An Audit Report on

The State Treasury and Its Trust Company, the Texas Tomorrow Fund, and TexPool

October 2001

Report No. 02-007

State Auditor's Office

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State Auditor

Key Points of Report

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Overall Conclusion

Treasury Operations (Treasury), a division within the Office of the Comptroller of Public Accounts (Comptroller), handles more than $1 trillion in financial transactions and manages more than $25 billion in investments directly and through its wholly owned Texas Treasury Safekeeping Trust Company (Trust Company). While we saw no evidence of loss or misappropriation of state assets, the fact that the Treasury does not adhere to certain significant industry standards followed by its counterparts in the private sector could increase the risk that such incidents could occur. No statute or regulation requires the Treasury to adhere to these standards.

During our audit work, we identified substantial opportunities for improvement in organizational structure, staffing, and internal controls. We brought these to the attention of the Comptroller. The Comptroller has started to implement the majority of the recommendations we made regarding these issues, and we encourage the Comptroller to continue this effort.

Key Facts and Findings

- Although the Treasury is not expressly obligated to adhere to financial industry and regulatory standards, doing so could help it maximize investment returns, improve internal controls, enhance its accounting and information system, and strengthen its monitoring efforts.
- Aspects of Trust Company oversight, policy, and investment practices need to be strengthened.
- As of August 31, 2000, the Texas Tomorrow Fund remained actuarially sound and provided the expected prepaid tuition services. However, financial risks associated with this $970 million financial institution need to be identified and addressed to ensure the Fund's viability.
- Management of the Texas Local Government Investment Pool (TexPool) has restored confidence so that the pool continues to grow. However, there are still opportunities to improve TexPool's operations.

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This audit was conducted in accordance with Government Code, Sections 321.013(a) and 404.104.

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Executive Summary

Treasury Operations (Treasury), a division within the Comptroller of Public Accounts (Comptroller), handles more than $1 trillion in financial transactions and manages more than $25 billion in investments directly and through its wholly owned Texas Treasury Safekeeping Trust Company (Trust Company) without adhering to certain significant financial industry standards followed by its counterparts in the private sector.

Funds Managed by the Treasury as of August 31, 2000

- $1.1 billion long-term endowment funds originating from the tobacco settlement
- $295 million long-term Higher Education Fund endowment
- $199 million Texas Tomorrow Fund fixed income portfolio
- $8.3 billion TexPool portfolio
- $2.4 billion in trust accounts on behalf of 21 state agency clients
- $13.5 billion primarily in operating funds

Source: Treasury's annual financial report

While we saw no evidence of loss or misappropriation of state assets, the fact that the Treasury does not adhere to these standards increases the risk that such incidents could occur. The Treasury is not expressly obligated to adhere to the financial industry and regulatory standards that are applicable to banks and trust companies, but doing so could help it improve its operations and maximize investment returns.

The State Treasury and the Trust Company

The State Treasury, merged by constitutional amendment with the Comptroller of Public Accounts in 1996, conducts its operations directly and through the Texas Treasury Safekeeping Trust Company (Trust Company). The operations of the Treasury and the Trust Company are intertwined and, therefore, we reviewed the organizations as one entity.

The Trust Company provides the Treasury with direct access to the Federal Reserve System. With this access, the Treasury can initiate and receive transfers of money by wire, pay state warrants, and settle and maintain custody of government securities without using a separate bank. The Comptroller of Public Accounts is the sole officer, director, and shareholder of the Trust Company.

During the course of our audit work, we identified substantial opportunities for improvement in organizational structure, staffing, and internal controls and brought these to the attention of the Comptroller. The Comptroller has started to implement the majority of the recommendations we made regarding these issues, and we encourage the Comptroller to continue strengthening the operations of the Treasury and the Trust Company. This effort will require firm commitment on the part of the Comptroller, the Treasury, and the Trust Company.

Conduct Treasury Operations According to Well-Established Financial Industry and Regulatory Standards

Although the Treasury is not expressly required to follow most relevant banking, securities, and trust standards and regulations, it could benefit from adhering to these standards and regulations as a matter of "good practice" for a fiduciary and self-governed financial institution. In many respects, the Treasury's activities are similar to those of a bank or trust company.

Adhering to standards and regulations is of particular importance for the Treasury. Unlike its counterpart in other states, the Treasury does not use an intermediary bank to provide services. The use of an intermediary bank reduces risk because the intermediary bank overlays its own set of internal control procedures and is potentially liable for loss in the event of errors or irregularities.

The fact that the Treasury was not required to adhere to industry standards may have contributed to it not being prepared to assume the responsibility it was given during the late 1990s to manage long-term investment funds. Specifically, the Treasury held most of its long-term funds in cash investments until it hired investment managers in October 2000. This was nearly four years after initial funding of the Higher Education Fund, 16 months after the authorizing legislation was enrolled for the Public Health Fund, and 16 months after the authorizing legislation was enrolled for the Tobacco Settlement Permanent Trust Fund.

In 2000 and 2001, the Treasury started taking steps toward strengthening its investment operations by establishing investment allocation plans, hiring investment consultants, adding key investment staff positions, and hiring a network of experienced external money managers.

Adhering to customary financial industry standards could help the Treasury take the following steps to further strengthen its operations:

- **Aspects of Trust Company oversight, policy, and investment practices could be strengthened.** Before 2001, the Treasury's Trust Company operated without the benefit of oversight provided by a governing board or advisory board. However, the 77th Legislature authorized the Comptroller to appoint an advisory board to advise the Comptroller with respect to managing the assets held by the Comptroller's Trust Company.

  The creation of an advisory board is a step toward strengthening the Trust Company's operations. However, the manner in which the advisory board operates will be crucial in ensuring that the Trust Company receives the full potential benefit of this change. For example, adopting the Federal Depository Insurance Company's basic principles of trust and forming a trust committee could help bolster the Trust Company's operations.

- **The Treasury should continue strengthening its investment expertise.** The Treasury's long-term investment responsibilities expanded before it had acquired the necessary investment expertise. However, the recent and proposed addition of key positions at the Treasury should improve investment results, reduce risk, and strengthen controls and safeguards.

- **The Treasury's internal controls could be strengthened to better safeguard the State's assets.** The Treasury could bolster its operations by following the three internal control objectives and the nine internal control procedures identified by the Federal Reserve Board as necessary for providing adequate safeguards. Although the Treasury is not expressly obligated to adhere to these standards, it could benefit from following them.

- **The accounting and information system used by the Treasury and the Trust Company should be improved to meet financial industry standards**. The accounting and information system used by the Treasury and the Trust Company does not fully accommodate standards for financial institutions. Although they are not expressly required to adhere to such standards, the Treasury and the Trust Company should have an accounting and information system that provides management with the best information on which to base investment decisions. Complying with financial industry standards would help to achieve this.

- **The Treasury should consider implementing the monitoring standards required of financial institutions.** The Treasury does not adhere to some of the monitoring requirements that are commonly applied to financial institutions. Such requirements include ensuring regular internal audit coverage based on the standards applicable to financial institutions, obtaining unqualified auditor opinions on the comprehensive annual financial statements, and obtaining periodic audits based on regulatory examination standards. Although it is not required, adhering to these monitoring standards could help ensure that management acts in a disciplined fashion, operations are sound, and the organization has adequate professional knowledge.

Identify and Address Texas Tomorrow Fund Financial Risks

As of August 31, 2000, the Texas Tomorrow Fund remained actuarially sound and provided the expected prepaid tuition services. However, financial risks associated with this $970 million financial institution need to be clearly identified and addressed to ensure the Fund's viability.

Improve Monitoring of TexPool Contractors

The management of the Texas Local Government Investment Pool (TexPool) has restored confidence so that TexPool continues to grow. However, there are still opportunities for Treasury management to improve operations. (The Comptroller of Public Accounts manages TexPool through the Comptroller's Treasury Division.) TexPool management needs to improve its monitoring of the contractors who conduct TexPool's operations, consider increasing the range of eligible investments, and enhance the role of the TexPool Advisory Board. As of August 31, 2000, TexPool managed $8.3 billion for 1,598 local governmental entities.

Summary of Management Responses

With certain exceptions, the Comptroller generally agrees with our findings and recommendations.

Summary of Audit Objectives

Treasury and Trust Company. Our first objective was to determine whether the Trust Company employs effective controls and procedures when processing the State's transactions and assess whether it effectively and appropriately manages the funds under its care.

Our second objective was to determine whether the Treasury has implemented the recommendations made in a previous State Auditor's Office report (*A Review of Controls Over Investment Practices at Six Major State Investing Entities,* SAO Report No. 97-014, November 1996).

Texas Tomorrow Fund. Our objective was to assess the Texas Prepaid Higher Education Tuition Board's oversight of the Texas Tomorrow Fund's actuarial assumptions, contracting decisions, benchmarking, and risk assessment process.

TexPool. Our objective was to determine whether the Texas Local Government Investment Pool receives sufficient monitoring.

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The Texas State Treasury
and
the Texas Treasury Safekeeping Trust Company

Overall Summary

Treasury Operations (Treasury), a division within the Comptroller of Public Accounts (Comptroller), handles more than $1 trillion in financial transactions and manages more than $25 billion in investments directly and through its wholly owned Texas Treasury Safekeeping Trust Company (Trust Company) without adhering to certain significant financial industry standards followed by its counterparts in the private sector.

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Source: Treasury's annual financial report

While we saw no evidence of loss or misappropriation of state assets, the fact that the Treasury does not adhere to these standards increases the risk that such incidents could occur. No statute or regulation expressly requires the Treasury to adhere to the financial industry and regulatory standards that are applicable to banks and trust companies, but doing so could help it improve its operations and maximize investment returns.

During the course of our audit work, we identified substantial opportunities for improvement in organizational structure, staffing, and internal controls, and brought these to the attention of the Comptroller. The Comptroller has started to implement the majority of the recommendations we made regarding these issues, and we encourage the Comptroller to continue strengthening the operations of the Treasury and the Trust Company. This effort will require firm commitment on the part of the Comptroller, the Treasury, and the Trust Company.

Section 1:

Conduct Treasury Operations According to Well-Established Financial Industry and Regulatory Standards

Although the Treasury is not expressly required to follow most relevant banking, securities, and trust standards and regulations, it could benefit from adhering to these standards and regulations as a matter of "good practice" for a fiduciary and self-governed financial institution. In many respects, the Treasury's activities are similar to those of a bank or trust company (see text box).

Banking Activities Performed By the Treasury

- Accepting and processing deposits
- Receiving and sending wires
- Clearing checks and drafts
- Providing cash management services such as lockbox processing
- Settling securities transactions through the Federal Reserve or the Depository Trust Company
- Keeping custody of securities
- Safeguarding valuable items in a vault
- Pooling and investing funds on behalf of others
- Acting as an escrow agent or bond trustee
- Managing endowment funds
- Acting as a fiduciary

Adhering to standards and regulations is of particular importance for the Treasury. Unlike its counterparts in most other states that use an intermediary bank to provide services, the Treasury performs many bank functions itself. These self-performed activities include directly accessing the Federal Reserve System and safekeeping the State's investments. Normally, an intermediary bank provides these services, which reduces risk because the bank overlays its own set of internal control procedures and is potentially liable for loss in the event of errors or irregularities.

Adhering to financial industry standards could help the Treasury ensure that management and staff have appropriate investment expertise, operational safeguards are adequate, and periodic monitoring occurs. In addition, following such standards could help the Treasury adjust to an expanded role that now includes managing long-term funds and providing trust services.

The fact that the Treasury was not required to adhere to industry standards may have contributed to it not being prepared to assume the responsibility it was given during the late 1990s to manage long-term investment funds. Specifically, when the Treasury initially became responsible for managing the Higher Education Fund, the Public Health Fund, and the Tobacco Settlement Permanent Trust Fund, it lacked the following fundamental investment elements:

- Asset allocation plans specifying how funds were to be invested and corresponding performance benchmarks with which to compare the funds' actual investment returns to ensure optimum return from these legislatively-mandated investments.
- Investment consultants to verify performance and recommend a strategy to properly diversify the investment portfolio and minimize risk.
- Staff with appropriate expertise to make investment decisions and supervise the investment consultants.
- A network of experienced external money managers.
- An accounting and information system that met financial industry standards and was capable of capturing and communicating all pertinent financial data.
- Independent internal investment performance measurement capability.
- An appropriate system of internal controls based on financial industry standards.
- The level of external and internal audit coverage suggested by financial industry standards.

Because its operations initially did not encompass the investment elements listed above, the Treasury held most of its long-term funds in cash investments until it hired investment managers in October 2000. This was nearly four years after the initial funding of the Higher Education Fund, 16 months after the authorizing legislation was enrolled for the Public Health Fund, and 16 months after the authorizing legislation was enrolled for the Tobacco Settlement Permanent Trust Fund. Because the value of the stock market has risen over the long-term, it is prudent to invest funds in long-term investments as promptly as possible. (See Appendix 2 on page 51 for additional detail regarding the timing of the investment of these funds.)

The Treasury has started taking steps toward improving the weaknesses noted above. Specifically, the Treasury:

- Established asset allocation plans for each long-term investment fund and began investing according to these plans in October 2000.
- Hired investment consultants in the first quarter of calendar year 2000.
- Added key investment staff positions in 2000 and 2001.
- Hired a network of experienced external money managers in October 2000.

We encourage the Comptroller to continue to strengthen the Treasury's operations.

Section 1-A:

Aspects of Trust Company Oversight, Policy, and Investment Practices Could Be Strengthened

Before 2001 the Treasury's Trust Company operated without the benefit of oversight provided by a governing board or advisory board. However, the 77th Legislature, through the addition of Texas Government Code, Section 404.108, authorized the Comptroller to appoint an advisory board to advise the Comptroller with respect to managing the assets held by the Trust Company. The Trust Company provides trust services for 21 state entities (fiduciary clients) with $2.4 billion in assets.

The creation of an advisory board is one step toward strengthening the Trust Company's operations. However, the manner in which the advisory board will operate will be crucial in ensuring that the Trust Company receives the full potential benefit of this change.

Federal Depository Insurance Company (FDIC) Guidelines for a Trust Committee

- Meet at least quarterly, and more frequently if considered necessary and prudent, to fulfill committee supervisory responsibilities.
- Approve and document the opening of all new trust department accounts; all purchases, sales, and changes in trust assets; and the closing of trust accounts.
- Provide for an annual review of each trust department account. The scope, frequency, and level of review should be addressed in written policies. Account reviews should cover both account administration and investment suitability.
- Keep comprehensive minutes of committee meetings and actions.
- Make periodic reports to the advisory board of committee actions.

Source: FDIC *Trust Examination Manual*

While the Trust Company adjusts to its changing oversight structure, it also should consider implementing the following fundamental trust department controls:

- <u>The adoption of basic principles of trust and the formation of a trust committee</u>. The Federal Depository Insurance Company (FDIC) publishes a trust company examination manual that sets out a detailed framework for the proper administration of fiduciary activities. The *Statement of Principles of Trust Department Management* (Statement) within this manual summarizes the framework viewed as a minimum standard. A key element of the Statement is the creation of a trust committee. The Statement recognizes that it might not be practical for an institution's governance structure to closely monitor the conduct of trust activities. Therefore, it suggests the creation of a specialized committee to oversee fiduciary activities to ensure that they are properly conducted (see text box).

- <u>An independent investment policy, separate from the Treasury's policy, governing the conduct of activities on behalf of each fiduciary client</u>. Such a policy establishes guidance for all areas of the Trust Company's management and operations.

In addition to operating without an independent investment policy, the Trust Company exclusively invests discretionary cash (cash for which the client has not provided specific investment instructions) in overnight repurchase agreements for many of its fiduciary clients. The Trust Company does this so that its clients will have ready access to short-term cash funds (liquidity) if needed. An alternative approach would be to consider investing these funds in short-to intermediate-term government agency securities or a local government investment pool such as the Treasury Pool or the Texas Local Government Investment Pool (TexPool). These alternatives provide the same liquidity to the client and have greater diversification. These alternatives also have longer average maturities (duration) that tend to provide higher returns.

<u>Recommendation</u>:

The Treasury should:

- Consider adopting the FDIC's *Statement of Principles of Trust Department Management* and creating a trust committee that includes individuals with relevant expertise and experience to monitor fiduciary activities as outlined in the FDIC's guidelines.
- Consider appointing Trust Company advisory board members to staggered terms and soliciting the board's advice with respect to Trust Company executive management recruitment and other financial institution matters.
- Consider establishing an investment policy specifically geared toward the Trust Company.
- Consider having the Trust Company invest discretionary cash in short- to intermediate-term government agency securities or a local government investment pool such as the Treasury Pool or TexPool.

<u>*Management's Response*</u>:

Although the entire implementation process took longer than we had anticipated and the State Auditor deemed reasonable, we believe Treasury Operations performed in a prudent manner as it assumed the role of endowment and trust fund manager. In retrospect, perhaps timeliness was compromised in the pursuit of quality and long-lasting results, however it is important to note that fund performance was not negatively impacted by the delay. There is a three-step process that must be followed when executing a start-up, long-term investment program:

- *Establish the overall goals and objectives of the funds.*
- *Determine how the assets need to be allocated and the blend of investment styles required that would historically achieve the return objectives.*

- *Perform an extensive due diligence search and review process to select the external investment managers that will best serve the needs of the fund.*

As the above steps were being performed, investment and asset allocation consultants and custodial agents were hired.

Treasury Operations accomplished all of the necessary tasks within a reasonable amount of time considering the complexity of the fund objectives, the fact that investment policies and asset allocations had not yet been developed, and the number of investment managers required. It is typical for an asset allocation study followed by an investment manager search to take up to a year from start to finish for a mature pension or endowment fund. A prudent investor should never approach such a long-term program with a knee-jerk reaction to current market conditions. It would have been irresponsible to make a less intensive due diligence effort.

With regard to your recommendations, we do share your view that there are indeed opportunities for improvement in our operation.

- *While we decline to unequivocally adopt the Federal Deposit Insurance framework, we agree that Treasury Operations could benefit from adhering to many of the banking, securities, and trust standards that are commonly practiced in the private sector. We will review the standards developed by the Federal Deposit Insurance Corporation, the Federal Reserve Bank, and the State Banking Commission in order to determine the "best practices" for a fiduciary and self-governed public financial institution. In the course of our review we will consider and closely review the FDIC's Statement of Principles of Trust Department Management.*
- *SB 1547 authorizes the creation of an Investment Advisory Board for the Comptroller's office. The members will be appointed by the Comptroller and serve at the will of the Comptroller.*
- *We agree that the Trust Company should have its own investment policy specifically geared to its operation and will develop one with the restructuring of the Safekeeping Trust Company under House Bill 2914.*
- *We agree that we should expand the options that are available for the investing of discretionary cash managed by the Trust Company for its clients and will make it a high priority with the restructuring of the Safekeeping Trust Company under House Bill 2914.*

Section 1-B:

The Treasury Should Continue Strengthening Its Investment Expertise

The Treasury's long-term investment responsibilities expanded before it had acquired the necessary investment expertise. However, the recent and proposed addition of key positions at the Treasury has begun to address issues related to limited investment expertise raised during this audit. The addition of these positions should improve investment results, reduce risk, and strengthen controls and safeguards.

Prior to the hiring of a chief investment officer in 2001, Treasury personnel responsible for investing $1.6 billion in long-term investment funds had no prior professional experience allocating and supervising investments of this nature. In addition, Treasury personnel had little to no prior professional experience hiring and monitoring external money managers for long-term investments. In addition to hiring a chief investment officer, the Treasury has filled two other positions (a manager of external managers and a compliance officer) that should help boost its investment expertise.

Recommendation:

The Treasury should:

- Continue to establish key positions with the knowledge and experience to conduct operations in a safe and sound manner.
- Fully inform the Legislature about the resource requirements and possible obstacles to implementation that could be associated with proposed additional responsibilities. If the Treasury believes it is unprepared for additional responsibilities, certain functions can be outsourced if internal expertise does not exist.

Management's Response:

- *The Comptroller's office will continue its practice of hiring competent, qualified personnel for key positions.*
- *The Comptroller's office will continue its practice of fully informing the Legislature about any and all issues concerning pending legislation. Our obligation is to comply in the most prudent and effective manner possible. This includes ensuring that we have the appropriate knowledge, experience, and qualifications on board to carry out our mission.*

Federal Reserve Board

Three Internal Control Objectives

(1) Competent persons must perform internal control procedures.

(2) Internal control procedures must both exist and be applied regularly.

(3) Independent performance must be established. Employees who have access to assets should not also have access to accounting records, perform related review of operations, or immediately supervise the activities of other employees who maintain records or perform the review operations.

Nine Internal Control Procedures

(1) Transactions and activities should be authorized.

(2) Important duties should be segregated.

(3) Assets should be under dual control.

(4) Job descriptions should be well defined.

(5) Adequate human resource polices should be established, clearly understood, and consistently followed.

(6) A consecutive absence policy should be required.

(7) Adequate documents and records should be kept.

(8) Physical safeguards over access to assets should be in place.

(9) Independent checks on performance and proper valuation of recorded amounts should be regularly conducted.

Source: *Examination Manual for US Branches and Agencies of Foreign Banking Operations*. Federal Reserve Board, Section 4020, Internal Control.

Section 1-C:

The Treasury's Internal Controls Could Be Strengthened to Better Safeguard the State's Assets

The Treasury could bolster its operations by following the internal control objectives and procedures identified by the Federal Reserve Board as necessary for providing adequate safeguards (see text box). Although the

Treasury is not expressly obligated to adhere to these standards, it could benefit from following them.

Shortly after the creation of the Trust Company in 1986 (before the Treasury was transferred to the Comptroller) the State Auditor's Office issued *A Report on the Internal Control System Necessary to Safeguard the State's Use of the Federal Reserve System Fedwire for Book-Entry Security Transfer and Safekeeping* (SAO Report No. 89-028, September 1988). In that report, we made similar recommendations to strengthen internal controls.

The following examples illustrate opportunities for improvement.

Internal Control Procedures Must Both Exist and Be Applied Regularly

The Treasury's investment policy requires that repurchase agreements bought after the Federal Reserve System closes have collateral held by third-party custodians. However, the Treasury did not have a procedure in place to verify the placement of the required collateral with the independent custodians. In addition, there was no procedure to periodically verify the counter-party's or the independent custodian's creditworthiness or to set transaction size limits. The Comptroller indicates that this situation has been corrected.

The Treasury also could strengthen its internal controls by requiring the wire room clerk to validate transactions over a specified amount by calling designated contact persons at the agencies that originate these transactions. In addition, during our audit, a Treasury wire room clerk could not visually validate signatures for wire transfer requests because this individual did not have immediate access to signature lists. Although the wire room clerk was familiar with the signatures, it is important that all authorized employees have immediate access to the documentation needed for signature verification.

Treasury Management Is Responsible For:

- Establishing and maintaining internal controls over financial reporting.
- Presenting the Treasury and Trust Company's financial position and the results of operations in conformity with generally accepted accounting principles.
- Identifying errors, irregularities, or illegal acts involving Treasury staff and taking appropriate corrective action.
- Maintaining compliance with state and federal laws and regulations.

Independent Performance Must Be Established

The Treasury's investment department has authority over the acquisition and disposition of investment assets and is responsible for the following duties that, when performed or supervised together, violate the independent performance objective. These responsibilities include:

- Investment performance reporting
- Internal administrative reporting
- Vendor procurement and contract management

A conflict of interest exists when those responsible for investment activities also directly or indirectly measure or report on their own performance.

Transactions and Activities Should Be Authorized

Certain activities that the Trust Company conducts through the Federal Reserve System are not clearly authorized by the Federal Reserve's agreement with the Trust Company. These activities include the transmittal of non-repetitive wires and the settlement of non-governmental securities transactions representing billions of dollars.

There also is a lack of clarity regarding whether the Trust Company is authorized to retain accumulated earnings from sources other than capital stock or investments. The Trust Company has accumulated capital of approximately $9.1 million ($1 million of capital stock plus accumulated earnings primarily from fees charged to TexPool customers prior to 1997). It is not apparent that there is a purpose for these accumulated earnings.

Important Duties Should Be Segregated

Wire room activities have not always been appropriately segregated from the investment function. Until 2000 the wire room, which serves as a "checks and balances" mechanism for investment transactions (see text box), was under the supervision of the manager of investments. We identified this same control weakness in *Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996).

> **What Does a Wire Room Do?**
>
> The Trust Company's wire room connects to the Federal Reserve's Fed Wire System. The Fed Wire System provides for the electronic transfer of immediate and irrevocable payments between participating institutions. It functions as both a clearing and settlement facility for funds and securities transfers.
>
> One of the Trust Company wire room's duties is to verify trade tickets prepared by investment traders and to reconcile the transactions with Federal Reserve Bank data. The wire room also performs the reconciliation of investments held in the Depository Trust Company, which holds non-government bonds and stocks.

The nature of the transactions and the magnitude of business processed electronically by means of wire transfers necessitates the implementation of strictly imposed security measures and controls. Funds transferred electronically are available immediately and can be a source of large losses due to both fraud and human error. Though we detected no fraud or abuse, there is potential for both.

In 2000 the Treasury began to address this weakness by moving the Fed Wire/Depository Trust Company supervisory line of reporting from the manager of investment to the director of treasury operations.

Assets Should Be Under Dual Control

The Treasury kept passwords to funds transfer equipment in a locked file cabinet, rather than in a vault. We observed that the key to the file cabinet was kept in a nearby unlocked desk drawer. Using these passwords, an individual could gain unauthorized access to the funds transfer system using a remote telephone.

Dual control also should be enforced in the unclaimed property vault where, on occasion, a single employee has inventoried newly arrived items. Requiring two people to perform sensitive tasks reduces the risk of loss. In addition, authorized Treasury employees individually accessed the unclaimed property vault (individuals who access the vault are not required to sign vault logs). The vault holds hard-to-trace valuables such as jewelry.

Adequate Human Resource Polices Should Be Established, Clearly Understood, and Consistently Followed

The Treasury did not conduct employee background checks that extended beyond simple employment verification. While an individual's past does not predict his or her future actions, it would be to the Treasury's advantage to conduct thorough credit, employment, and criminal background checks on prospective employees who may be responsible for handling transactions and investing state funds.

The FDIC recommends that management check the credit and previous employment references of prospective employees. The FDIC also recommends that management conduct criminal background checks. The FDIC notes that the facilities of the Federal Bureau of Investigation (FBI) are available to check fingerprints of employees and prospective employees of financial institutions. The FBI also can supply financial institutions with criminal records, if any, for individuals whose fingerprints are submitted. Alternatively, the FDIC recommends using the services of an insurance company that writes banker's bonds to obtain assistance in screening officers and employees.

<u>Recommendation</u>:

The Comptroller should:

- Consider having the Treasury and Trust Company follow the internal control objectives and procedures set forth by the Federal Reserve Board. Guidance may be obtained from the Federal Reserve Board's Examination Manuals. These manuals outline specific industry practices that would mitigate the risks that result from weaknesses in internal controls.
- Ensure that Treasury and Trust Company staff understand the importance of internal control safeguards.
- Request an amendment to the agreement between the Trust Company and the Federal Reserve so that all of the Trust Company's Federal Reserve System activities are clearly authorized.
- Consider allocating the accumulated surplus from the Trust Company to funds held and managed by the Comptroller, similar to Texas Government Code, Section 404.071(a), unless there is a specific purpose for the continued retention of the surplus.

<u>Management's Response</u>:

- *We agree that Treasury Operations could benefit from adhering to many of the banking, securities and trust standards that are commonly practiced in the private sector. We will review the standards developed by the Federal Deposit Insurance Corporation, the Federal Reserve Board and the State*

Banking Commission in order to determine the "best practices" for a fiduciary and self-governed public financial institution. In the course of our review we will consider and closely review the FDIC's Statement of Principles of Trust Department Management. It should be noted that the FDIC Trust Examination Manual recognizes that the cost/benefit of internal controls should be evaluated. It provides the following guidance to its examiners: "Examiners should realize that an effective system of personnel policies designed to establish dual control, duty separation and rotation may be costly. Examiners need to exercise judgment in assessing a department's control system. One or more basic points may have deficiencies, but the system may be strengthened by bolstering others. Often this is accomplished by reliance upon a strong audit, whether by an external CPA firm or an internal auditor."

- *On two separate occasions during fiscal year 2001, the Comptroller's office has engaged the services of an outside consultant to raise management's awareness of internal control safeguards and risk management. In addition, we will be utilizing this consultant in fiscal year 2002 to help management and staff at the Treasury to implement an on-going risk management program. In addition, a number of Comptroller employees attended Federal Reserve Bank training in San Antonio on the topic of internal controls and security.*
- *Under our current agreement with the Federal Reserve Bank of Dallas, the Bank has the right to make periodic examinations of the Trust Company and its activities. To date, the Trust Company has maintained a positive relationship with the Federal Reserve Bank. However, because of the upcoming restructuring of the Trust Company, we will be in contact with the Federal Reserve Bank in order to update the agreements and resolutions.*
- *House Bill 2914, passed by the 77th Legislature, specifically addressed the issue of accumulated surplus. The language now reads: "The trust company shall hold capital stock and reserve balances outside the treasury in an amount required by applicable regulatory bodies for eligibility for federal reserve services, for participation in a depository trust company, and as necessary to achieve its purposes under section 404.103." Retention of the surplus was a management decision of the Comptroller's Office. We believe it was a prudent and proactive decision to ensure adequate start-up capital for the new Safekeeping Trust Company*

Section 1-D:

The Accounting and Information System Used by the Treasury and the Trust Company Should Be Improved to Meet Financial Industry Standards

The accounting and information system used by the Treasury and Trust Company does not fully accommodate standards for financial institutions. Although they are not expressly required to adhere to such standards, the Treasury and the Trust Company should have an accounting and information system that provides management with the best information on which to base decisions. Complying with financial industry standards would help achieve this.

The accounting and information system does not independently capture all of the financial activity processed by the Trust Company. As a result, it is difficult to report on the Trust Company's overall financial condition including the results of operations (income statement) and a statement of cash flows, in conformity with generally accepted accounting principles. Therefore, it would be difficult for an auditor to issue an independent opinion, without qualifications, on the Trust Company's financial statements without auditing the entire Treasury.

A national accounting firm conducted the Trust Company's most recent audit. Its report, dated January 24, 1997, limited the accountant's responsibility to expressing an opinion on the balance sheet of the Trust Company as of August 31, 1996.

The Trust Company's previous independent auditor limited its opinion to the Trust Company's balance sheet, rather than issuing an opinion on the Trust Company's overall financial condition including the results of operations and a statement of cash flows. Because the Trust Company's bylaws require that all books and records regarding the operation of the Trust Company shall be audited annually, an improved system is warranted.

Recommendation:

The Treasury and the Trust Company should:

- Consider improving the information system to meet financial industry standards. The system should capture all financial activity so that pertinent information is communicated to appropriate personnel on a timely basis.
- Ensure that the information system accommodates complete accounting controls such as audit trails, transaction journals, trial balances, and frequent reporting. Management should design methods to use this system to evaluate strategies and detect errors or irregularities.

Management's Response:

The current Treasury systems can provide financial information and reporting, but we recognize the need for improvement and modernization. Funding for a new treasury management/accounting system has been approved. An RFP has been developed and should be issued during October 2001.

Section 1-E:

The Treasury Should Consider Implementing the Monitoring Standards Required of Financial Institutions

The Treasury does not adhere to some of the monitoring requirements commonly applied to financial institutions. Although not required, adhering to these monitoring standards could help ensure that management acts in a disciplined fashion, operations are sound, and the organization has adequate professional knowledge.

The following are areas in which monitoring could be improved.

A More Regular Program of Internal Audits is Warranted

Until 2000 there had been very limited internal audit coverage of the Treasury. According to management, since 1996 internal audit coverage of the Treasury consisted of:

- Five 1997 follow-up reviews
- A 1997 Treasury quarterly collateral reconciliation
- A 1997 internal control review of the withdrawal of funds from TexPool and the Trust Company
- A 1997 money bag report
- A 2000 review of investment policies and procedures
- A 2001 audit of unclaimed property/wire room and stock claim
- A 2001 audit of electronic funds transfer
- Fifteen surprise cash counts
- Two audits that included indirect coverage of the Treasury
- Two projects in which the internal audit staff provided assistance to others

Examples of internal audit functions that are expected of a financial institution, but which have not been routinely performed at the Treasury, include but are not limited to:

- Balance and proof of subsidiary ledgers to general ledgers
- Asset account confirmations
- Spot-checking and tracing of transactions for accuracy and validity

There are at least fifteen additional elements of a comprehensive internal audit program that may be applicable. These elements are specified in the FDIC *Manual of Examination Policies* and the FDIC *Trust Examination Manual*. The audit function for a financial institution of the Treasury's size should incorporate full-time, continuous internal audit procedures coupled with periodic external audits. The internal audit department should focus its efforts on control elements and record keeping integrity. External auditors should evaluate fiduciary risk factors and perform sufficient testing to render an audit opinion for the annual financial statements.

In 2001 the Comptroller began to address this issue by assigning an internal auditor to audit Treasury operations on a full-time basis.

Annual Independent Financial Audits Should Be Conducted

Texas Government Code, Section 404.104(c), requires the Comptroller to submit an audited report regarding the operations of the Trust Company to the Legislative Budget Board. Although Texas Government Code does not specify the type or frequency of these audits, the Trust Company's bylaws require annual financial audits. Conducting annual financial audits also is consistent with standard financial industry practice.

However, since 1996 only TexPool and the Texas Tomorrow Fund, which are segments of the Treasury, have received regular audits of their financial statements. The Tobacco Settlement Permanent Trust Fund's December 31, 2000, financial statements (for the period from inception) were recently audited for the first time. The Treasury also received two consultant reports (not audit reports) during this time. Because the financial audit coverage has been limited, it will be more difficult to identify internal control weaknesses that help detect whether fraud or loss of funds has occurred.

A Regular Program of Examinations by a Competent Regulatory Agency Could be Beneficial

Control Requirements of the Trust Company's Agreement With the Federal Reserve Bank of Dallas

"The Trust Company shall institute adequate internal control procedures. The Federal Reserve Bank reserves the right to make periodic examinations of Trust Company to evaluate the quality of management of Trust Company, and to examine the books and records of Trust Company. . . . The Trust Company agrees to conduct periodic audits and examinations to determine compliance with internal controls and procedures."

Source: Section 4 of the Agreement with the Federal Reserve Bank of Dallas

The Trust Company's agreement with the Federal Reserve Bank of Dallas (Reserve Bank) grants the Reserve Bank the right to examine the Trust Company (see text box); however, the Reserve Bank has never exercised this right. The Reserve Bank routinely examines a broad range of financial institutions and can be presumed to be competent to evaluate the quality of an institution's management and the sufficiency of its internal controls. Periodic examinations by a competent regulatory agency can provide assurance that an institution's bank and trust activities are being managed in a safe and sound manner. In addition, such examinations help ensure that activities are managed consistently with applicable and up-to-date industry standards.

Recommendation:

The Treasury and the Trust Company should:

- Receive regular internal audit coverage based on the standards applicable to financial institutions. A comprehensive internal audit program is outlined in the FDIC *Manual of Examination Policies* and the FDIC *Trust Examination Manual*.
- Ensure that the Trust Company annually obtains an unqualified opinion on its comprehensive annual financial statements from an independent auditor.
- Ensure that the Trust Company is examined periodically by a competent regulatory authority according to applicable federal standards. Because the Treasury has an agreement granting the Federal Reserve jurisdiction over certain of its activities, it would be logical to request that the Federal Reserve

perform these specific audits or examinations. Alternatively, an outside audit firm on an annual basis could:

- Report on and describe the Trust Company's internal controls and whether those controls are suitably designed to achieve specified control objectives.
- Determine whether the controls were placed in operation during the year.
- Test if the controls were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the year.

<u>*Management's Response*</u>:

- *Internal Audit will continue to provide regular audit coverage of the Treasury and has assigned one auditor full-time to focus on the Treasury. In addition, the Trust Company will have its own internal auditor/compliance officer.*
- *On an annual basis, the Trust Company will obtain from an independent auditor an unqualified opinion on its comprehensive annual financial statements.*
- *Jurisdiction granted to the Federal Reserve through our agreement allows case specific audits only and not regulatory examinations. In addition, the Federal Reserve does not have the requisite knowledge of Texas state law and statutes. Therefore, the Trust Company will consider developing a plan for contracting with an outside audit firm with the appropriate expertise to conduct a compliance audit on a periodic basis.*

Section 2:

Status of the Treasury's Implementation of Prior Audit Recommendations and Related Additional Recommendations Based on Expanded Responsibilities

Table 1 summarizes the status of the Treasury's implementation of recommendations from *Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996). Because the Treasury's investment responsibilities have expanded since 1996, we have included additional recommendations where appropriate.

Table 1

Status of Recommendations For the Treasury From *Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996)	
Recommendation From SAO Report No. 97-014	**Auditor Comments**
Recommendation Not Yet Implemented By the Treasury	
A written investment strategy should be prepared and reviewed periodically to determine if adjustments to the portfolio are needed in response to changing market conditions. Executive management's involvement in the monitoring process should be documented.	The Treasury does not prepare and retain written strategies. Carefully formulated strategies, particularly those for the Treasury portfolio, are much more specific than policy objectives. Such strategies are an important tool in achieving the intended results of the investment policies. These strategies also can be used to evaluate the performance of both internal and external portfolio managers.
Recommendation Partially Implemented By the Treasury	
We also recommend that the State Treasury revise its investment policy to address portfolio diversification, acceptable risk levels, expectations regarding portfolio performance, investment maturity limitations, eligible collateral, and investment staff quality and capability. The new investment policy should also address Lottery investments.	Staff quality and capability have not been considered in the policy. The investment policy should consider both the complexities of how the funds are to be managed and the minimal internal or external resources needed to enforce the policy. Specific investment policy guidelines will help maintain hiring standards.
Recommendations Implemented By the Treasury During the 2000-2001 Audit By the State Auditor's Office	
We recommend that State Treasury management implement a portfolio-monitoring process that includes comparisons to other portfolios and indexes with similar composition, size, and average maturity.	**Additional Recommendation:** Those involved with or supervising the actual investing should not prepare their own performance reports. Specifically, the Treasury Pool's performance should be calculated by someone outside of the investment department.
We recommend that the internal audit function perform audits relating to the State Treasury investment activity each year. Controls over the acquisition, custody, performance, and disposal of investments should be reviewed and monitored periodically to ensure investments are properly accounted for and transactions are executed in accordance with established policies and procedures.	None.
We recommend the Investments Division ensure that procedures are in place to review and approve transactions executed by investment traders. We also recommend the review process include procedures to ensure that supporting documentation is included in documents that evidence the execution of investment transactions.	None.

Status of Recommendations For the Treasury From *Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996)	
Recommendation From SAO Report No. 97-014	**Auditor Comments**
Recommendations Implemented By the Treasury During the 2000-2001 Audit By the State Auditor's Office	
Executive management should establish procedures to ensure that financial disclosure statements are completed at least annually by key employees and that these statements are reviewed in a timely manner. A process should also be established to resolve any questions resulting from the review of the financial disclosure statements.	**Additional Recommendation:** Senior and/or executive management (depending on which individual is making the disclosure) should have direct involvement in the process that identifies and resolves questions resulting from the review of financial disclosures.
Treasury Policy - We recommend that management review the investment policy periodically to ensure that public funds are invested prudently and in accordance with applicable statutes and management's decisions.	None.
We recommend that the wire room activities be segregated from the Investments Division so that errors can be detected without intervention from the traders initiating the investment transaction. Verification and reconciliation of investment transactions should be performed independent of the transaction initiation process.	None.
Recommendations Implemented By the Treasury Before the 2000-2001 Audit By the State Auditor's Office	
We recommend that management segregate the responsibilities to provide oversight and to enter into investment transactions. Authorization to execute investment transactions should be limited to the Director of Investments and the traders in the Investment Division.	**Additional Recommendation:** Because the investment department has undertaken the management of multiple long-term investment portfolios, management should also segregate discretionary authority over investment management from record keeping, investment accounting, and performance reporting.
We recommend the State Treasury complete the process of updating the procedures manual for investments as soon as possible.	**Additional Recommendation:** Because of recent changes of responsibilities between the investment department and the Trust Company, additional revisions to the procedures manual reflecting the change of responsibilities appears to be warranted.
We recommend that the State Treasury document the criteria, policies, and procedures used in the selection and retention of broker/dealers. Executive management, in consultation with the Director of Investments, should make decisions relating to the selection and retention of broker/dealers. In addition, procedures should be established to ensure that the State Treasury receives updated financial information from broker/dealers in a timely manner. The Treasury should not use broker/dealers for investment transactions if deadlines for requested information are not met.	**Additional Recommendation:** Management should consider assigning someone outside of the investment department to review and approve broker and dealer applications. Investment transaction activity with brokers and dealers should be actively monitored to reduce the risk of abuse.
In addition, we recommend the State Treasury establish a program that requires employees in the Investment Division to maintain a certain level of continuing education related to their job responsibilities. As the financial environment continuously changes, investment personnel should ensure they have the skills necessary to analyze and make decisions relating to investment information presented from various sources.	**Additional Recommendation:** The investment department now manages a broader range of investments. Therefore, investment department staff should increase their levels of proficiency by attending a structured selection of courses overseen by senior management.

Recommendation:

The Treasury should implement outstanding recommendations from our prior audit report and the additional recommendations specified above.

Management's Response:

We disagree with your assertion that "The Treasury does not prepare and retain written strategies." Our general portfolio strategy is specifically addressed in our investment policy, however we acknowledge the need to further document written current strategy assessments. We will fulfill this need through updates within the weekly status reports to executive management and prepare written documentation of the investment strategy as presented at the Investment Advisory Committee quarterly meetings.

- *Recommendation Partially Implemented*:

  The Comptroller has revised its investment policy to include all the areas recommended except for staff quality which has been addressed in its written job descriptions.

- *Recommendations Implemented During the Audit:*

  Additional Recommendations: The performance of the endowment funds are calculated by an independent consultant while the Treasury pool's performance is calculated by an investment staff member who is not involved in the actual investing function. With the implementation of the Texas Treasury Trust Company, this staff member will no longer report to the Chief Investment Officer but to the Director of Accounting.

  Executive management has established a process to receive and review financial disclosure statements. This process includes the how to handle any questions resulting from this review.

- *Recommendations Implemented Before the Audit:*

  Proper segregation of duties will be achieved in the reorganization of the Trust Company.

  As we continue to make changes in the structure of Treasury Operations and the Trust Company, we will update the necessary procedure manuals.

  The newly hired Compliance Officer will be in a position to review investment transaction activity with broker dealers.

  The Chief Investment Officer is currently evaluating training opportunities for the staff that would be considered as advanced investment training. In fact, several staff members have already attended some of the training classes. In addition, all investment staff members will be encouraged to actively work to pass Level 1 of the CFA exam.

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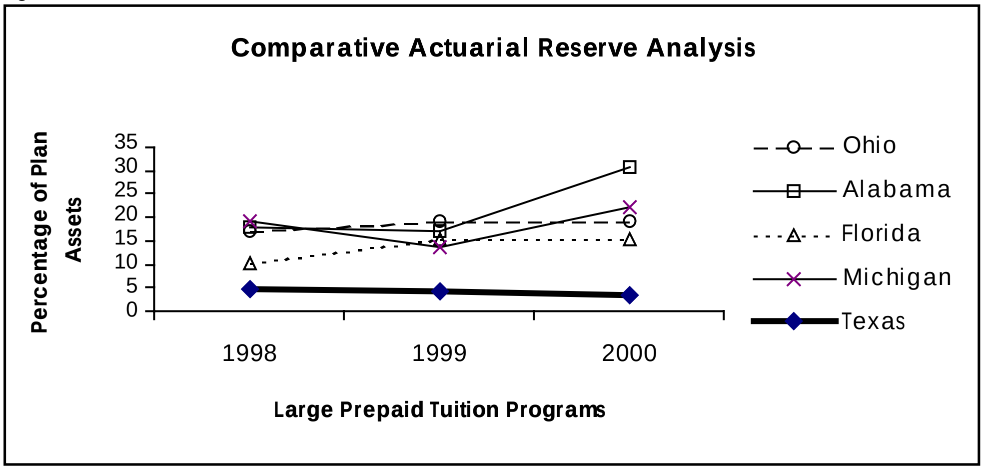
Texas Tomorrow Fund

Overall Summary

While the Texas Tomorrow Fund (Tomorrow Fund) remained actuarially sound[1] and provides the expected prepaid tuition services, financial risks associated with this $970 million financial institution need to be clearly identified, and addressed to assure the Fund's viability.

Figure 1



Source: Based on each program's annual financial statements.

A higher actuarial surplus (or reserve) as a percentage of total assets increases the likelihood that a program will be able to meet its commitments. Inadequate analysis and planning has, in all likelihood, prevented the accumulation of a more substantial actuarial surplus and negatively affected the number of participants. Additionally, the Texas Prepaid Higher Education Tuition Board (Board) does not appear to have access to sufficient and accurate information required to support its supervisory and decision-making processes. A board that operates without adequate information cannot identify and implement corrective actions in a timely manner. The responsibility for collecting and providing information to the Board belongs to the Fund's staff members, who are supplied and supervised by the Office of the Comptroller of Public Accounts (Comptroller).

What is the Texas Tomorrow Fund?

The Texas Tomorrow Fund (Tomorrow Fund) is administered by the Texas Prepaid Higher Education Tuition Board. The Tomorrow Fund acts like an insurance company by allowing Texans to prepay college tuition costs at fixed prices. A prepaid tuition contract provides two main benefits for families:

(1) it locks in present-day tuition rates and

(2) creates a tax-deferred investment vehicle similar to certain IRAs or tax-deferred annuities.

A Tomorrow Fund contract transfers the risk of rapidly rising tuition costs from families to the Tomorrow Fund. The Tomorrow Fund manages this risk over time by attempting to invest the contract proceeds at a rate of return that exceeds tuition's rate of inflation. Regardless of the Tomorrow Fund's actual investment returns, purchasers bear no financial risk because the State of Texas unconditionally guarantees the Tomorrow Fund's obligations. As of August 31, 2000, the Tomorrow Fund's obligations exceeded $950 million.

In May 2000, the Comptroller retained a management consultant to review the operations of the Tomorrow Fund. The consultant's report included 18 recommendations (see Appendix 3 on page 52 for a copy of the consultant's report). In June 2000, the Comptroller reorganized the Tomorrow Fund "to make it more efficient and consumer friendly." The Fund's staffing was significantly reduced and organizational reporting within the Comptroller's office was shifted from Treasury Operations to Special Programs.

In the expectation that the operations of the Tomorrow Fund would be substantially reorganized, the scope of our review did not include testing internal controls and

[1] Based on the Tomorrow Fund's audited financial statements for the fiscal year ending August 31, 2000, dated January 16, 2001.

operating procedures. The Comptroller has started to improve the operations of the Tomorrow Fund. As a part of this process, the following recommendations should be considered.

Section 1:

Strengthen the Actuarial Process

The Tomorrow Fund's actuarial process, critical to ensuring the program's solvency, may not ensure that management and the Board have the information they need to adequately assess and manage the Tomorrow Fund.

For a prepaid tuition program like the Tomorrow Fund, an actuarial study is required in order to prepare the program's audited financial statements, determine the program's price structure, and provide vital information. An actuarial study involves estimating the timing and amount of future tuition payments. The study uses assumptions about future conditions such as investment earnings, tuition costs, operating costs, and participation in the program. The resulting estimates of future liabilities are used to draw conclusions about the program's ability to meet its future financial commitments. When a program's assets are greater than the present value of its projected liabilities, it is considered to have an actuarial surplus. This surplus is considered to be the program's "retained earnings" or "net worth."

Section 1-A:

Clarify, Document, and Communicate the Process for Determining Actuarial Assumptions

The Board's process for setting actuarial assumptions may not consider a full range of possibilities and is not clearly documented. The Board may not fully understand that it, and not the actuary, is responsible for selecting the best assumptions to determine the financial condition of the Tomorrow Fund. As a result, the best actuarial decisions might not be made, the logic used in the decision-making process is not documented, and it is difficult to analyze and learn from previous decisions. A comprehensive actuarial process also decreases the likelihood that the Tomorrow Fund will be exposed to unanticipated risks and circumstances that might result in the need for an infusion of state General Revenue monies into the program.

The Board is responsible for providing the assumptions to the actuarial consultant. The actuary advises the Board but does not take responsibility for determining the most appropriate assumptions, except for those related to mortality. While the actuary will comment if he thinks an assumption is unreasonable and will opine that the assumptions are "not unreasonable," he does not believe that it is within his professional scope to determine the best assumptions. This places special importance on the Board's decision-making process as it selects the assumptions to be used in the actuarial report.

The transcripts of the June 1999 through June 2000 Board meetings contain limited evidence of detailed analysis and discussion relating to the selection of actuarial assumptions. The actuarial consultant provided the Board with some input on a one-page handout and discussed actual tuition trends. The Board did not develop or consider independent research or data.

However, the Board's process for setting one key assumption, the expected returns for the Tomorrow Fund's investment portfolio, is an exception. The Board allocated the Tomorrow Fund's investment portfolio and determined the portfolio's expected returns using a study prepared by a firm expert in these matters. The Board asked the consultant to determine an optimal allocation of the Tomorrow Fund's assets that would support and justify the Board's eight percent investment return assumption. A detailed oral and written presentation was made to the Board's Investment Committee at the study's completion.

Recommendation:

When developing actuarial assumptions, Tomorrow Fund staff and Board members should:

- Thoroughly research existing relevant trends.
- Seek expert opinions about likely future developments.
- Document the decision-making process in the Board minutes.
- Incorporate key trends and supporting information in the published actuarial report so that interested public parties can better interpret the assumptions used in the report.
- Consider establishing a Board committee to focus on actuarial issues or add this responsibility to the Board's Investment Committee.
- Provide training opportunities on actuarial issues for Board members.

Management's Response:

In January 2001, the Board added an analysis of actuarial trends and issues to the scope of responsibilities of its Investment Committee. Further, in June 2001, the Board's Investment Consultant, Watson Wyatt of Atlanta, conducted a daylong Board seminar on current actuarial issues, trends, and methodology.

Management directed the Research and Policy Development Division of the Comptroller's office to provide expert assistance in researching higher education trends, projections of increases in tuition and required fees, and actuarial analysis. Staff also sought outside opinion on future developments in higher education from academic authorities and the Texas Higher Education Coordinating Board. The Research Division prepared and presented briefing papers on these topics to the Board at an August 2001 meeting for its consideration in the decision-making process.

Finally, official Board minutes and transcripts will reflect all actions related to actuarial assumptions.

Section 1-B:

Include More Sensitivity Testing in Actuarial Reports

What is Sensitivity Testing?

While an actuarial report is based on one set of assumptions, it is good financial practice to consider and document alternative scenarios. This process is called sensitivity testing. Testing quantifies the impact that different assumptions have on a program's liabilities and surplus. Ideally, the results of many combinations of assumptions should be analyzed using a statistical process that can calculate the probability of a program staying solvent in the future.

The sensitivity testing conducted by the actuary needs to be expanded. At present, only four modest alternatives are considered. In comparison, Florida's prepaid program looks at a more thorough range of possibilities (see Table 2). More extensive sensitivity testing might clearly identify potential risks so they can be considered and corrective action taken, if needed.

Table 2

Comparison of Assumptions Used By Florida and Texas In Sensitivity Testing

Florida Scenarios	Texas Scenarios
• Inflation increases by 5% for 15 years, 6.8% thereafter. • Inflation increases by 5% for 10 years, then 6.8% thereafter. • Inflation increases by 7.2% in all future years. • Inflation increases by 9.7% in all future years. • Inflation increases by 10% for 10 years, then 6.8% thereafter. • Inflation increases by 13% for 1 year, then 6.8% thereafter. • Inflation increases by 15% for 2 years, then 6.8% thereafter. • Immediate 50 basis-point[a] drop in investment earnings rate. • Gradual 50 basis-point[a] drop in investment earnings rate over 10 years.	• Immediate 25 basis-point[a] increase in the tuition rate of inflation. • Immediate 25 basis-point[a] drop in investment earnings rate. • Tuition is 25 basis-points[a] higher and investment return 25 basis-points[a] lower. • Contract sales fall by 5,000 contracts each year.

[a] A basis-point is 1/100 of 1 percent. Fifty basis points would be 1/2 of 1 percent. Twenty-five basis points would be 1/4 of 1 percent.

Sources: 1999 actuarial report for the Florida Prepaid College Board, 1999 Texas Tomorrow Fund annual report.

<u>Recommendation</u>:

The Tomorrow Fund should expand its sensitivity testing to include a more comprehensive set of assumptions. Tomorrow Fund staff should collect, compare, and contrast the assumptions used by other states employing different actuarial consultants. This would provide additional assurance that a full range of actuarial approaches is considered.

<u>Management's Response</u>:

The Board's actuary has agreed to provide expanded sensitivity testing in the soundness report for the Fund. At the January 9, 2001 Board meeting, the actuary presented six additional actuary assumption options for the Board's consideration. In addition, as part of its ongoing responsibilities, the Board's investment consultant will collect and analyze examples of soundness reports from prepaid tuition programs in other states.

Section 1-C:

Work With the Actuary to Improve the Accuracy of Interim Financial Statements

The Tomorrow Fund's accounting staff members have difficulty incorporating actuarial adjustments into the interim financial statements. This causes the financial statements to become increasingly inaccurate as the fiscal year progresses. This inaccuracy results from many factors, including hard-to-calculate changes in the Tomorrow Fund's prepaid tuition liability as new contracts are sold, as payments are collected, and as investment results change. This problem results in significant adjustments between interim and year-end actuarially adjusted audited financial statements.

Since May 1999, Tomorrow Fund accounting staff members, in consultation with the actuary, have been implementing procedures to improve their ability to estimate actuarial adjustments in the preparation of interim financial statements. However, the June 30, 1999, internally prepared interim financial statements, submitted to the Board at its August 20, 1999, meeting, showed the Tomorrow Fund's retained earnings (surplus) to be $94.8 million. The actuarially adjusted audited financial statements for the August 31, 1999, fiscal year end showed an actual retained earnings balance of only $32.3 million.

As a general principle, it is important for the Board to receive the most accurate and practical picture of the Tomorrow Fund's fiscal condition at each Board meeting. In addition, in its efforts to ensure the program's viability, one of the few actions within the Board's direct control is the ability to set prepaid tuition contract prices. Prices for the next year are customarily set in August, before the audited financial statements are available. Thus, it is particularly important for the Board to have accurate financial information when it sets contract prices.

<u>Recommendation</u>:

Working with the actuary, Tomorrow Fund accounting staff and the Board should:

- Review the effectiveness of the procedures designed to improve the accuracy of interim financial statements after the preparation of the August 31, 2000, audited financial statements. If necessary, modify the process so that it presents interim period accounting information in a more accurate and meaningful manner.

- Consider postponing the Board's price-setting actions until audited financial statements become available if the Tomorrow Fund cannot develop internal statements of sufficient reliability.

Management's Response:

Since the State Auditor's field work began, the Fund's accounting staff has been working with the actuary to ensure that interim financial statements presented to the Board are as accurate as possible. Working with the actuary, staff will modify the process for preparing interim financial statements to ensure they are reliable before the Board takes any price-setting actions.

However, it would not be feasible to postpone price-setting actions until audited financial statements are available because this practice would significantly shorten the duration of the program's enrollment periods, which typically run from November through May.

Section 1-D:

Develop a Policy for Periodically Rotating Actuarial Consultants

The Tomorrow Fund does not have a process to consider the rotation of actuarial consultants. Given the importance of the actuarial process in properly managing a prepaid tuition program, it is prudent to consider the need for selecting a new actuarial consultant periodically to get a fresh perspective and "second opinion."

As an example, Texas Government Code, Section 825.206(c), requires the Teacher Retirement System's Board of Trustees to re-designate its actuary at least once every three years (there is not a prepaid tuition industry standard for rotating actuaries).

Recommendation:

The Board should adopt a formal policy that addresses rotating actuarial consultants. In the absence of an industry standard, the Board should look to Texas Government Code, Section 825.206(c). Absent any specific reasoning to the contrary, this may be a good business standard to adopt.

Management's Response:

At its January 9, 2001 meeting, the Board approved an actuarial re-designation policy that requires actuarial services to be put up for bid every three years. In the event that the Board's current actuary is re-designated for a new contract, a peer review of his or her work would be required. Because of the limited number of actuaries who have experience with prepaid tuition programs, the Board would be able to re-designate its current actuary if the proposals received so warrant.

A salutary effect of the Board's re-designation policy is to enable the work of the actuary to be reviewed periodically and to provide a "second opinion" on actuarial *conclusions. The Board's actuarial re-designation policy is similar to that used by the Teacher Retirement System, but also allows the Board more flexibility than a fixed rotation requirement would offer.*

Section 2:

Improve the Contracting Process

The Board's contracting decisions do not ensure that the Tomorrow Fund's administrative tasks will continue if a key contractor leaves the prepaid tuition business, nor do they ensure that the Tomorrow Fund pays a fair price for the services it receives. In addition, the Tomorrow Fund's contracts are not always finalized in a timely manner. By not having its contracts finalized promptly, the Tomorrow Fund loses the benefits of those services during the contract finalization period.

Section 2-A:

Consider if Contracting for Fundamental Services Is a Sound Decision

Tomorrow Fund staff members do not monitor the financial condition of the administrative services vendor or other contractors on an ongoing basis. A financially weak contractor that suddenly ceases business could interrupt the Tomorrow Fund's operations and undermine public confidence. Monitoring the financial condition of the administrative services vendor is especially important given that there are limited sources for these fundamental services and the implementation process for a new provider could be complex and may require lengthy lead times.

The Tomorrow Fund contracts with an outside vendor for administrative tasks. This vendor maintains participant records, bills participants, posts participant payments, processes payments to colleges, tracks tuition credits in participant accounts, and processes refunds.

Recommendation:

Management of the Tomorrow Fund should:

- Develop a contingency plan for providing critical services in the event that a contractor can no longer provide them.
- Monitor the financial condition of key contractors, especially the administrative services vendor, and share this information with the Board as part of the contract renewal process.
- Consider the risks of contracting for fundamental services when few providers offering the needed services are known to exist.

<u>*Management's Response*</u>:

In February 2001, the Board directed staff to issue a request for proposals (RFP) to test the marketplace for the best-qualified vendor to provide records administration and management services for the Fund. The Board received three proposals from experienced and qualified vendors, whose cost proposals offered competitive pricing for the Fund's scope of records administration services. As part of the evaluation of these proposals, staff examined the audited financial statements of each vendor to determine financial soundness.

In May 2001, the Board awarded a new contract to a nationally recognized vendor for state prepaid tuition programs. Finally, as part of the process of contract renewal, staff will monitor the financial condition of key contractors and will share this information with the Board.

Section 2-B:

Strengthen the Competitive Bidding Process

Contractors that are the only respondents, or one of only two respondents, to the Tomorrow Fund's requests for proposals provide fundamental services for the Tomorrow Fund. Because, in situations where only one or two respondents bid, the respondents' prices might not be subject to sufficient competition and the Tomorrow Fund may be overpaying for services.

As identified in Section 2-A, the administrative services vendor was one of only two bidders. Its prices might not have been subject to sufficient competition, and its services may not be the most cost-effective option. Another example is actuarial services. The last request for proposal (RFP) issued in December 1999 had only one respondent. In addition to concerns about effective price competition, actuarial services represent a critical service area for which the qualifications and methodologies of different providers should be considered. There are many actuarial firms in the United States and at least three are known to actively service the prepaid tuition industry.

<u>Recommendation</u>:

The Tomorrow Fund should:

- Take advantage of the competitive bidding process to ensure that it is paying the best prices.
- Make efforts to ensure that multiple qualified contractors respond to RFPs.
- Conduct and document detailed analyses to ensure that in situations where there is only one or two respondents, the selected services represent the most cost-effective option.

Management's Response:

We agree that this is an important management issue. To strengthen the competitive bidding process, we have worked with the Contracts Legal Section of the Comptroller's Office and have:

- *Hired an additional half-time contracts attorney to monitor the process of preparing and soliciting responses to the Fund's Requests for Proposals (RFP) for vendor services;*
- *Developed an Access contracts database as a management tool to improve monitoring of contract award, funding, and performance of services. The database will track, among other key dates, the period between Board approval and contract signature. TTF management, Executive management and contracts section management will all have online access to the database for routine and ad hoc reporting capability.*
- *Redesigned the solicitation process, including rewriting and redirecting Requests for Proposals and Invitations to Bid, to more effectively specify program expectations and to target prospective marketplace vendors.*

Section 2-C:

Finalize Contracts in a Timely Manner

Board-approved contracts were not finalized in a timely manner. More than once, substantial amounts of time had passed between the Board's approval of a contract and the signing of the contract. In contrast, the Fund's investment consultant states that most of its clients implement contracts with new investment advisers in less than 30 days. While waiting for contracts to be signed, the Tomorrow Fund does not benefit from the contracted services.

For example, in April 1998 the Board approved an investment adviser to manage the Tomorrow Fund's international stock portfolio. Staff turnover in the Contract Section of the Comptroller's General Counsel Division contributed to the delay. The contract process was not finalized and the adviser was not funded until August 1999. Pending finalization of investment advisory contracts, the Tomorrow Fund holds the money to be managed in short-term cash investments. Given that the Board expects a higher rate of return from stock investments compared to cash investments, delays in placing money with investment advisers hurt the Fund's investment performance. Based on the Board's assumptions, the monetary cost of delay in funding the international manager was $147,383 per month. In addition, on June 6, 2000, the Board approved another investment adviser to manage part of the Fund's stock portfolio. This contract was not finalized until August 30, 2000.

Recommendation:

The Comptroller should finalize the Tomorrow Fund's contracts in a timely manner. This could include having these contracts negotiated by the Tomorrow Fund's outside law firm.

Management's Response:

We agree that contracts were not finalized in a timely manner after initial TTF Board approval during the period from 1998 through end of FY1999. Finalizing contracts in a timely manner after TTF Board approval requires coordination between the Board, TTF management, the Comptroller's contract section, and legal counsel for the investment advisors.

Several factors contributed to the lengthy period in the 1998 example listed by SAO, including additional Board discussion in open meetings throughout that period, severe understaffing and lack of senior legal experience in the contract section during 1998 and the first half of 1999, and turnover of key staff in that section in late 1998. Over the period from June 24, 1999 to date, the section was reorganized with a section manager and has added 4 attorneys and 3 support staff. One of the added attorneys devotes one-half of his time to the Fund's contracts management.

In addition, the contracts section developed and prepares detailed weekly assignments reports to agency and TTF Management with the status of all outstanding contracts. The section works with TTF management on a daily basis to advise of the status of and assist in finalizing outstanding contracts. With the assignment reports in hand, TTF management now advises the Board in open meetings of the detailed status of all outstanding contracts.

Finally, the Contracts Section developed an Access contract management database, which will track, among other key dates, the period between TTF Board approval and contract signature. TTF management, Executive management and contracts section management will all have online access to the database for routine and ad hoc reporting capability.

Section 3:

Compare the Tomorrow Fund's Expenses to Those of Other Prepaid Tuition Programs

The Tomorrow Fund does not compare the costs of its operations to those of other prepaid tuition programs. As a result, the Tomorrow Fund may be missing an opportunity to learn from others' successes and mistakes. The Tomorrow Fund's management should benchmark its costs, compare them to other programs, and communicate the results to the Board.

Section 3-A:

Compare the Costs of Administering Participant Contracts to Other States' Costs

When the Tomorrow Fund's administrative costs are compared to those incurred by Ohio and Michigan, which operate similarly sized programs, the Tomorrow Fund's costs are higher (see Table 3 on next page). Texas employs an administrative services contractor to manage participant accounts. Ohio and Michigan perform these services internally. We estimate that the Tomorrow Fund could save at least $360,000 annually if it could attain the levels of efficiency achieved by Ohio and Michigan. In addition, administering participant contracts internally would mitigate some of the concerns identified in Section 2.

Table 3

Comparison of Prepaid College Tuition Programs			
Category	**Ohio Fiscal Year 1999 7/1/98-6/30/99**	**Michigan Fiscal Year 1999 10/1/1998-9/30/1999**	**Texas Fiscal Year 1999 9/1/1998-8/31/1999**
Program Size			
Total State Population	11,021,419	9,443,665	17,682,538
Authority FTEs	28.75	15.0	14.5
Total Participants	74,024	58,749	73,380
New Participants 1999	12,595	1,513	9,755
Total Assets	$ 427,701,117 (as of 6/30/1999)	$ 777,730,493 (as of 9/30/1999)	$ 780,177,671 (as of 8/31/1999)
Program Expenditures			
Total Expenditures	$ 2,959,701.00	$ 1,764,200.00	$ 3,985,354.00
1999 Cost per Participant	$ 39.98	$ 30.03	$ 54.31
Total Administrative Costs[a]	$ 561,289.00	$ 248,100.00	$ 1,639,699.00
Administrative Costs per Participant	$ 7.58	$ 4.22	$ 22.35
Total Program Overhead Costs[b]	$ 1,376,351.00	$ 1,262,425.00	$ 628,643.00
Program Overhead Costs per Participant	$ 18.59	$ 21.49	$ 8.57
Combined Administrative and Program Overhead Costs per Participant	$ 26.17	$ 25.71	$ 30.91
Marketing Costs	$ 1,022,061.00	$ 253,675.00	$ 1,717,011.00
Marketing Costs per **New** Participant	$ 81.15	$ 167.66	$ 176.01

[a] Administrative costs represent participant account servicing expenses.

[b] Program overhead costs include the cost of managing the program excluding participant account servicing expenses. Ohio's and Michigan's investments are managed by state agencies at less-than-market rates. To make the comparisons more meaningful, Texas' program overhead total has been reduced by $814,579 of investment advisor fees.

Sources: Texas data was provided by the Tomorrow Fund; Michigan and Ohio data were from an Ohio State Performance Audit dated September 26, 2000. Population information for each state comes from 1990 U.S. Census data. Not all data may be directly comparable across states.

<u>Recommendation</u>:

Tomorrow Fund staff should analyze the Tomorrow Fund's administrative costs and compare them to those of other prepaid tuition programs. Staff should present this information to the Board so that it can make the most informed decisions possible.

<u>Management's Response</u>:

While benchmarking and comparison to other state prepaid tuition programs can be useful, there is an inherent danger of drawing conclusions from too limited an amount of information. We believe that the Ohio and Michigan programs have fundamental *differences from the Texas Tomorrow Fund that prevent a simple comparison of cost per participant. For example, Ohio sells units to purchasers with 100 units equaling one year of tuition and fees at a public Ohio college or university.*

Texas, on the other hand, sells semester hours in one-year increments, totaling 32 semester hours. Given the large difference in total assets between the Ohio and Texas programs, it appears that Ohio's total participant figure must include a significant number of individuals who purchased a small number of units. This difference would distort cost-per-participant, marketing cost-per-participant, and other such comparisons.

With respect to the Tomorrow Fund's administrative costs, the Board (as noted) in February 2001 directed staff to issue a request for proposals (RFP) to identify a vendor to provide records administration and management services to the Fund. The Board received three proposals from experienced and qualified vendors, whose cost proposals offered competitive pricing for the Fund's scope of records administration services. In the course of the evaluating these proposals, management gave prime consideration to cost and value for all alternatives.

Finally, staff has continued its ongoing discussions with prepaid tuition programs in other states to analyze administrative costs and to develop benchmarks. Staff will present these findings to the Tomorrow Fund's Board for its discussion, evaluation, and possible management action.

Section 3-B:

Compare the Tomorrow Fund's Marketing Costs and Results to Those of Other States

The Tomorrow Fund's lack of benchmarking could keep it from learning about effective marketing practices. For example, during 1999 Texas spent $176 per new participant on marketing, while Ohio only spent $81 per new participant. Texas gained 9,755 new clients; Ohio gained 12,595. (See Table 3 on previous page. The results for Michigan are not relevant because Michigan is not actively seeking new participants and has a minimal marketing budget.) More efficient marketing practices might result in more potential customers learning about the Tomorrow Fund and lead to higher participation rates in the program.

While Ohio is a much smaller state geographically, it is similar to Texas because it has many media markets that make it difficult to reach a statewide audience. However, Texas depends on mass media advertising (such as TV and radio) while Ohio spends no money on mass media advertising. Instead, after testing the results of using mass media in previous years, Ohio now directs its budget toward direct mail and community outreach.

This does not mean that Texas should avoid mass media advertising, but it shows that benchmarking can highlight alternatives for consideration.

Recommendation:

Tomorrow Fund staff should research other prepaid tuition programs' marketing costs and results and compare them to those of the Tomorrow Fund. Staff should present this information to the Board so that it can make the most informed decisions possible.

Management's Response:

Again, management believes that fundamental differences between the Ohio and Michigan programs and the Tomorrow Fund should be taken into account in any benchmarking comparisons. With respect to marketing costs, for example, the Ohio program employs a branding arrangement with a retailer who absorbs a portion of Ohio's marketing costs and thus lowers direct marketing expenses incurred by the program.

Staff will continue to research other prepaid tuition programs' marketing costs and results and compare them to those of the Tomorrow Fund. We will then present this information to the Board so that it can make the most informed decisions possible.

Section 4:

Identify and Address Financial Risks and Opportunities, and Include the Board in the Process

The Tomorrow Fund does not adequately identify and address financial risks and opportunities to the degree expected of a $970 million financial institution. Addressing these risks will assure the Fund's viability. The current planning process does not address many issues that are critical to the Tomorrow Fund, such as a target actuarial surplus, market penetration, competitive analysis, benchmarking, or contingency planning. In addition, there is no record of the Board's participation in a formal planning process in the June 1999 through June 2000 minutes and transcripts. Inadequate planning reduces the likelihood that the Tomorrow Fund will take full advantage of opportunities and increases the likelihood that the Tomorrow Fund will not identify or plan for problems in a timely manner.

Why Risks Must Be Identified

Financial risk analysis helps decision-makers set priorities, allocate resources, and seek opportunities. The strategic planning process can help to accomplish this since it typically includes:

1. The organization's mission and role.
2. An analysis (current and projected) of the organization's **S**trengths and **W**eaknesses (usually internal) and **O**pportunities and **T**hreats (usually external), commonly called a SWOT analysis.
3. The organization's goals, objectives, and strategies for the planning period.
4. Specific actions, with an explanation of how each fulfills the organization's mission, goals, and strategies.
5. A schedule for accomplishing each action, the person responsible, and the resources required.
6. A procedure and schedule for evaluating the plan and its implementation.
7. A schedule for the next iteration of the planning process.

Tomorrow Fund staff developed the *Texas Tomorrow Fund Business Plan 2000* (Plan 2000) dated August 26, 1999. Plan 2000 sets forth a brief mission statement and philosophy and then proceeds into a ten-page job description of the different organizational divisions of the Tomorrow Fund. The subsequent five pages respond to seven agency goals, some relevant to the Tomorrow Fund, some not, set forth by the Comptroller. Plan 2000 concludes with a table outlining seven "Performance Measures and Target Projections" (see Table 4).

Table 4

Performance Measures and Targets from *Texas Tomorrow Fund Business Plan 2000*	
Performance Measure	**Target**
Annual rate of return on total funds invested	8%
Annual soundness report with a surplus	Positive position
Percentage of management staff receiving 35 hours of training	100%
Percentage of employees receiving a minimum of 21 hours of training	100%
Number of Investment Analysis Reports presented to Board	4 annually
Number of new participants enrolled during FY 2000	15,000
Percentage favorable comments received in survey	80%

Source: *Texas Tomorrow Fund Business Plan 2000*

While these are worthy objectives, Plan 2000 does not cover key related planning information including:

- Support for the development of each measure.
- Comparison to other states' programs or to prior years' results.
- Steps for achieving each measure.
- Discussion of relative importance or how the issues inter-relate.
- Remedial actions in the event a particular measure is not achieved.

<u>Recommendation</u>:

While the Tomorrow Fund Board and staff may be intuitively aware of the financial risks, these need to be documented and comprehensively addressed. Tomorrow Fund staff should develop an analysis of the financial risks and opportunities that sets forth the critical issues facing the Tomorrow Fund and how these issues will be addressed. In addition to incorporating the additional support for current objectives noted above, the Tomorrow Fund should consider completing the following as part of its analysis:

- <u>Set a target actuarial surplus</u>. The surplus, or net worth of the program, creates a starting point against which the Tomorrow Fund can establish measures of tolerable risk.
- <u>Set a target for penetrating the prepaid tuition market</u>. The Tomorrow Fund needs to assess who its customers are, how many customers exist in Texas, and how many can reasonably be served over what timeframe.
- <u>Plan for contingencies</u>. A financial institution of the Tomorrow Fund's size needs to develop contingency plans in the event of operating and financial obstacles. Examples include but are not limited to a legislative change in

public university tuition levels, a bear market for stock investments, and an interruption in the provision of important services by a key contractor.

- Benchmark performance. An active benchmarking process would allow the Tomorrow Fund to create a rising standard of performance and efficiency.
- Analyze the competition. The prepaid tuition industry is a competitive market. The Tomorrow Fund should identify and prepare for changing market trends. One example is the development of college savings plans. Some states now market their savings plans in other states, creating competition where there had been none.

It is the responsibility of Tomorrow Fund management to analyze risks and opportunities based on general parameters set by the Board. Once these risks and opportunities are identified, the Board should thoroughly review them. The Board should regularly monitor the Tomorrow Fund's progress toward mitigating risks and taking advantage of opportunities.

Management's Response:

In fiscal year 2002, we will develop an analysis of the financial risks and opportunities facing the Fund, including identifying critical issues and how they will be addressed. We will consider various key assumptions in determining actuarial soundness; contingency planning; benchmarking performance; and analyzing performance of prepaid tuition programs in other states.

Section 5:

Consolidate Safekeeping of the Fixed Income Portfolio With the Equity Portfolio Held at the Custodian Bank

The Treasury Division of the Comptroller of Public Accounts, which manages and has custody of the Tomorrow Fund's fixed income portfolio, provided incorrect fixed income portfolio investment results for the quarters ended December 31, 1999, and March 31, 2000. Transcripts from the Board's and the Investment Committee's February and May 2000 meetings also indicate that the Treasury does not maintain systems sufficient to correctly report the book value of the fixed income portfolio.

The department within the Treasury that invests the Tomorrow Fund's fixed income and cash investments also has asset custody, accounting, and performance measurement responsibilities. Good internal control procedures commonly applied within the investment industry dictate that these duties be segregated. Independent performance of important duties reduces the likelihood of errors and fraud.

Additionally, as noted in the Treasury section of this report (see page 5), there are internal control weaknesses in the operation of the Treasury. The Tomorrow Fund's investment consultant also believes that the Treasury's process for pricing securities does not meet industry standards because it is not independent of those who manage the investments. The investment consultant has also stated that it has no way of ensuring that information from the Treasury is accurate. The fixed income portfolio makes up approximately 40 percent of the Tomorrow Fund's investments.

In contrast, the Board does receive independent investment return information about the Tomorrow Fund's equity investment portfolio, which is held for safekeeping at a custodian bank. According to the investment consultant, the bank also has good systems in place for valuing securities and providing the consultant with verifiable information required to calculate investment returns. The equity investment portfolio makes up approximately 60 percent of the Tomorrow Fund's investments.

At present, the Treasury does not charge the Tomorrow Fund for safekeeping the fixed income securities. However, a rider in the General Appropriations Act seems to indicate that the Comptroller should recover the costs of investing the assets of non-General Revenue funds. This would include costs related to the custody of assets as well as accounting and investment performance calculation.

Recommendation:

The Board should transfer the safekeeping of the Tomorrow Fund's fixed income portfolio to the custodian bank. This action will ensure that independent and verifiable investment return information is provided to the Board and improve internal control safeguards for the Fund's assets. In addition, the Board may consider the possibility of allowing the bank to structure a securities lending program for the Tomorrow Fund. The revenue from a securities lending program could partially offset any incremental bank custody fees.

Management's Response:

In February 2001, the Board transferred custodianship of the Texas Tomorrow Fund's fixed income investments to the Board's custodian bank. Because the Board's contract with its current custodian bank was due to expire with no renewal options, the Board issued a Request for Proposals to select a custodian bank to provide program services in the future. A new contract was subsequently awarded to this custodian to begin services in September 2001.

TexPool

Overall Summary

The management of the Texas Local Government Investment Pool (TexPool) has restored confidence so that it continues to grow. However, there still are opportunities for Treasury management to improve operations. (The Comptroller of Public Accounts (Comptroller) manages TexPool through the Comptroller's Treasury Division.) TexPool management needs to improve its monitoring of the contractors who conduct TexPool's operations; it needs to consider increasing the range of eligible investments; and it needs to enhance its agreements and communications with the local governments that invest in TexPool. As of August 31, 2000, TexPool managed $8.3 billion for 1,598 local governmental entities.

> **What is TexPool?**
>
> The Texas Local Government Investment Pool's (TexPool) mission is to offer a safe, liquid, and efficient investment alternative to Texas local governments so that they may benefit from economies of scale and investment expertise.
>
> TexPool is organized to conform with Chapter 791 (Interlocal Cooperation Act) and Chapter 2256 (Public Funds Investment Act) of the Texas Government Code. These acts provide for the creation of public investment pools and permit eligible governmental entities, such as cities, counties, and school districts, to jointly invest their funds. Public funds investment pools such as TexPool are exempt from federal securities law and U.S. Securities and Exchange Commission regulation.
>
> TexPool's investment objectives in order of priority are (1) preservation or safety of capital, (2) liquidity, (3) diversification, and (4) yield. The State of Texas and the Comptroller of Public Accounts do not guarantee the principal or interest of any investment in TexPool.

Despite the improvements needed, TexPool's recent accomplishments are worth noting. Following a liquidity crisis in December 1994 (prior to the merger between the Treasury and the Comptroller) that resulted in a multi-million dollar cash infusion of state General Revenue monies, TexPool placed a primary emphasis on the safety and liquidity of its investments (see textbox and *A Review of the State Treasury's Management of TexPool*, SAO Report No. 96-053, March 1996). As a result, the number of participants has surpassed pre-1994 crisis levels. In addition, as required by a 1997 amendment to the Public Funds Investment Act, TexPool maintains a AAAm rating, the highest possible rating, from a nationally recognized rating agency.

Compared to similar funds, TexPool operates efficiently. TexPool participants pay 5.5 basis points (0.00055) of total funds per year. According to the Standard & Poor's Local Government Investment Pool Index, as of December 1999, the estimated average cost to participants in similar funds was 23 basis points (0.0023). TexPool's rate of return for the first six months of 2000 also compares favorably to the returns of TexPool's three largest Texas competitors (see Table 5 below).

Table 5

Comparative Rates of Return: January Through June 2000

	TexPool		TASB Daily Liquidity[a]		TASB Liquidity Corporate[b]		LOGIC	
2000 Average	Yield	WAM	Yield	WAM	Yield	WAM	Yield	WAM
	6.00%	38	5.77%	24	5.96%	38	5.94%	42

[a] Maximum Allowed WAM is 60 days.

[b] Maximum Allowed WAM is 120 days.

Source: Information drawn from TexPool, TASB, and LOGIC websites. TASB is the Texas Association of School Boards, LOGIC is the Local Government Investment Cooperative. WAM is the Weighted Average Maturity in days.

Section 1:

Improve Monitoring of the TexPool Subcontractors

TexPool management (the Comptroller's Treasury Division) should improve its monitoring of the contractors that provide all of TexPool's operational duties. The Treasury should ensure that the contractors meet all of the standards set forth in their contracts with TexPool, TexPool's investment policy, the guidelines for AAAm rated funds, and applicable statutes. In addition, the Treasury should select and pay the accounting firm that audits TexPool. Currently, the contractors select and pay the accounting firm, which reduces the appearance of independence between the contractors and the auditors.

TexPool's Investment Policy

TexPool's investment policy is based on the requirements established for regulated money market funds to ensure the maintenance of a stable net asset value (that is, safety of principal). The requirements include:

- A conservative limit on the weighted average maturity of portfolio (less than 60 days).
- A narrow allowable range for net asset value per share ($0.995 - $1.005).
- A limit on the maximum percentage of total assets invested in certain types of investments (diversification).
- Prudent requirements for collateralizing repurchase transactions (102 percent).
- A prohibition against investing in volatile derivative securities like collateral mortgage obligations (CMOs).

Effective May 12, 1997, the day-to-day management of TexPool was contracted out to external parties. Although the Comptroller maintains oversight and legal responsibility, contractors perform all of the operational aspects of TexPool. These contracted duties include investment management, custody of assets, participant records administration, marketing, and processing of participant deposits and withdrawals.

Section 1-A:

Ensure Contractors Meet All Applicable Standards

The Treasury's process for monitoring TexPool's contractors does not ensure that the contractors meet all applicable standards set forth in the contract, the request for proposals, the rating guidelines for AAAm rated funds, or applicable statutes. The process has the following weaknesses:

- The Treasury staff member who acts as TexPool Portfolio Manager does not regularly monitor the prices of the securities held in the TexPool portfolio. TexPool's investment policy requires that the contractors value the portfolio based on information from pricing vendors. Rating agency guidelines require that the Treasury check securities prices periodically for reasonableness and validity. The Investment Policy also stipulates: "As a further check, the TexPool Portfolio Manager also monitors the prices of securities held in TexPool, in order to independently determine reasonableness and validity." Accurate pricing of securities is important in ensuring that the fund is fairly valued and in compliance with requirements.
- Although the Treasury monitors the contractors' compliance, the Treasury monitoring process does not hold the contractors to the correct standards set forth in the contract (see Table 6 on next page). These measures are critical in order to check the safety of the fund's investments.
- The Treasury does not monitor or analyze which broker-dealers the contractors use to purchase investments for TexPool. Without monitoring, the

Treasury does not know if contractors use approved brokers-dealers who meet ethics, disclosure, and credit standards. In addition, Treasury staff members do not analyze broker-dealer usage. Monitoring broker-dealer usage can disclose the preferential use of certain broker-dealers and may pinpoint potential problems in advance.

- On at least three occasions, the TexPool contractor purchased prime rate-based adjustable rate notes. TexPool's investment policy does not authorize the purchase of prime rate-based notes. The purchase of unauthorized securities increases the possibility that TexPool participants might incur a loss.
- TexPool's investment policy allows the purchase of Cost Of Funds Index (COFI) adjustable rate notes. The purchase of COFI-based notes is expressly prohibited by rating agency guidelines. In order to maintain its AAAm rating, it is important that management ensure that TexPool's investment policy conforms to rating agency guidelines.

Table 6

Standards Required By TexPool Contract Versus Standard Actually Measured		
Safety Measures	**Required Standard**	**Lesser Standard Actually Measured**
Weighted Average Maturity of the Portfolio	60 days	90 days
Minimum Repurchase Agreements Collateral Coverage	102%	100%
Maximum Repurchase Agreements Maturity Limit	90 days	6 months
Minimum/Maximum Allowed Net Asset Value per Share	0.9975 -1.0025	0.9950 -1.0050

Source: State Auditor's Office.

Recommendation:

TexPool management should improve its monitoring of TexPool's contractors by researching and compiling all required standards from the TexPool contract and related request for proposal (RFP), investment policy, rating agency guidelines for AAAm rated funds, the TexPool Participation Agreement, and applicable statutes. These standards should be broken into daily, weekly, and monthly tasks and summarized into checklists. TexPool activities should be promptly verified with the appropriate checklist. This process should be documented and periodically reviewed by the internal audit or compliance function. Summary results should be communicated to the TexPool Advisory Board on a regular basis.

Management's Response:

We concur with the auditor's recommendation about Treasury Operations improving its monitoring of the contractors. To this end, we will:

- *Regularly monitor the reasonableness and validity of prices of the securities held in the TexPool portfolio based on information from pricing vendors.*

- *Hold contractors accountable to the standards set forth in their contracts. We have already modified the compliance checklist, which will assist us in holding contractors to the standards specified in the contract and the policy.*
- *Monitor and ensure that contractors only use approved broker-dealers.*
- *We will clarify the investment policy so that it specifically excludes the purchase of COFI adjustable rate notes. It should be noted that TexPool has never purchased this type of note.*

We will modify the investment policy to include prime rate notes based adjustable rate notes.

Section 1-B:

Ensure Auditor Independence

TexPool's contractors select and pay the public accounting firm that conducts TexPool's annual financial and compliance audits. Given that the responsibilities of the contractors include the safekeeping, investment management, and bookkeeping for TexPool, the contractors' additional responsibility of selecting and paying the independent auditors undermines the appearance of independence between the contractors and the auditor.

Recommendation:

The Comptroller and/or the TexPool Advisory Board should select, enter into an engagement letter with, and pay the accounting firm conducting TexPool's annual audits. The audit fee could be paid from either a reimbursement arrangement with the subcontractors and/or "TexPool's Earnings on Management Fees Reserved for Operating Expenses" account.

Management's Response:

In the future, the Treasury will select and pay the independent public accounting firm that performs TexPool's annual financial and compliance audit.

Section 2:

Consider Broadening the Range of Eligible Investments

TexPool's narrow range of eligible securities limits its ability to diversify and may limit its ability to increase the earnings of its investments. TexPool restricts its eligible investments to a narrow range of securities. For this reason, as of June 30, 2000, approximately 98.4 percent of all TexPool assets were invested in U.S. government agency securities and repurchase agreements, and the remaining 1.6 percent was invested in money market mutual funds. While government agency securities are generally perceived to be risk-free, rating agency guidelines for AAAm funds identify a concentration of agency securities within a portfolio as a potential risk factor. The flexibility to invest in a broader range of securities allows for greater diversification of the portfolio, which reduces risk, and increases the opportunity to earn a higher rate of return.

Recommendation:

TexPool should consider expanding the list of authorized investments into other investment categories that are authorized under the Public Funds Investment Act and conform to the requirements of the rating agency for an AAAm fund. One category to consider would be highly-rated commercial paper. (Commercial paper refers to the short-term notes issued by corporations.)

Some participants may want to maintain the present policy, while others would be in favor of adding commercial paper or other investment classes. One solution would be to institute the series fund structure used in the mutual fund industry. A series fund is a group of different funds, each with its own investment objective and policies, that is structured as a single corporation or trust in order to reduce costs and ease administrative burdens.

Management's Response:

We have surveyed the participants in TexPool and while most favor expanding the list of authorized investments to include commercial paper, a substantial number of them are prohibited from making investments in a pool that contains commercial paper. Until such time, that we establish a second fund to include commercial paper as an investment option, we do not want to take any action that would force some participants out of the fund. However, we will consider the possibility of starting a second fund in the future to include commercial paper and other eligible investments as investment options.

Section 3:

Enhance the Role of the TexPool Advisory Board

TexPool's Advisory Board does not provide meaningful oversight for TexPool's activities. TexPool operates under the auspices of the Treasury Safekeeping Trust Company, which in turn is under the sole control of the Comptroller. The Public Funds Investment Act (Act) requires that an investment pool have an advisory board. However, the Act does not specify any duties for an advisory board. The participation agreement each participant signs provides that the TexPool Advisory Board "shall advise the Trust Company on the Investment Policy and on various other matters affecting TexPool, and shall approve fee increases."

Standard & Poor's, a leading rating agency, sets forth the following expectations for the board of a cash management fund:

> A board should act as an independent body and demand that advisers be able to clearly explain all investments and investment strategies. . . .

> boards should receive detailed reports regarding fund investments and activities at least monthly. Boards should be active, questioning fund advisers at any time during the year, not just at quarterly meetings. Too often, boards are passive or lack the necessary independence to do their jobs properly. This leads to rubber-stamp approval of investment adviser activities. Such boards are not fulfilling their responsibility to fund shareholders.

Since February 1998, the TexPool Advisory Board has only met four times – twice in 1998 (February and May), not at all in 1999, and twice during 2000. In addition, director attendance at meetings has been low. At the May 1998 and October 2000 meetings, the TexPool Advisory Board failed to assemble a quorum of directors and could not conduct business.

Effective board oversight is important for any organization, but particularly for a financial institution that manages billions of dollars. In the absence of a TexPool governing board, it is important for the TexPool Advisory Board to provide effective oversight. However, a board that does not meet regularly cannot provide effective oversight.

<u>Recommendation</u>:

TexPool management should amend the TexPool Participation Agreement to provide for an Advisory Board that meets regularly and is responsible for overseeing all aspects of TexPool's operation. A board that comprises participants and qualified independent members, as contemplated by the Act, can help ensure that TexPool is managed in the best interests of the participants and at the least possible risk to the State and TexPool participants.

<u>Management's Response</u>:

We concur that a strong advisory board is an essential component to the governance of TexPool. To ensure an effective advisory board, we will:

- *Continue appointing qualified members to the advisory board*
- *Coordinate with the board members to schedule four board meetings annually to coincide with the quarterly financial statements*
- *Encourage high attendance of board members by early publication of board meetings*

Section 4:

Improve the Participation Agreement and the Participants' Understanding of TexPool's Relationship With the State

The agreement between the Comptroller and local governments that invest in TexPool allows, and in some cases requires, participants to assign too many duties to one person. In addition, some participants may not understand that the State does not guarantee their investments in TexPool. TexPool management should address these issues to ensure that participants are aware of the risks associated with investing in an investment pool.

Section 4-A:

Allow Participants to Use Good Control Procedures

TexPool's *Operating Procedures Manual* allows each TexPool participant to designate one person to establish the destination for repetitive fund transfers and to receive all TexPool communications. As of July 2000, 41 participants had designated only one Authorized Representative. Each participant must also designate an Authorized Representative to be the Primary Contact to "facilitate the dissemination of important account information." This arrangement does not ensure that participants separate duties, particularly in cases in which a participant has only one Authorized Representative. An example of separation of duties is designating one employee or person to make transactions and a different employee to receive all transaction confirmations and account information. This structure can significantly increase the likelihood that unauthorized activity would be discovered in a timely manner.

Recommendation:

TexPool management should, at a minimum, modify TexPool's *Operating Procedures Manual* to allow each participant to designate a primary contract who is not an authorized representative. Ideally, TexPool management should consider recommending that its participants use improved control procedures such as requiring or recommending that a primary contact be a responsible individual other than the Authorized Representative.

Management's Response:

We will modify the Operating Procedures Manual to suggest to participants that they should designate a primary contact for TexPool who is not an authorized representative.

Section 4-B:

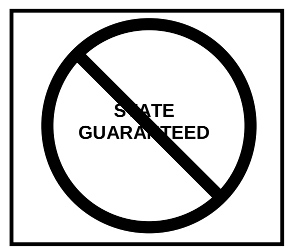
Determine if Participants Expect the State to Support TexPool

The perception may exist among many TexPool participants that investments in TexPool are in some way backed or guaranteed by the State. This incorrect perception could result from participants' knowledge that TexPool is a state-sponsored investment vehicle under the auspices of the Comptroller. Participants may also recall when state funds were used to "rescue" TexPool. The legal and marketing documents employed by TexPool explicitly state that the only source of payment to the participants are the assets of TexPool and that there is no secondary source of payment such as insurance or guarantees. TexPool management acknowledges that some participants may perceive that a state guarantee exists. The degree of this misperception is unknown.

Participants who assume that the State guarantees TexPool are likely to assign a reduced level of importance to TexPool governance issues, and they are likely to pressure the State to bail out TexPool in the event of another crisis. A small 1 percent error could equal an $83 million loss.

<u>Recommendation</u>:

TexPool management should determine the extent of any misunderstanding of the state guarantee issue. If a substantial misperception exists, TexPool management should develop an action plan to resolve the issue. Possible actions include:



- Adding graphics on all communications similar to those used by the banking industry for non-FDIC insured investments sold by banks.
- Requiring participant boards to pass annual resolutions acknowledging the lack of any guarantees.
- Separating TexPool from the Comptroller and establishing TexPool as a free-standing entity supervised by a governing board.

<u>Management's Response</u>:

To help ensure that no participant misunderstands that the pool is not guaranteed by the State of Texas, we will include a reminder in each newsletter that the pool is not guaranteed by the State of Texas. As noted in the report text above, it should be noted that the legal and marketing documents employed by TexPool explicitly state that the only source of payment to the participants are the assets of TexPool and that there is no secondary source of payments such as insurance or guarantees.

Appendices

Appendix 1:
Objectives, Scope, and Methodology

Objectives

The objectives of the audit were to:

- Determine whether the Texas Treasury Safekeeping Trust Company (Trust Company) employs effective controls and procedures when processing the State's transactions and assess whether it effectively and appropriately manages the funds in its care.
- Determine whether the Comptroller's Treasury Division (Treasury) had implemented recommendations made in a previous State Auditor's Office report (*A Review of Controls Over Investment Practices at Six Major State Investing Entities,* SAO Report No. 97-014, November 1996).
- Assess the Texas Prepaid Higher Education Tuition Board's oversight of the Texas Tomorrow Fund's actuarial assumptions, contracting decisions, benchmarking, and strategic planning.
- Determine whether the Texas Local Government Investment Pool (TexPool) receives sufficient monitoring.

Scope

Treasury and Trust Company:

Our scope included quantifying and gaining an understanding of the funds and client relationships managed by the Trust Company as of March 31, 2000. Because the responsibilities and operations of the Trust Company are not clearly delineated from the responsibilities and operations of the Treasury, our review covered both the Trust Company and the Treasury. Specifically, we evaluated whether the current infrastructure is appropriate to handle the Treasury's expanded responsibilities. The infrastructure components we examined included the following:

- Mission
- Governance
- Investment expertise
- Operational control structure
- Information systems
- Monitoring

Texas Tomorrow Fund:

We reviewed the Texas Tomorrow Fund's actuarial process, contract processes, and performance as compared to other states. We also reviewed the fund's identification of financial risks and the safekeeping of the fund's fixed income portfolio.

TexPool:

We analyzed TexPool performance, TexPool's monitoring of subcontractors, and the scope of eligible TexPool investments. We also reviewed the oversight provided by the TexPool Advisory Board and TexPool's relationships with local governments.

Methodology

The methodology for this audit consisted of obtaining applicable criteria, conducting interviews, performing audit tests and procedures, and analyzing and evaluating results against established criteria. We conducted fieldwork from March 2000 through November 2000.

Information collected to accomplish the audit objectives included the following:

- Applicable constitutional and statutory provisions.
- Agency internal audit reports.
- Reports prepared by outside consultants.
- Texas Tomorrow Fund board minutes.
- Financial disclosure statements.
- Investment and operating policies and procedures manuals.
- Ethics policies.
- Contracts with consultants, advisors, external portfolio managers, and investment custodians.
- Divisional organization charts.
- Personnel files.
- Personnel hiring procedures at other state agencies.
- Investment staff qualifications at other state investing entities.
- Investment reports.
- Annual financial statements.

Procedures and tests conducted:

- Conducted interviews with:
  - Agency management and staff.
  - Consultants who performed services for the Texas Tomorrow Fund, TexPool, or the Treasury.
  - Officials from the Dallas and Washington, D.C. branches of the Federal Reserve Bank.
  - Officials from other states that have prepaid tuition programs.
- Reviewed prior external audits, internal audits, and other reviews.
- Reviewed the Trust Company's agreement with the Federal Reserve Board.

- Determined the nature and extent of activities performed for or by the Trust Company, how the Trust Company is governed, and how the Trust Company's activities relate to the Treasury's operations
- Compared the performance of the Treasury's long-term investment funds to benchmarks.
- Performed steps specified in the *Department and Trust Company Examination Procedures* published by the Texas Department of Banking. These steps included reviewing:
  - Operations, internal controls, and auditing.
  - Fiduciary management.
  - Trust Company management.
- Consulted procedures from the *Branch and Agency and Commercial Bank Examination* manuals published by the Federal Reserve Board and the Federal Deposit Insurance Corporation.
- Observed various phases of operations to gain additional understanding.
- Reviewed contractor selection and evaluation procedures.
- Compared selected contractor service fees with contractual rates.
- Reviewed investment reports.
- Reviewed financial disclosures.

Criteria used:

- Trust Department and Trust Company Examinations, Chapters F-1, F-2, F-5, and C-3, Texas Department of Banking.
- *Trust Examination Manual*, Federal Deposit Insurance Corporation.
- Book-Entry Securities Account Maintenance and Transfer Services, Federal Reserve Operating Circular 7, January 2, 1998.
- Title 12 USC, Chapter 3, Federal Reserve System.
- Texas Government Code, Section 404.101, Texas Treasury Safekeeping Trust Company.
- Texas Government Code, Section 403.1041, Tobacco Settlement Permanent Trust Account.
- Education Code, Chapter 63, Permanent Funds for Health-Related Institutions of Higher Education.
- Comptroller's Investment Policy, February 2000.
- Investment policy for the Tobacco Settlement Permanent Trust Account, April 5, 2000.
- Investment policy for the Permanent Fund for Higher Education Nursing, Allied Health and other Health-Related Programs; the Permanent Fund for Minority Health Research and Education; and Permanent Funds for Health-Related Institutions; effective August 30, 1999.
- Investment policy for the Permanent Fund for Tobacco Education and Enforcement; the Permanent Fund for Children and Public Health; the

Permanent Fund for Emergency Medical Services and Trauma Care; the Permanent Fund for Rural Health Facility Capital Improvement; and the Community Hospital Capital Improvement Fund; effective August 31, 1999.

- Investment policy for the Permanent Higher Education Fund (HEF), effective August 31, 1999.
- Agreement for Banking Services between the Texas Treasury Safekeeping Trust Company and the Federal Reserve Bank of Dallas, October 17, 1989.
- Board of Governors of the Federal Reserve System, Supervisory Letter 2516, regarding access to Federal Reserve services by limited purpose, non-member trust companies established by states.

Statement of Compliance With Applicable Auditing Standards

The audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit work:

- Robert Sahm, CPA (Project Manager)
- Mike Chandler
- Carla Kleinwachter
- Hugh Ohn, CPA
- Joe White, CFA
- William Wood, CPA
- Worth Ferguson, CPA (Quality Control Reviewer)
- Carol Smith, CPA (Audit Manager)
- Deborah L. Kerr, Ph.D (Audit Director)

Appendix 2:

Timing of Treasury Endowment Fund Long-Term Investment

Timeline for Treasury Investment of Endowment Funds				
Fund and Background Information	**Enrollment Date for Bill Creating the Fund**	**Effective Date for Bill Creating the Fund**	**Date the Treasury Received Initial Funding and Subsequent Funding (if any)**	**Date Treasury Fully Implemented a Long-Term Investment Plan**
Permanent Public Health Fund The fund was established by House Bill 1676 (76th Legislature). As of May 31, 2000, 86 percent of the fund remained in short-term cash investments. Full implementation of a long-term investment plan began in October 2000.	6/99	8/99	9/99	10/00
Tobacco Settlement Permanent Trust Fund The fund was established by House Bill 1161 (76th Legislature). As of May 31, 2000, 86 percent of the fund remained in short-term cash investments. Full implementation of a long-term investment plan began in October 2000.	6/99	8/99	12/99 and 12/00	10/00
Higher Education Fund (HEF) The Texas Constitution specified that the HEF "shall be invested in a manner provided for the Permanent University Fund." The Permanent University Fund is invested in a full range of long-term investments. Effective September 1, 1995, House Bill 1207 (73rd Legislature) gave the Treasurer (Comptroller) the authority to "administer the fund and invest the fund in the same manner as the permanent university fund." Senate Bill 805 (76th Legislature) further specified the Comptroller's clear legal authority to invest the HEF in long-term investments appropriate to an endowment fund. The Treasury hired an investment consultant in March 2000. As of May 31, 2000, 87 percent of the fund remained in short-term cash investments. Full implementation of a long-term investment plan began in October 2000.	6/93	9/95	12/96, 9/97, 9/98, 10/99, and 9/00	10/00

Appendix 3:

Management Audit of the Texas Tomorrow Fund

Texas Tomorrow Fund

Tomorrow's College at Today's Prices

Management Audit of the Texas Tomorrow Fund

June 5, 2000

McConnell Jones Lanier & Murphy LLP
11 Greenway Plaza, Suite 2902
Houston, Texas 77046
Tel.: (713) 622-7666
Fax: (713) 622-7879

MCCONNELL JONES LANIER & MURPHY LLP
CONSULTANTS & BUSINESS ADVISORS

June 5, 2000

The Honorable Carole Keeton Rylander
Texas Comptroller of Public Accounts
LBJ State Office Building
111 East 17th Street
Austin, Texas 78774

Dear Comptroller Rylander:

We are pleased to present the *Final Report* for McConnell Jones Lanier & Murphy LLP's Management Audit of the Texas Prepaid Higher Education Tuition Program, commonly referred to as the Texas Tomorrow Fund.

The primary objective of the management audit was to determine whether the Texas Tomorrow Fund is operating at maximum efficiency and effectiveness by reviewing the organization's staffing, business practices, operations procedures, and office procedures.

We reviewed the Texas Tomorrow Fund's organization and management, marketing, and administration and operations functions, resulting in 18 recommendations that will help make incremental improvements to significantly enhance customer service levels and potentially increase participation in the program.

We are grateful for the cooperation of the Texas Tomorrow Fund's management team and staff during the management audit. We are especially grateful to the manager and assistant manager of the fund, who assisted us with scheduling interviews and collecting data during the engagement.

Very truly yours,

Odysseus M. Lanier
Partner

SUMMIT TOWER • 11 GREENWAY PLAZA, SUITE 2902 • HOUSTON, TEXAS 77046 • TEL: 713.622.7866 FAX: 713.622.7878

Executive Summary

Background

In 1995, the Texas legislature created the Texas Prepaid Higher Education Tuition Program (the Program). The Texas Prepaid Higher Education Tuition Board (Board) operates the Program, commonly known as the Texas Tomorrow Fund (TTF), which offers a simple and affordable way for families to save for future college expenses associated with tuition and required fees. The board is chaired by the Texas Comptroller of Public Accounts (Comptroller) and includes two members appointed by the Governor and four members appointed by the Lt. Governor; two members are submitted by the Speaker of the House. The Board commenced operations on September 1, 1995, and, as of May 26, 2000, 92,274 college tuition contracts have been sold. The current enrollment period ended June 5, 2000.

Prepaid tuition contracts can be purchased for Senior Colleges and Universities (four-year public schools), Junior and Community Colleges (two-year schools), Junior-Senior Colleges (two years of public community college combined with two years of public senior college) and Private Colleges. The purchasers of prepaid tuition contracts must pay an initial application fee and designate a beneficiary and the anticipated date the beneficiary intends to matriculate into post-secondary education. Beneficiaries must be Texas residents, or, if they are not residents, their parents must be the purchasers and reside in Texas.

Over the past five years, the number of prepaid tuition contract purchases has steadily declined, causing the Comptroller to examine both external and internal factors that possibly contributed to reduced purchases. The Comptroller commissioned a management audit of the TTF and hired McConnell Jones Lanier & Murphy LLP (MJLM) to determine whether the TTF is operating at maximum efficiency and effectiveness by reviewing the following areas of the TTF:

- Organizational structure;
- Staffing;
- Business practices, such as contracting for outside services;
- Operating procedures; and
- Office procedures.

MJLM was hired to prepare a report, including recommendations for changes in any of the above areas, to enhance the Comptroller's efficiency and effectiveness in carrying out the responsibilities as the chief fiscal office of the state and to suggest improvements for the management and financial controls of the Comptroller.

Methodology

The methodology used to conduct the management audit implemented MJLM's management and operations review and assessment guidelines and techniques to analyze existing data and information obtained from interviews with TTF management and staff. MJLM conducted activities necessary to complete a comprehensive management audit of TTF's organization, management, and operations at the Thomas Jefferson Rusk Building in Austin, Texas, from May 22, 2000 through May 26, 2000. MJLM's review included:

- Reviewing and analyzing existing budget documents, independent audit reports, policies and procedures, job descriptions, contracts with major vendors, and historical performance data;
- Conducting confidential interviews with TTF management and staff knowledgeable about the fund's operations;
- Reviewing marketing proposals, strategic marketing plans and promotional literature, statistical reports, and available performance data;
- Developing recommendations to identify opportunities to improve the overall efficiency and effectiveness of TTF management and operations; and
- Providing a detailed report outlining all recommendations necessary to correct the underlying causes of administrative, management, marketing, and operations deficiencies noted during the management audit.

Organization of Report

This report provides an executive summary and three separate sections, one for each of the following areas:

- Organization and Management (Section A)
- Marketing (Section B)
- Administration and Operations (Section C)

Major Recommendations

This section includes a summary of major recommendations resulting from MJLM's review and assessment of the TTF organization, management, marketing, and operations. A summary of recommendations included in the report for each functional area follows.

Organization and Management

Major Recommendations:

- Implement a comprehensive management accountability system requiring the manager of TTF and unit managers to engage in planning, direction, execution, and follow-up activities.
- Enhance office communication by establishing a standard date and time for periodic staff meetings to encourage information sharing and open dialogue between units.
- Hire permanent employees to answer incoming calls in the Customer Service unit.
- Reorganize the division, evaluate the skills of the existing staff, consolidate similar administrative and operations functions, and transfer all records administration tasks to the records administration contractor.

Marketing

Major Recommendations:

- Restructure the Marketing unit.
- Develop an internal marketing plan.
- Re-bid the advertising contract to determine if a more effective campaign can be developed and consider increasing the budget for the advertising contract.

Administration and Operations

Major Recommendations:

- Transfer data-entry process performed by Administrative Services to the records administrator and eliminate the temporary employees within the unit.
- Consolidate the Administrative Services and Customer Service units.
- Expand the records administration contract to include manual records management processes currently performed by the Accounting unit.
- Encourage the records administrator to reduce the length of time authorizations for refund are held to 10 days to improve customer service.

Detailed Report

A. Organization and Management

The Texas Tomorrow Fund (TTF) is a division within the Comptroller's Office that is directed by a manager and organized into four separate units: (1) Accounting, (2) Customer Service, (3) Administrative Services, and (4) Marketing. The manager reports to the director of the Office of the Treasury (also located within the Comptroller's Office) and is responsible for the day-to-day management and administration of the TTF.

The TTF has an assistant manager who is responsible for contract management and administration, oversight of the individual units, and special projects. Unit managers direct the activities of each unit and report to the manager of the TTF. Thirteen full-time employees and seven temporary employees make up the total staffing complement of the TTF. **Exhibit A-1** presents the current TTF organization.

Exhibit A-1
Texas Tomorrow Fund
Current Organization

Source: Texas Tomorrow Fund

The manager is also primarily responsible for developing and managing the TTF operating budget. **Exhibit A-2** presents the TTF comparative budgets for FY 1998, FY 1999, and FY 2000.

Exhibit A-2
Texas Tomorrow Fund
Comparative Budgets
FY 1998, FY 1999, and FY 2000

	FY 2000	FY 1999	FY 1998
Salaries and Wages			
Classified Salaries	$ 511,703	$ 388,519	$ 507,063
Salary Actions	5,479	-	3,000
One-Time Merit Increase	-	3,718	5,856
Bonus pay	-	-	-
Overtime	-	-	-
Longevity	3,860	3,700	5,000
Benefit Replacement Pay	6,700	6,700	3,502
Payroll and Other Fringe	104,186	86,420	-
Total Salaries and Wages	$ 635,608	$ 489,759	$ 524,421
Operating Expenses			
Non-ELP Capital Outlay	-	2,995	4,917
Travel	27,387	27,829	25,967
Consultants and Professional Fees	5,227,815	3,594,286	3,165,978
Rental and Leasing	13,963	7,952	12,370
Telephones and Utilities	63,423	68,536	37,435
Supplies and Materials	125,219	109,623	15,705
Maintenance and Repair	704	445	76
Other Operating Expenses	343,681	227,827	684,456
Total Operating Expenses	$ 5,802,202	$ 4,039,997	$ 3,846,566
Available Reserve/Lapse	$ 130,311	$ 1,532,381	$ 183,733
Grand Total	$ 6,568,011	$ 6,061,488	$ 4,554,720

Source: Texas Tomorrow Fund Operating Budgets for FY 1998, FY 1999, and FY 2000

The TTF budget increased 44 percent between FY 1998 and FY 2000, primarily because of normal increases in costs associated with records administration activities outsourced to the private sector and increases in fees paid to fund managers. The FY 2000 budget also includes increased marketing costs associated with paying commissions to Certified Sales Organizations to market prepaid tuition contracts.

Recommendation 1:

Eliminate the assistant manager position and require unit managers to be accountable for contract administration and management in their respective areas.

One manager's supervising four unit managers is a manageable span of control that does not require an additional layer of management. Moreover, unit managers should have basic contract administration and management skills as a prerequisite for managerial positions.

Recommendation 2:

Implement a comprehensive management accountability system requiring the manager of TTF and unit managers to engage in planning, direction, execution, and follow-up activities.

The board should require the manager of TTF to develop annual goals and objectives for the division and communicate them to unit managers. Unit managers should be required to develop specific goals and objectives for their respective areas and should be held accountable for achieving them. The manager and unit managers can use weekly planners, detailing prioritized tasks necessary to accomplish specific objectives, as an effective planning and management tool.

Disciplinary measures for unit managers who do not comply with TTF policy initiatives must be an integral component of the comprehensive accountability system.

Recommendation 3:

Enhance office communication by establishing a standard date and time for periodic staff meetings to encourage information sharing and open dialogue between units.

Periodic staff meetings will allow unit managers to share information regarding problems they may have interfacing with each other and identify interunit issues that may affect the overall efficiency of TTF and the effectiveness of its customer service.

Recommendation 4:

Develop formal, written policies and procedures for each unit within TTF.

Formal, well-documented policies and procedures are essential to providing consistent quality customer service. Policies represent courses of action or guiding principles of TTF that are approved by the board, while procedures are the methods and steps necessary to implement the policies. Procedures are the links that allow an organization to transfer knowledge from one employee to another and maintain consistent levels of service to purchasers of prepaid tuition contracts.

Recommendation 5:

Hire permanent employees to answer incoming calls in the Customer Service unit.

Hiring permanent employees in the Customer Service unit will reduce turnover and allow TTF to build a competent staff of well-trained employees to answer incoming calls from contract purchasers.

TTF is contracted to spend $119,035 for temporary employees in FY 2000, an average of $17,005 for each of the seven positions. The division should evaluate its present workload and determine the actual number of full-time employees needed to answer incoming calls and reallocate resources from the temporary services contract as appropriate.

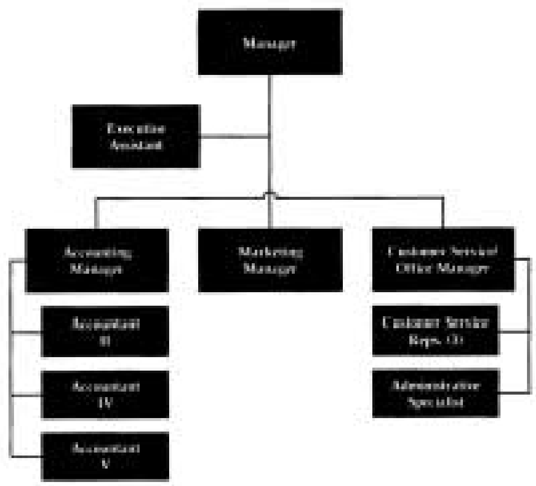
Recommendation 6:

Reorganize the division, evaluate the skills of the existing staff, consolidate similar administrative and operations functions, and transfer all records administration tasks to the records administration contractor.

To become an efficient organization, TTF staff members must be evaluated to determine if they have the appropriate skill sets to perform their respective functions. Similar administrative and operations functions should be consolidated. All records administration should be transferred to the private records administration contractor.

Reorganizing TTF based on recommendations included in this report will result in a net reduction of one full-time position and all seven temporary positions. **Exhibit A-4** presents TTF's recommended organization based on recommendations included in this report.

Exhibit A-4
Proposed Organization



Source: MJLM

B. Marketing

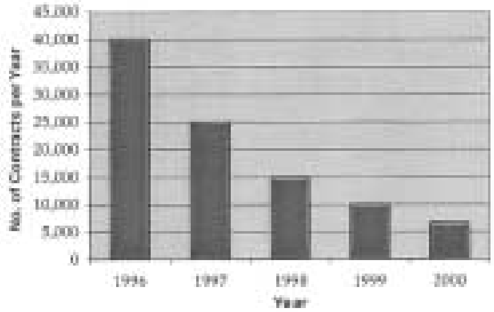
The Marketing unit for the Texas Tomorrow Fund (TTF) is headed by a marketing manager. Additional staff assigned to the unit include a senior marketing representative and a marketing representative, both of whom report to the marketing manager. A senior market development specialist, who reports to both the manager and assistant manager of TTF and functions in a staff capacity, is also assigned to the unit.

Major responsibilities of the Marketing unit include directing advertising, public relations, and outreach activities for TTF. For example, the TTF Marketing unit is charged with strategic market planning, creating alliances with the private sector, developing publications and print materials, and organizing and executing direct mail and grass roots outreach (presentations to potential enrollees) campaigns.

In 1996, when TTF was initially rolled out, approximately 40,000 contracts were sold. On June 5, 2000, TTF will complete its fifth enrollment period and the number of contracts sold as of June 2, 2000 is 6,840. **Exhibit B-1** presents TTF's five-year enrollment trend.

Despite TTF's declining enrollment trend, when compared to other states that offer similar prepaid tuition plans, the number of contracts sold in Texas was the second highest. **Exhibit B-2** presents the states with the 10 highest contract enrollment numbers as of 1998.

Exhibit B-1
Texas Tomorrow Fund
Five-Year Enrollment Trend
(Number of Contracts Sold)



Source: Texas Tomorrow Fund (Year 2000 amounts are estimated)

Exhibit B-2
States with the Ten Highest
Prepaid Tuition Contract Enrollment
(As of 1998)

State	Total Number of Contracts Sold	Date of Initial Offering
Florida	468,000	Oct. 88
Texas	78,000	Jan. 96
Ohio	69,000	Nov. 89
Michigan	56,315	1988
Alabama	50,886	Mar. 90
Massachusetts	42,216	Feb. 95
Virginia	22,698	Dec. 96
Pennsylvania	22,029	Sep. 93
Alaska	14,517	Apr. 91
Mississippi	8,300	Feb. 97

Source: College Savings Plan Network Conference Data, July 1999

Recommendation 7:

Restructure the Marketing unit.

Transfer all marketing planning and implementation functions and activities to a private advertising agency, eliminate the three marketing staff positions and identify innovative ways to use selected staff in the Comptroller's field offices throughout the state to perform marketing outreach functions. Comptroller staff located within field offices throughout the state will provide significantly more coverage for grass roots outreach efforts to potential enrollees in the Prepaid Tuition Program.

Field office employees could be provided financial incentives in the form of bonuses or commissions to participate in TTF's grass roots marketing activities. Since TTF is an enterprise fund and field office staff are paid from the state's general fund, TTF will be required to reimburse the general fund for all payroll, fringe benefits, travel and related costs associated with the time field office staff spend performing marketing and outreach functions.

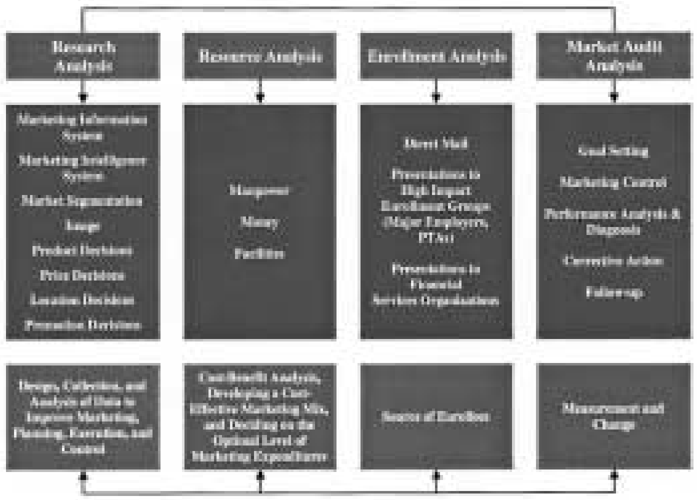
The manager of the Marketing unit will be responsible for the management and oversight of the private advertising agency and coordinating statewide marketing and outreach efforts conducted by designated field office personnel.

Recommendation 8:

Develop an internal marketing plan.

Benchmark successful prepaid tuition plans (Florida) and use the data to assist with developing an internal marketing plan. **Exhibit B-3** presents a schematic of the components of an internal marketing plan.

Exhibit B-3
Schematic of Components of
Internal Marketing Plan



Source: MJLM

Recommendation 9:

Increase the involvement of key TTF staff members in advertising planning sessions and improve oversight of advertising agencies.

Increasing the involvement of key staff members in planning sessions will improve the coordination of internal marketing efforts. Improving TTF's management oversight of advertising agencies will facilitate better contract administration.

Recommendation 10:

Re-bid the advertising contract to determine if a more effective campaign can be developed and consider increasing the budget for the advertising contract.

Recommendation 11:

Enhance the TTF web site to allow users to complete the enrollment agreement and pay the required fee via credit card directly over the Internet.

Recommendation 12:

Identify staff resources in the Information Technology Department that can be used to complete backlogged programming requests to facilitate more effective management reports that can be used to track marketing efforts.

C. Administration and Operations

Administrative and operations functions within the TTF are conducted by the Accounting, Administrative Services, and Customer Service units. **Exhibit C-1** describes the primary functions of each administrative and operations unit.

Exhibit C-1
Texas Tomorrow Fund
Administrative and Operations Units and Related Functions

Unit	Functions
Accounting	• Investment accounting and financial reporting • Contract management • Contract pricing support to actuary • Contract conversions • First-Time-in-College Letters and identification card handling • Processing of matriculation (tuition) payments to colleges and universities • Processing of refunds from cancellations of prepaid tuition contracts
Administrative Services	• Processing of incoming mail, including payments on contracts, Purchaser Acceptance Forms, and correspondence to downgrade payment options, upgrade contract (conversions), address changes, and complaint letters • Data entry of original applications (Intent to Enroll forms) • Assigning of correspondence to TTF staff as appropriate • Processing of vendor invoices • Acting as liaison for personnel actions (prepares Personnel Action Forms), computer network, and open records requests • Coordination of telephone service, travel, and acquisition of supplies • Back-up for property inventory
Customer Service	• Answering of incoming calls from purchasers regarding their contracts, including upgrading, downgrading, late fees, types of plans, and payment options • Researching of incoming correspondence and responding as appropriate

Records administration activities are contracted to InTuition Solutions, Inc. (InTuition) in Jacksonville, Florida. InTuition is primarily responsible for responding to correspondence from participants in the prepaid tuition program, forwarding special petitions for waiver of program rules to the board, preparing customer service reports, posting purchaser payments, processing invoices from post-secondary institutions for payment, and processing refunds for payment.

InTuition performs its records administration activities electronically with a proprietary computer system commonly referred to as PRIMA. The PRIMA system allows InTuition to electronically receive applications from TTF, post tuition credits purchased to purchasers' accounts, initiate and receive automated clearing house payments, and verify account information, including available tuition credits to purchasers, beneficiaries, and institutions. PRIMA also has the capability to electronically generate correspondence to notify matriculating beneficiaries of procedures to follow for enrolling in an institution, and issue late letters resulting from delinquent payments on prepaid tuition contracts. TTF has "read-only" access to all screens produced by the PRIMA system, allowing Accounting, Administrative Services, and Customer Service to view the status of purchasers' accounts, including correspondence received and action taken.

Administrative Services is the initial point of data entry for applications for prepaid tuition contracts and all changes to existing contracts. Tuition contracts and changes are initially entered into TTF's mainframe and electronically transmitted to InTuition each night through a data line. The actual hardcopy applications from which data is entered are sent to InTuition via overnight courier to create and file a permanent record containing purchasers' actual signatures.

Recommendation 13:

Transfer data-entry process performed by Administrative Services to the records administrator and eliminate the temporary employees within the unit.

Restructure the contract with the records administrator to allow for entering original applications for prepaid tuition contracts and changes to existing contracts. This will allow TTF to transfer data-entry functions currently performed by Administrative Services to InTuition.

TTF should prepare a cost vs. benefit analysis before restructuring the contract to determine the net financial impact to the division. The analysis should consider the cost of temporary staff, associated turnover, and efficiencies to be realized by moving the data-entry functions back to the records administrator

Recommendation 14:

Consolidate the Administrative Services and Customer Service units.

Consolidating the Administrative Services and Customer Service units will improve coordination of responses to purchaser inquiries and enhance customer service.

Recommendation 15:

Develop workload statistics and performance measurement reports to monitor the productivity of Customer Service representatives.

Workload statistics and performance measurement reports are effective management tools to measure the productivity of Customer Service representatives. These statistics and reports can be used to project staffing requirements as well as the quality and timeliness of services provided.

Recommendation 16:

Expand the records administration contract to include manual records management processes currently performed by the Accounting unit.

Preparing third-party bill letters, mailing First-Time-in-College packets, and mailing matriculating rosters are manual administrative processes that could be performed more efficiently by InTuition.

Before making the decision to expand the records administration contract, TTF should conduct a cost vs. benefit or outsourcing analysis to determine if expanding the contract will result in higher quality service for an equal or lower cost.

Recommendation 17:

Encourage the records administrator to reduce the length of time authorizations for refund are held to 10 days to improve customer service.

Commercial banks only hold out-of-state checks for 10 days before making funds available to depositors. Reducing the length of time for withholding authorizations for refunds to 10 days will reduce the turnaround time for refunds to four weeks, improve customer service and reduce the number of complaints received by Customer Service.
The records administrator's contract should be amended to include a provision to reduce the holding period for authorizations for refunds to 10 days.

Recommendation 18:

Cross-train employees to perform all functions and related activities in the combined Administrative and Customer Service units.

Cross-training permanent employees to perform multiple functions and activities, coupled with well-documented policies and administrative procedures, will insure that "institutional knowledge" will be spread among several individuals. As a result, the unit will operate efficiently even if key employees leave or become incapacitated.

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Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable James E. “Pete” Laney, Speaker of the House, Chair
The Honorable Bill Ratliff, Lieutenant Governor, Vice Chair
The Honorable Rodney Ellis, Senate Finance Committee
The Honorable Florence Shapiro, Senate State Affairs Committee
The Honorable Robert Junell, House Appropriations Committee
The Honorable Rene O. Oliveira, House Ways and Means Committee

Governor of Texas

The Honorable Rick Perry, Governor

Comptroller of Public Accounts

The Honorable Carole Keeton Rylander, Comptroller of Public Accounts
Mr. Billy Hamilton, Deputy Comptroller

Texas Tomorrow Fund Board Chair and Members