required reports.

- **Sunset across-the-board provisions.** The Sunset Commission has developed a set of standard recommendations that it applies to all state agencies reviewed unless an overwhelming reason exists not to do so. These ATBs reflect an effort by the Legislature to place policy directives on agencies to prevent problems from occurring, instead of reacting to problems after the fact. ATBs are statutory administrative policies adopted by the Sunset Commission that contain "good government" standards for state agencies. The ATBs reflect review criteria contained in the Sunset Act designed to ensure open, responsive, and effective government.
- **Reporting requirements.** The Sunset Act establishes a process for the Sunset Commission to consider if reporting requirements of agencies under review need to be continued or abolished.¹ The Sunset Commission has interpreted these provisions as applying to reports that are specific to the agency and not general reporting requirements that extend well beyond the scope of the agency under review. Reporting requirements with deadlines or that have expiration dates are not included, nor are routine notifications or notices, or posting requirements.

Findings

ERS' statute does not reflect standard language typically applied across the board during Sunset reviews.

- **Board member training.** Members of the ERS Board of Trustees receive training from ERS staff and must participate in the Pension Review Board's Minimum Educational Training Program. However, ERS' statute does not specifically establish the type of training and information trustees need to properly execute their duties.
- **Alternative dispute resolution.** ERS' statute does not include a standard provision relating to alternative rulemaking and dispute resolution that the Sunset Commission routinely applies to agencies under review. Without this provision, ERS could miss ways to improve rulemaking and dispute resolution through more open, inclusive, and conciliatory processes designed to solve problems by building consensus rather than through contested proceedings.

All of the agency's reporting requirements continue to be useful, but one has an inappropriate due date.

One agency report does not allow inclusion of the most accurate data.

State law requires ERS to produce eight reports specific to the agency's functions, three of which are required by riders to the General Appropriations Act. Appendix C summarizes ERS' reporting requirements, all of which Sunset staff determined still serve a useful purpose.

The annual *Cost Management and Fraud Report* currently provides valuable information about managed care cost containment practices and fraud prevention procedures in ERS' Group Benefits Program, and would provide even more comprehensive information about the program in the future, as recommended in Issue 2. While the report remains useful to the ERS Board of Trustees and stakeholders, the January 1 due date does not allow inclusion of the most accurate healthcare data since final health insurance claims data are not available until mid-January, after the report is due.

Recommendations

Change in Statute

5.1 Apply standard across-the-board requirements to ERS.

- **Board member training.** This recommendation would formally require trustees to receive training and clearly establish the type of information to be included in the training. The training would need to provide trustees with information regarding the legislation that created ERS; its programs, functions, rules, and budget; the results of its most recent formal audit; the requirements of laws relating to open meetings, public information, administrative procedure, and conflicts of interest; and any applicable ethics policies. ERS' current internal training for trustees would likely meet these training requirements and this recommendation would not conflict with or replace the Pension Review Board's required training.
- **Alternative dispute resolution.** This recommendation would ensure ERS develops and implements a policy to encourage alternative procedures for rulemaking and dispute resolution, conforming to the extent possible, to model guidelines by the State Office of Administrative Hearings. The agency would also coordinate implementation of the policy, provide training as needed, and collect data concerning the effectiveness of these procedures.

5.2 Change the due date for the *Cost Management and Fraud Report* and continue the agency's other reports.

This recommendation would allow ERS to include the most accurate and up-to-date healthcare data regarding insurance claims in its *Cost Management and Fraud Report* by requiring the report to be submitted by February 1 instead of January 1 each year. The remaining seven reports would continue, since they provide valuable information for the agency, board, and stakeholders.

Fiscal Implication

These recommendations would not have a fiscal impact to the state or ERS.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.0075, 325.011(13), and 325.012(a)(4), Texas Government Code.

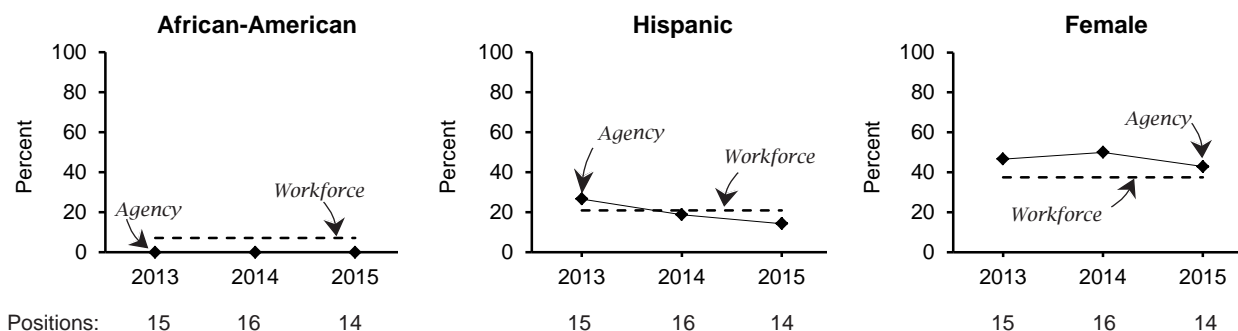
APPENDICES

APPENDIX A

Equal Employment Opportunity Statistics 2013 to 2015

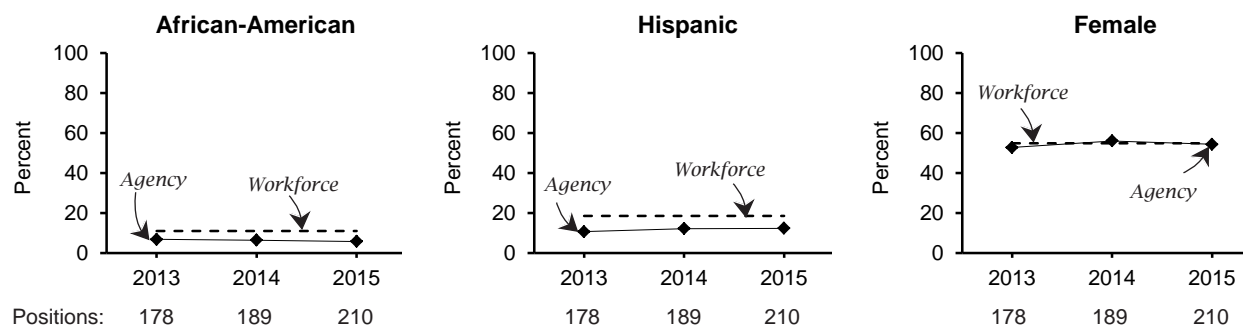
In accordance with the requirements of the Sunset Act, the following material shows trend information for the employment of minorities and females in all applicable categories by the Employees Retirement System of Texas (ERS).¹ The agency maintains and reports this information under guidelines established by the Texas Workforce Commission.² In the charts, the dashed lines represent the percentages of the statewide civilian workforce for African-Americans, Hispanics, and females in each job category.³ These percentages provide a yardstick for measuring agencies' performance in employing persons in each of these groups. The diamond lines represent the agency's actual employment percentages in each job category from 2013 to 2015. For most categories, ERS has fallen slightly below civilian workforce percentages. However, ERS has very few employees in the service/maintenance and skilled craft categories. ERS has a recruitment plan it reviews annually to ensure it reflects the agency's goals.

Administration



ERS fell below the civilian workforce percentages for African-Americans in all three fiscal years and for Hispanics in fiscal years 2014 and 2015, but exceeded the percentages for females in the last three fiscal years.

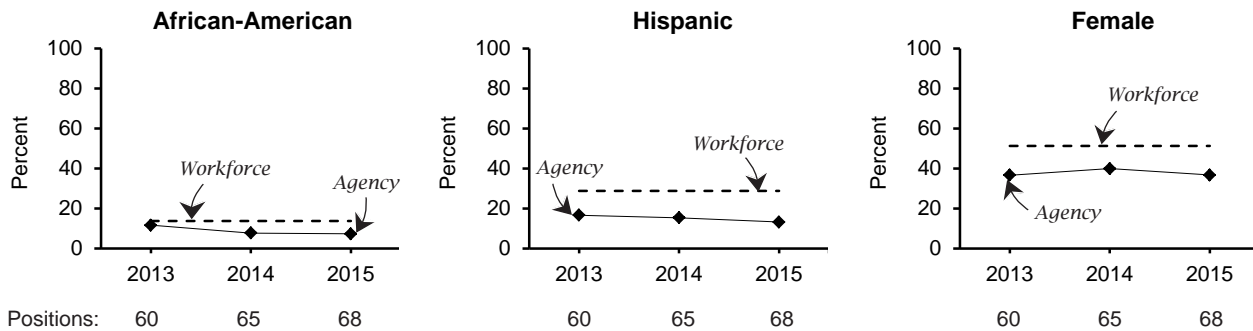
Professional



ERS fell slightly below the civilian workforce percentages for minorities and females in the last three fiscal years.

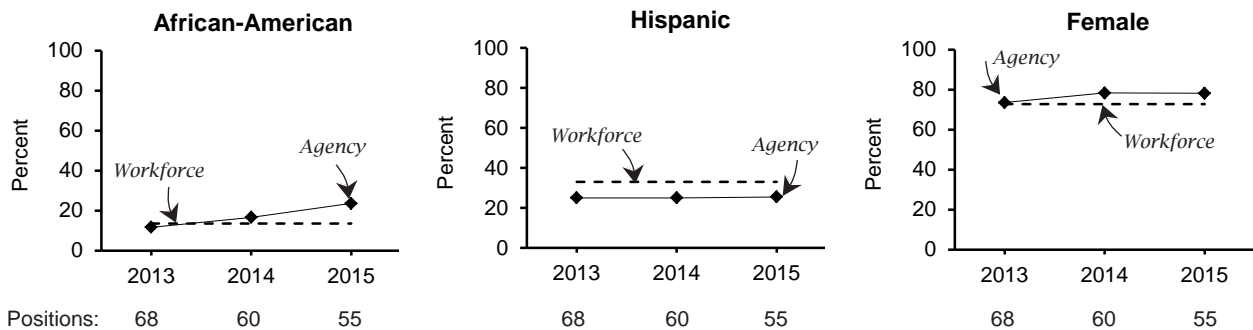
Appendix A

Technical



ERS fell below the civilian workforce percentages for minorities and females in the last three fiscal years.

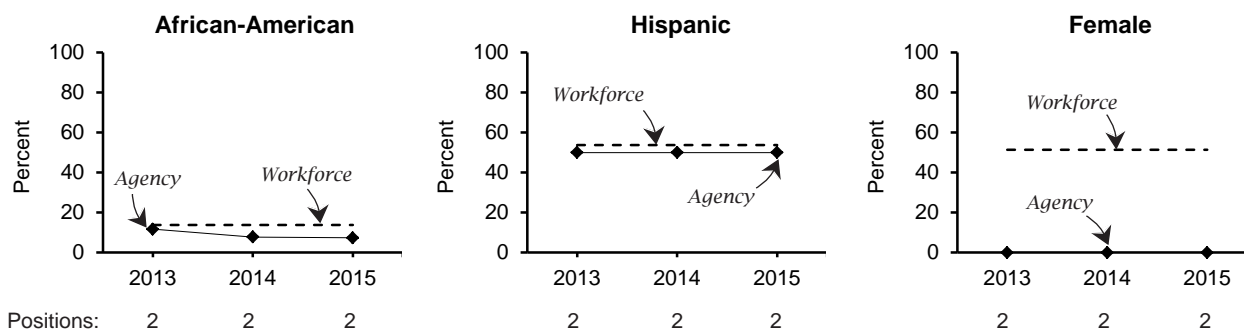
Administrative Support



ERS exceeded or almost exceeded the civilian workforce percentages for African-Americans and females in the last three fiscal years, but fell slightly below the percentages for Hispanics.

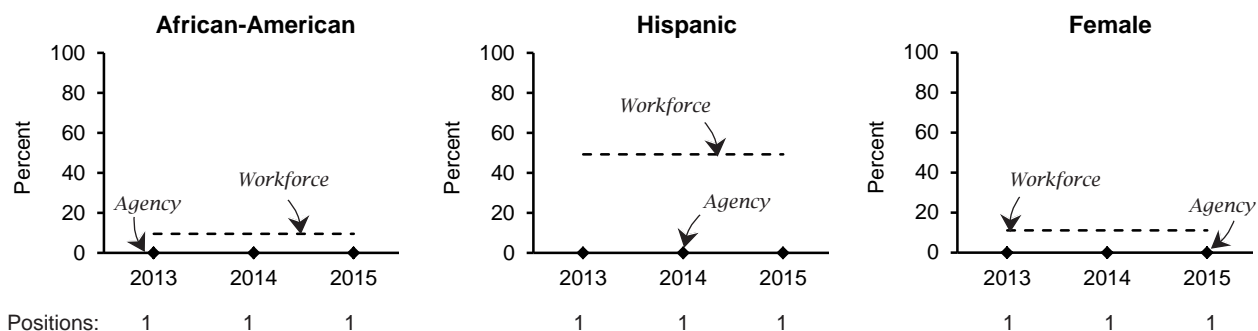
Appendix A

Service/Maintenance



ERS did not meet the civilian workforce percentages for minorities or females in the last three fiscal years, but has only two employees in this category.

Skilled Craft



ERS did not meet the civilian workforce percentages for minorities or females in the last three fiscal years, but has only one employee in this category.

¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.011(9)(A), Texas Government Code.

² Section 21.501, Texas Labor Code.

³ Based on the most recent statewide civilian workforce percentages published by the Texas Workforce Commission.

APPENDIX B

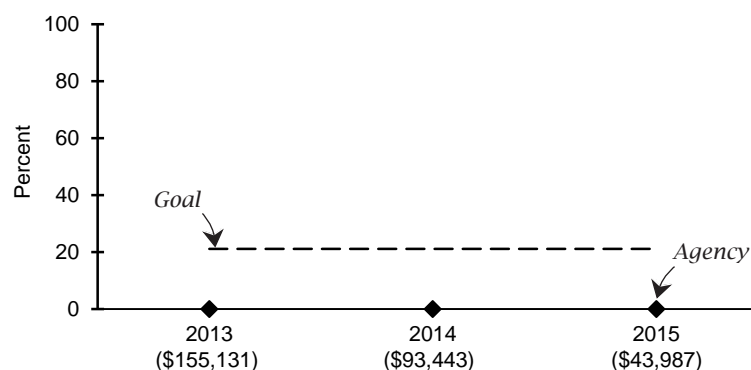
Historically Underutilized Businesses Statistics 2013 to 2015

The Legislature has encouraged state agencies to increase their use of historically underutilized businesses (HUBs) to promote full and equal opportunities for all businesses in state procurement. The Legislature also requires the Sunset Commission to consider agencies' compliance with laws and rules regarding HUB use in its reviews.¹

The following material shows trend information for the Employees Retirement System of Texas' (ERS) use of HUBs in purchasing goods and services. The agency maintains and reports this information under guidelines in statute.² In the charts, the dashed lines represent the goal for HUB purchasing in each category, as established by the comptroller's office. The diamond lines represent the percentage of agency spending with HUBs in each purchasing category from 2013 to 2015. Finally, the number in parentheses under each year shows the total amount the agency spent in each purchasing category.

ERS' HUB spending for commodities and other services has increased since 2013 and exceeded the statewide HUB purchasing goals in 2015. ERS did not meet the goal for building construction, special trade, or professional service in the last three years. ERS follows the comptroller's HUB rules and complies with other HUB-related requirements, including requiring subcontracting plans for large contracts, appointing a HUB coordinator, and developing a mentor-protégé program.

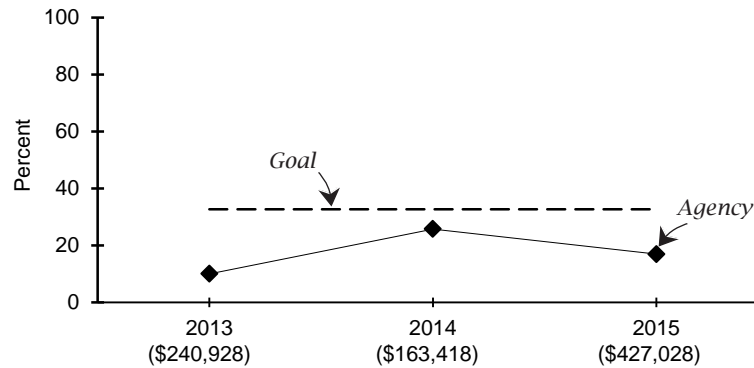
Building Construction



ERS fell consistently below the state goal for HUB spending for building construction from 2013 to 2015, but had limited spending in this category.

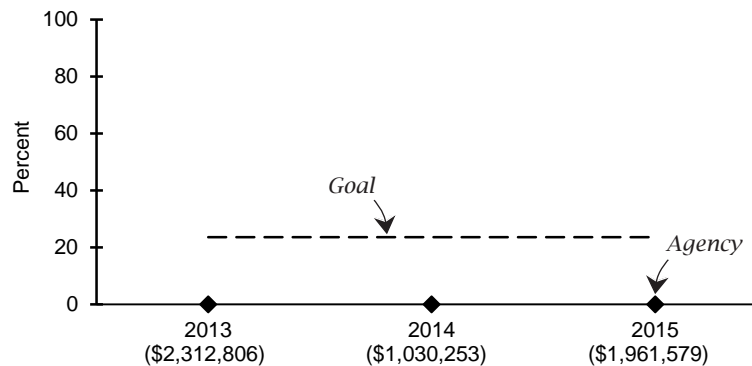
Appendix B

Special Trade



ERS did not meet the state goal for special trade in each of the last three years.

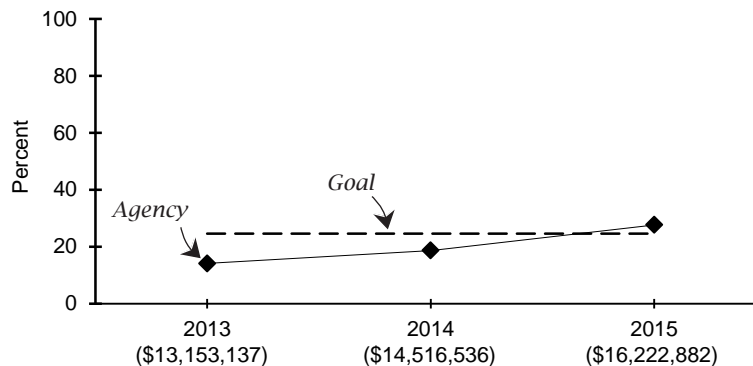
Professional Services



ERS failed to meet the statewide goal for HUB spending for professional services from 2013 to 2015. ERS indicates it has few contracts in the professional services category due to the nature of services in the category.

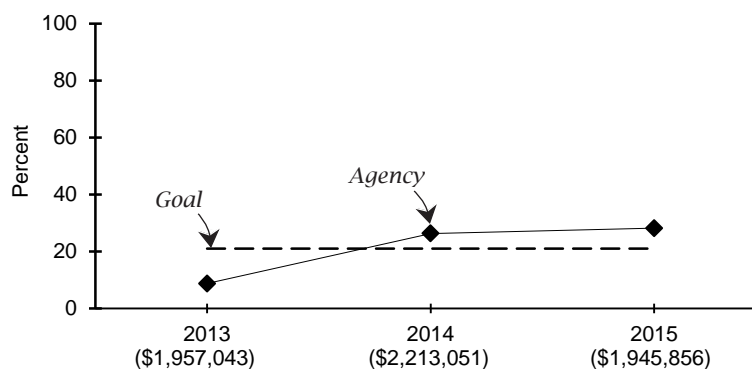
Appendix B

Other Services



ERS fell just short of the state goal for other services in 2013 and 2014, but exceeded the goal in 2015.

Commodities



ERS fell just short of the state goal for commodities in 2013, but exceeded the goal in 2014 and 2015.

¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.011(9)(B), Texas Government Code.

² Chapter 2161, Texas Government Code.

APPENDIX C

Employees Retirement System of Texas Reporting Requirements

Report Title	Legal Authority	Description	Recipient	Sunset Evaluation
1. Cost Management and Fraud Report	Section 1551.061, Texas Insurance Code	Annual report on the effectiveness and efficiency of managed care cost containment practices, and fraud detection and prevention procedures within the Group Benefits Program.	Governor, Lieutenant Governor, Speaker, and Legislative Budget Board	Continue – Change due date from January 1 to February 1 of each year.
2. Investments Annual Summary	Section 815.510, Texas Government Code	Includes the end-of-fiscal year market value of the trust fund, asset allocations of the trust fund, and the investment performance of the trust fund using accepted industry measurement standards.	Governor, Lieutenant Governor, Speaker, Legislative Budget Board, Pension Review Board Executive Director, and appropriate oversight committees	Continue
3. Sudan Investments	Section 806.102, Texas Government Code	Reports on investments sold, redeemed, divested, or withdrawn related to the requests of the statute.	Presiding Officer of each house of the Legislature, Attorney General, and U.S. Presidential Special Envoy to Sudan	Continue
4. Iran Investments	Section 807.102, Texas Government Code	Reports on investments sold, redeemed, divested, or withdrawn related to the requests of the statute.	Presiding Officer of each house of the Legislature and Attorney General	Continue
5. Actuarial Experience Study	Section 815.206, Texas Government Code	Actuarial investigation of the mortality, service, and compensation experience of the members and beneficiaries of the retirement system.	Not applicable	Continue
6. Updated Actuarial Valuation	Rider 3, page I-34, Article I (H.B. 1), Acts of the 84th Legislature, Regular Session, 2015 (the General Appropriations Act).	A limited actuarial valuation of the assets and liabilities of ERS to determine the effect of investment, salary, and payroll experience on the trust fund.	None specified	Continue

Appendix C

Report Title	Legal Authority	Description	Recipient	Sunset Evaluation
7. HealthSelect Contract Follow Up	Rider 13, page I-35, Article I (H.B. 1), Acts of the 84th Legislature, Regular Session, 2015 (the General Appropriations Act)	Demonstrates compliance with the state's <i>Contract Management Guide</i> , including all documentation verifying the request for proposal will comply with the statutory requirements and ERS policies. Provides documentation of the established evaluation process, process for verifying the mathematical accuracy of the evaluation, and an explanation as to why any recommendations included in the audit were not complied with. Certifies all processes were followed during the procurement and development process.	Varies. Includes State Auditor's Office, Legislative Budget Board, Office of the Attorney General, and Comptroller	Continue
8. Diabetes Type 2 Report	Rider 14, page I-36, Article I (H.B. 1), Acts of the 84th Legislature, Regular Session, 2015 (the General Appropriations Act)	Analysis related to providing an evidence-based prevention program.	Legislature and Governor	Continue

APPENDIX D

Staff Review Activities

During the review of the Employees Retirement System of Texas (ERS), Sunset staff engaged in the following activities that are standard to all Sunset reviews. Sunset staff worked extensively with agency personnel; attended board meetings; met with staff from key legislative offices; conducted interviews and solicited written comments from interest groups and the public; reviewed agency documents and reports, state statutes, legislative reports, previous legislation, and literature; researched the agency and functions of similar state agencies in other states; and performed background and comparative research.

In addition, Sunset staff also performed the following activities unique to ERS:

- Surveyed employees of state agencies and institutions of higher education, as well as retirees, and other ERS members and stakeholders
- Observed vendor finalist interviews for the health savings account program
- Observed three Grievance Review Committee meetings
- Interviewed select current, former, and potential ERS vendors
- Attended two health benefit information fairs
- Attended a solution session presentation
- Attended a due diligence site visit for a potential infrastructure investment

Sunset Staff Review of the *Employees Retirement System of Texas*

————— *Report Prepared By* —————

Emily Johnson, *Project Manager*

Krystal Duran

Danielle Nasr

Skylar Wilk

Janet Wood

Jennifer Jones, *Project Supervisor*

Ken Levine
Director

Sunset Advisory Commission

Location
Robert E. Johnson Bldg., 6th Floor
1501 North Congress Avenue
Austin, TX 78701

Mail
PO Box 13066
Austin, TX 78711

Website
www.sunset.texas.gov

Email
sunset@sunset.texas.gov

Phone
(512) 463-1300