

An Follow-up Audit Report on

The Texas Treasury Safekeeping Trust Company, the Texas Guaranteed Tuition Plan, and the Texas Local Government Investment Pool

October 2003

Report No. 04-007



The Texas Treasury Safekeeping Trust Company, the Texas Guaranteed Tuition Plan, and the Texas Local Government Investment Pool

Overall Conclusion

During this audit, we followed up on recommendations we made in 2001 to strengthen the operations of the Texas Treasury Safekeeping Trust Company (Trust Company), the Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund), and the Texas Local Government Investment Pool (TexPool). We also pursued additional objectives to audit (1) specific aspects of the Plan actuarial assumptions, asset management, and payment timeliness and accuracy and (2) the Plan's and the Trust Company's contract management processes. Overall, we found that:

- The Trust Company has fully or partially implemented all of our 2001 recommendations, many of which were aimed at establishing basic building blocks through the consideration of industry standards.

While the Trust Company has strengthened its organizational structure, staffing, and internal controls, it still needs to fully implement outstanding 2001 recommendations. Most importantly, it needs to fully implement outstanding recommendations through its implementation of new automated systems. As it continues modifying its structure and processes, other necessary improvements have been identified and may continue to be identified. For example, the banking examination the Trust Company obtained in response to our 2001 recommendation identified weaknesses in governance and financial integrity. The financial audit the Trust Company obtained in response to our 2001 recommendation identified material weaknesses in segregation of duties and accounting reconciliations.

- The Plan has fully or partially implemented most of our 2001 recommendations, but it still needs to fully implement outstanding 2001 recommendations. Most importantly, it needs to implement outstanding recommendations to obtain formal research on investment rate of return assumptions and broaden the range of sensitivity testing in its actuarial reports. It should also be noted that the Plan's financial health has declined since our 2001 audit. Much of the decline in the Plan's financial health can be attributed to conditions in financial markets. In addition, the effect of tuition deregulation on the

Background Information

Our audit focused on the following units within the Office of the Comptroller of Public Accounts (Comptroller):

- The Texas Treasury Safekeeping Trust Company (Trust Company) (1) provides a means for the Comptroller to obtain direct access to services provided by the Federal Reserve System and (2) enables the Comptroller to manage, disburse, transfer, protect, and invest funds and securities. As of December 31, 2002, the Trust Company managed \$16.5 billion in assets.
- The Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund) is a prepaid college tuition program. The Plan is overseen by the Texas Prepaid Higher Education Tuition Board. As of March 31, 2003, the Plan had \$1.3 billion in total assets.
- The Texas Local Government Investment Pool (TexPool) is a local government investment pool that provides investment services to more than 1,700 communities. As of December 31, 2002, TexPool managed \$13.1 billion in assets.



Plan's financial health is uncertain. As of March 31, 2003, the Plan projected that its liabilities exceeded its assets by \$226 million. Under more conservative investment return assumptions, we estimate that deficit could be \$318 million. The Plan is guaranteed by the State; therefore, if the Plan's financial health does not improve, the State would eventually be required to contribute funds to the Plan.

The Plan's investment return assumptions exceed those of comparable prepaid tuition plans and two state retirement plans; therefore, they should be re-examined. Implementation of certain measures in areas such as decision making and investment policy also would help the Plan to balance the difficult task of managing assets to provide benefits to participants while minimizing future liabilities to the State. The Plan generally disburses tuition payments in an accurate and timely manner.

- Now managed by external vendors overseen by the Trust Company, TexPool has strengthened the oversight of its investment operations and its monitoring of external vendors by implementing all of our 2001 recommendations.
- The Trust Company did not consistently follow formal policies and procedures designed to ensure that it fairly and objectively awards contracts to external investment managers. The Trust Company and the Plan also lack formal policies and procedures for monitoring contracts. In addition, unlike other state investing entities, the Plan lacks a policy requiring the members of the Texas Prepaid Higher Education Board (Board) and key employees to disclose conflicts of interest regarding potential contractors.

Key Points

The banking examination and financial audit the Trust Company obtained in response to our 2001 recommendations identified significant weaknesses.

In its recent examination of the Trust Company, the Department of Banking made recommendations to strengthen the Trust Company's governance structure and financial integrity. (Some of those recommendations were similar to recommendations we made in 2001.) The banking examination report recommended that the Trust Company file new articles of incorporation to enhance its legal separation from the Comptroller of Public Accounts, strictly follow the Statement of Principles of Trust Management, and segregate corporate cash and investments from fiduciary assets. Based on its legal interpretation, Trust Company management disagreed with many of the banking examination report's recommendations.

The financial opinion audit that the Trust Company obtained identified material weaknesses in the Trust Company's segregation of duties and in its reconciliations of its general ledger. Material weaknesses are generally serious matters that could lead to the undetected misstatement of amounts in financial statements.

The Trust Company is implementing new automated accounting and investment systems that will help it to implement our prior recommendations.

Because the Trust Company's new accounting and investment systems are still under development, a final determination of their capacity to enable the Trust Company to fully

implement the remainder of our 2001 recommendations cannot be made at this time. We plan to follow up on the implementation of these systems at a later date.

The Plan's investment return assumptions exceed those of comparable plans and two state retirement plans.

The Plan's investment return assumptions are higher than those of (1) most comparable prepaid tuition programs in other states and (2) Texas's two largest state retirement systems. Using an investment return assumption that is too optimistic can lead to the understatement of the Plan's deficit and inaccurate pricing of prepaid tuition contracts. In May 2003, the Plan's investment consultant recommended that the Plan reduce its investment return assumption, but the Board has not yet taken any action on that recommendation.

The Plan lacks certain measures that would help it manage assets to provide benefits to participants while minimizing future liabilities to the State.

Balancing the dual goals of providing benefits to participants and minimizing future liabilities to the State can be a difficult task, and achieving the proper balance between these goals is a complex challenge. Addressing the following issues would both help the Plan to manage this challenge and strengthen the Board's fiduciary role:

- The Board does not always formally vote when making significant decisions. In June 2003, the Board discussed suspending the enrollment of new participants (except for newborns) in the Plan, but it did not formally vote on this decision. In addition, enrollment in the Plan was suspended without determining the actuarial consequences this action could have.
- The Plan's investment consultant does not provide the Board with information on the sources of investment overperformance or underperformance, portfolio turnover, best execution of trades, and investment-style analyses.
- The Plan's investment policy does not specify (1) whether money managers can make soft dollar arrangements, (2) standards to emphasize safety and liquidity over investment yield and standards for credit ratings or collateralization requirements for investments, and (3) a formal and detailed policy for investment manager review and retention.
- The Plan has not defined certain financial terms such as "actuarially unsound" or "financially infeasible." Without these definitions, it is not possible to determine when or if corrective action needs to be taken to strengthen the financial soundness of the Plan.

The Plan also should consider expanding its staff's investment expertise and using passive asset managers.

Summary of Management's Response and Auditor's Follow-up Comment

Management generally agrees with the recommendations in this report, with the exception of its response to the recommendations regarding the Trust Company's banking examination. Management's full responses are presented in Appendix 4. Certain items in management's responses required clarification; therefore, we have also included auditor follow-up comments in Appendix 4.

Summary of Information Technology Review

As discussed previously, the Trust Company is implementing new automated systems for its accounting and investment functions. Although we did not conduct a comprehensive review of information systems, we identified weaknesses in password administration and access authorization in the Trust Company's present investment accounting system. In addition, the management letter that the Trust Company's external auditor prepared noted that the Trust Company lacks written disaster recovery plans that are tested and updated at least annually.

Summary of Objectives, Scope, and Methodology


Our primary objective was to determine whether the Trust Company, the Plan, and TexPool have implemented recommendations we made in 2001. For the Plan only, additional objectives were to determine:

- Whether the Board has adopted actuarial assumptions that are consistent with other states' programs and reasonable when compared with other programs dealing with long-term liabilities.
- Whether the Plan manages its assets to provide benefits to participants while minimizing future liabilities to the State.
- Whether the Plan disburses tuition payments to universities and makes refunds to contract purchasers in an accurate and timely manner.

We also determined whether the Plan and Trust Company have established adequate controls over their contract management processes.

Our scope primarily covered fiscal year 2002. Our methodology consisted of gathering information through interviews; reviewing policies and procedures; testing controls and related documentation; reviewing information technology on a limited basis; attending selected Board meetings; comparing the Plan with Texas pension plans and endowment funds and other states' prepaid tuition plans; and reviewing the Trust Company's banking examination report, financial audit report, and related working papers.

Table of Results and Recommendations

 denotes entry is related to information technology

The Trust Company fully or partially implemented all of our 2001 recommendations, but it needs to fully implement important recommendations that remain outstanding. (Page 1)

The Trust Company should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)


The Department of Banking's examination identified weaknesses in the Trust Company's governance and financial integrity. (Page 2)

We acknowledge the Trust Company's position regarding the banking examination report (particularly in light of its current governing statute) but encourage it to consider the report's recommendations.

The financial opinion audit the Trust Company obtained identified material weaknesses in segregation of duties and timeliness of reconciliations. (Page 4)

The Trust Company should:

- Correct all weaknesses noted in the financial audit report.
- Ensure that the results of financial audits are issued in a timely manner and promptly share those results with the Trust Company's Investment Advisory Board.

 The Trust Company is developing new accounting and investment systems to strengthen its operations. (Page 5)

The Trust Company should:

- Continue working to implement its new financial accounting and investment accounting systems.
- Monitor to ensure that the new investment accounting system fulfills business and functional requirements.
- Correct the password and access authorization weaknesses in the current investment accounting system and ensure that they are not duplicated in the new financial accounting and investment accounting systems. Specifically, the Trust Company should:
 - ◆ Implement a process requiring users to change their passwords on a regular basis and follow the Comptroller's requirements for establishing passwords.
 - ◆ Ensure that user passwords are not available to division security coordinators for viewing. Passwords should be hidden or encrypted.
 - ◆ Ensure that access authorization is documented and fully supported for all users of the investment accounting system.
 - ◆ Periodically review access authorization for all users, including division security coordinators, to ensure that access rights match job duties and responsibilities.

The Plan fully or partially implemented most of our 2001 recommendations, but it needs to address important recommendations that remain outstanding. (Page 8)


The Plan should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)

The Plan's investment return assumptions are higher than those of most comparable prepaid tuition programs and Texas's two largest state retirement systems. (Page 9)

The Plan should:

- Re-examine its process for developing investment return assumptions to determine why its assumptions are higher than most other states' return assumptions for prepaid tuition plans.
- Work with its investment consultant to ensure that, at least on an annual basis, it receives formal, documented research to develop investment rate of return assumptions.
- Consider the average duration of its liabilities when developing investment return assumptions.

Table of Results and Recommendations

 denotes entry is related to information technology

The Plan lacks certain measures that would help it manage assets to provide benefits to participants while minimizing future liabilities to the State. (Page 11)

The Plan should:

- Ensure that its Board formally votes on significant decisions such as enrollment suspension, program modification, or program termination. In addition, the Plan should obtain actuarial analyses regarding the fiscal impact of any major decisions before making these types of decisions.
- Obtain additional, useful information from its external investment consultant or others, including information about attribution analysis, portfolio turnover, best execution of trades, investment style analysis, and average daily cash balances.
- Enhance its investment policy by:
 - ◆ Specifying provisions governing soft dollar arrangements.
 - ◆ Specifying more protective standards to emphasize safety and liquidity more than investment yield when choosing cash equivalent investments and establishing minimum standards for the credit ratings on investments or collateralization requirements for investments.
 - ◆ Establishing a money manager review and retention policy that includes guidelines for monitoring investment managers' performance.
- Define the phrases "actuarial soundness," "sufficiently actuarially sound," and "financially infeasible" and use them as criteria to determine when corrective action needs to be taken to ensure the financial health of the Plan.
- Consider (1) expanding its staff's investment expertise to better manage or at least monitor its investment programs and (2) the benefits of using passive indexation strategies for the management of a portion of its investment portfolio.

The Plan generally disburses tuition payments in an accurate and timely manner. (Page 13)

(No recommendations)

TexPool strengthened its operations by implementing all of our 2001 recommendations. (Page 14)

(No recommendations)

The Trust Company did not consistently follow contract award procedures. (Page 15)


The Trust Company should follow formal policies and procedures and adhere to established criteria in evaluating proposals and awarding contracts. In particular, it should:

- Abide by the stated minimum criteria for consideration of proposals that potential contractors submit in response to RFPs.
- Separate its procurements to hire investment managers from its investments in alternative assets.
- Document its evaluation of potential contractors' proposals and related deliberations in a manner that adequately explains the basis on which resulting contract award decisions are made.
- Research potential contractors' tax and child support payment histories sufficiently early in the contractor selection process so they can use the results of that research in the evaluation of potential contractors' proposals.

The Trust Company and the Plan lack formal contract monitoring policies and procedures. (Page 16)

The Trust Company and the Plan should:

- Develop and communicate formal policies and procedures for monitoring contractors. These policies and procedures should identify:
 - ◆ The specific monitoring activities to be performed and the frequency with which they should be performed.
 - ◆ How monitoring activities should be performed, including the information sources that should be used.
 - ◆ The individual responsible for performing each monitoring activity.
 - ◆ How monitoring activities should be documented.

Table of Results and Recommendations
 denotes entry is related to information technology

- ◆ How and to whom the results of monitoring should be communicated.
- ◆ How monitoring results should be used, including requirements for subsequent follow-up.
- Conduct monitoring and evaluation of contractors with a frequency that sufficiently supports the continuous management of contracts. Monitoring and evaluation criteria should directly relate to the specific services each contractor provides and the key provisions of each contract.

The Plan lacks a policy requiring Board members and key employees to disclose conflicts of interest regarding potential contractors. (Page 18)

The Plan should develop and implement a formal policy requiring Board members and key employees to disclose any relationships or other conflicts of interest they may have regarding potential contractors.

Recent SAO Work

Number	Product Name	Release Date
02-007	An Audit Report on the State Treasury and Its Trust Company, the Texas Tomorrow Fund, and TexPool	October 2001

Other SAO Products

Number	Product Name	Release Date
03-038	A Legislative Summary Document Regarding the Comptroller of Public Accounts	January 2003

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Detailed Results

Chapter 1

The Texas Treasury Safekeeping Trust Company Needs to Fully Implement Outstanding 2001 Recommendations and Address New Weaknesses that Have Been Identified

The Texas Treasury Safekeeping Trust Company (Trust Company) has fully or partially implemented all of our 2001 recommendations, many of which were aimed at establishing basic building blocks through the consideration of industry standards. While the Trust Company has strengthened its organizational structure, staffing, and internal controls, it still needs to fully implement outstanding 2001 recommendations. Most importantly, it needs to fully implement outstanding recommendations through its implementation of new automated systems.

As the Trust Company continues modifying its structure and processes, other necessary improvements have been identified and may continue to be identified. The banking examination the Trust Company obtained in response to our 2001 recommendation identified weaknesses in governance and financial integrity. The financial audit it obtained in response to our 2001 recommendation identified material weaknesses in segregation of duties and accounting reconciliations.

To address our 2001 recommendations, the Trust Company also is implementing new automated systems for its accounting and investment functions. Because these systems are in development, a final determination of their capacity to enable the Trust Company to fully implement the remainder of our recommendations cannot be made at this time.

Chapter 1-A

The Trust Company Fully or Partially Implemented All of Our 2001 Recommendations, but It Needs to Fully Implement Important Recommendations that Remain Outstanding

The Trust Company has strengthened its operations by implementing or partially implementing all of our 2001 recommendations. For example:

Summary of Implementation Status

Of the 13 new recommendations we followed up on, the Trust Company:

- Fully implemented 9.
- Partially implemented 4.

See Appendix 2 for the implementation status of each 2001 recommendation.

- The Trust Company adopted certain financial industry practices such as the following:
 - ♦ An Investment Advisory Board and Trust Committee are now actively involved in overseeing the Trust Company.
 - ♦ The operations of the Trust Company have become more separated from the Comptroller of Public Accounts' (Comptroller) Treasury Operations.

- ♦ The Trust Company developed written policies based on the Federal Deposit Insurance Company's Statement of Principles of Trust Department Management.
- ♦ The Trust Company established and filled chief executive officer, legal counsel, and compliance officer positions.
- The Trust Company developed policies to restrict Fedwire transfer activities to only transfers for investment purposes or transfers to fund accounts at depository institutions.
- The Trust Company obtained a banking examination and hired an external financial auditor to obtain an opinion audit (see Chapters 1-B and 1-C for additional details).

However, the Trust Company has not fully implemented all of our 2001 recommendations. The Trust Company anticipates that the implementation of new automated systems will eventually enable it to fully implement our 2001 recommendations relating to the following:

- The investment of discretionary cash
- The implementation of Federal Reserve Board internal control objectives and procedures
- The implementation of financial industry standards
- The development of certain accounting controls to evaluate strategies and detect errors

Recommendation

The Trust Company should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)

Chapter 1-B

The Department of Banking's Examination Identified Weaknesses in the Trust Company's Governance and Financial Integrity

In response to one of our 2001 recommendations, the Trust Company obtained a banking examination from the Department of Banking. Issued in May 2003, the banking examination report identified weaknesses in two areas: corporate governance and financial integrity. The report did not, however, identify evidence of bad faith or incompetence. Some of the recommendations in the banking examination report were similar to the recommendations we made in our 2001 report.

Regarding corporate governance, the banking examination report recommended that the Trust Company:

- **File new articles of incorporation to enhance its legal separation from the Comptroller.** The report stated that adequate, legal separation between the Trust Company and the Comptroller does not exist. The Trust Company does not have a board of directors with legal responsibilities and, by statutory design, the Comptroller is the sole decision maker for the Trust Company. The Trust Company's Investment Advisory Board is solely advisory in nature, and its members are not fiduciaries.
- **Strictly follow the Statement of Principles of Trust Management, modified to better fit the quasi-governmental nature of the Trust Company, and establish procedures to ensure adherence.** The Comptroller, Investment Advisory Board members, and employees of the Trust Company enjoy official immunity by statute. The report noted that, although it appears appropriate to grant official immunity to government employees, the existence of this statutory liability shield accentuates the need to follow principles that govern the fiduciary function.
- **Clearly separate duties and delegate authority.** The report noted that the Investment Advisory Board has apparently not been assigned the responsibilities that are normally associated with oversight bodies and, therefore, is not accountable for its recommendations or the actions of officers. The report further noted that current law assigns all authority and oversight responsibilities to a single individual, yet the size and complexity of the Trust Company's operations suggest that a more clearly documented delegation of responsibilities would improve the overall operations.

Regarding financial integrity, the banking examination recommended that the Trust Company:

- **Improve the reliability of financial records and reporting systems.** The report noted that management does not perform adequate or timely reconciliations of cash and fiduciary investments. This could subject the Trust Company and fiduciary accounts to losses. The report further states that the general ledger and supporting systems used to keep records for corporate and fiduciary investments are antiquated.
- **Segregate corporate cash and investments from fiduciary assets.** The report stated that management had commingled the Trust Company's corporate cash and investments with fiduciary cash and investments. This is not an acceptable practice among professional fiduciaries because of the conflict of interest implications.
- **Ensure that employees obtain trust-specific training.** The report stated that officers and employees of the Trust Company are inexperienced in standard fiduciary practice procedures and unfamiliar with applicable trust laws and regulations.

Based on its legal interpretation, Trust Company management disagreed with many of the banking examination report's recommendations and, in its response, stated that "...there are serious gaps between the organizations DOB [Department of Banking] is accustomed to evaluating and the [Trust Company], which is a different type of

organization. While we have gained valuable insights from the DOB analysis, the DOB failed to distinguish between the business models applicable to privately owned, for-profit trust companies and the [Trust Company], which is a state governmental entity.” The response further specified that “The utility of the Report is compromised because the DOB failed to consider and, at times disregarded, the legal framework within which the [Trust Company] operates.” In a letter to the Comptroller, the Department of Banking responded by stating that the Trust Company’s “statutory interpretation is extraordinarily narrow and unsupportable.” Appendix 3 contains the Department of Banking examination’s primary recommendations and a summary of the Trust Company’s responses.

Recommendation

We acknowledge the Trust Company’s position regarding the banking examination report (particularly in light of its current governing statute) but encourage it to consider the report’s recommendations.

Chapter 1-C

The Financial Opinion Audit the Trust Company Obtained Identified Material Weaknesses in Segregation of Duties and Timeliness of Reconciliations

What Is a Material Weakness?

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that misstatements in amounts would (1) be material in relation to the financial statements and (2) not be detected within a timely period by employees in the normal course of performing their assigned functions.

The financial opinion audit that the Trust Company obtained in response to our 2001 recommendation provided an unqualified opinion regarding the fair presentation of the Trust Company’s financial statements. However, the management letter that the external auditor prepared also identified the following material weaknesses:

- The Trust Company’s investment accounting systems do not provide for adequate segregation of duties and, therefore, are not restricted to only accounting personnel.
- The Trust Company does not reconcile its general ledger on a timely basis in accordance with industry best practices.

The external auditor also noted that:

- The Chief Investment Officer’s approval was not documented for some investment transactions.
- Although the Trust Company has an informal contingency plan in case its computer operations go down, it lacks written disaster recovery plans that are tested and updated at least annually.

The financial opinion audit results also were not reported in a timely manner. The audit work, which covered fiscal year 2002, was completed in April 2003; however, the final audit report was not issued until August 2003. Failure to promptly obtain audit results impairs management’s decision making and leaves insufficient time to correct audit issues before the next audit must begin. This is particularly important

given that, as of December 31, 2002, the Trust Company managed \$16.5 billion in assets (excluding TexPool assets). In addition:

- The Comptroller's own reporting guidelines required the Trust Company to obtain its financial opinion audit by December 20, 2002.
- Texas Government Code, Section 404.104(c), requires the Comptroller to submit an audit report regarding the operations of the Trust Company to the Legislative Budget Board.

Recommendations

The Trust Company should:

- Correct all weaknesses noted in the financial audit report.
- Ensure that the results of financial audits are issued in a timely manner and promptly share those results with the Trust Company's Investment Advisory Board.

Chapter 1-D

The Trust Company Is Developing New Accounting and Investment Systems to Strengthen Its Operations

To address our 2001 recommendations, the Trust Company is implementing new automated systems for its accounting and investment functions. Because these systems are in development, a final determination of their capacity to enable the Trust Company to fully implement our 2001 recommendations cannot be made at this time. We plan to follow up on the implementation of these systems at a later date.

The Trust Company is working with a contractor to develop a financial accounting system and an investment accounting system. Another vendor the Trust Company contracted with to evaluate its systems recommended that the Trust Company wait to develop the investment accounting system until it had developed business and functional requirements and performed a gap analysis. However, because of the perceived need for this system, the Trust Company proceeded with its development.

Although we did not conduct a comprehensive review of information technology controls, we identified the following weaknesses in the Trust Company's present investment accounting system:

- Weaknesses in password administration that could increase the risk of unauthorized access. Specifically:
 - ♦ There is no automatic process requiring users to change their passwords or preventing users from using passwords that have passed their expiration date. As of June 10, 2003, 34 of 57 passwords tested had passed their expiration dates; however, users still had access using these passwords. The Comptroller's *Security Coordinator Reference Guide* requires that passwords

expire every 90 days and that users change their passwords to continue to have system access.

- ♦ A user definition table in the investment accounting system displays each user's password without encryption.
- ♦ Users are not consistently complying with requirements in the Comptroller's *Security Coordinator Reference Guide* for establishing passwords.
- Weaknesses in access authorization that could increase the risk of unauthorized access. Specifically:
 - ♦ The Trust Company does not have access authorization documentation for 20 of 42 users of the present investment accounting system. While it was clear from their job titles that some of these 20 users required access, it was not clear why 11 of these 20 users needed access to the investment accounting system.
 - ♦ The Information Technology Director and two systems analysts have full access to the investment accounting system, including the ability to write and execute all system tasks and access all system tables. It is not apparent why these positions require full access.

Recommendations

The Trust Company should:

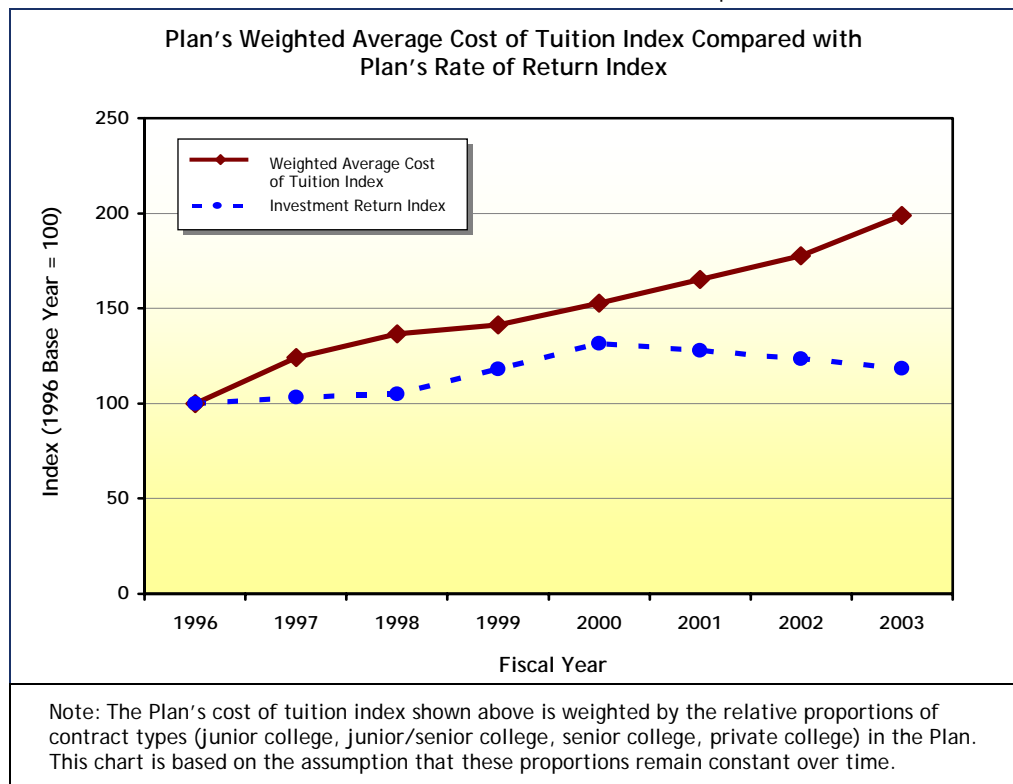
- Continue working to implement its new financial accounting and investment accounting systems.
- Monitor to ensure that the new investment accounting system fulfills business and functional requirements.
- Correct the password and access authorization weaknesses in the current investment accounting system and ensure that they are not duplicated in the new financial accounting and investment accounting systems. Specifically, the Trust Company should:
 - ♦ Implement a process requiring users to change their passwords on a regular basis and follow the Comptroller's requirements for establishing passwords.
 - ♦ Ensure that user passwords are not available to division security coordinators for viewing. Passwords should be hidden or encrypted.
 - ♦ Ensure that access authorization is documented and fully supported for all users of the investment accounting system.
 - ♦ Periodically review access authorization for all users, including division security coordinators, to ensure that access rights match job duties and responsibilities.

The Texas Guaranteed Tuition Plan Needs to Fully Implement Outstanding 2001 Recommendations; Also, Its Financial Health Has Declined

Although the Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund) fully or partially implemented most of our 2001 recommendations, it still needs to implement outstanding recommendations that are important to strengthening its operations. It should also be noted that the Plan's financial health has declined since our 2001 audit. As of March 31, 2003, the Plan projected that its liabilities exceeded its assets by \$226 million; under more conservative investment return assumptions, we estimate that deficit could be \$318 million. The Plan is guaranteed by the State. Therefore, if the Plan's financial health does not improve, this guarantee would require the State to eventually contribute funds to the Plan.

These deficits are the direct result of conditions in financial markets, and they are not uncommon among other states' prepaid tuition plans. In addition, as Figure 1 shows, the Plan's weighted average cost of tuition index has exceeded its investment return index since the Plan's 1996 inception.

Figure 1: Indexed using 1996 as the base year, the Plan's weighted average cost of tuition index has exceeded its investment return index since the Plan's 1996 inception.



Source: Calculated from data provided by the Plan

Although recent legislation was enacted to mitigate the effect of tuition deregulation on the Plan, tuition deregulation's ultimate effect on the Plan's financial health also is uncertain.

Because of these significant challenges, the Plan should re-examine its investment return assumptions, which are higher than those of other comparable prepaid tuition programs. In addition, because managing assets to provide benefits to participants while minimizing future liabilities to the State can be difficult, addressing certain issues related to decision making, obtaining additional investment information, and enhancing investment policy would help the Plan to manage this complex challenge.

Chapter 2-A

The Plan Fully or Partially Implemented Most of Our 2001 Recommendations, but It Needs to Address Important Recommendations that Remain Outstanding

Summary of Implementation Status

Of the 25 recommendations we followed up on, the Plan:

- Fully implemented 19.
- Partially implemented 5.
- Has not implemented 1.

See Appendix 2 for the implementation status of each 2001 recommendation.

The Plan has implemented or partially implemented most of the recommendations we made in 2001 to identify and address financial risks. For example:

- When developing its actuarial assumptions, the Plan now receives sufficient information regarding trends in higher education tuition.
- The Plan has made efforts to ensure that multiple qualified contractors respond to its requests for proposals (RFP).
- The Plan strengthened the safekeeping of its fixed income portfolio by transferring it to a custodian bank.

However, the Plan has not fully implemented all of our 2001 recommendations. For example:

- Plan staff did not obtain formal, documented research on investment rates of return for the 2002 *Actuary's Soundness Report*. As a result, the Texas Prepaid Higher Education Board (Board) did not have updated information to assist it in developing investment rate of return assumptions for 2002.
- Plan staff do not periodically reassess contractors' financial condition during the life of their contracts. Performing this assessment is critical in helping to ensure the continuity of the administration of the Plan.
- The Plan still has a narrow range of sensitivity testing in its actuarial reports. The Plan has increased the number of sensitivity testing scenarios included in its actuary's report. However, using a broader range of sensitivity testing would allow for enhanced forecasting about the effect of changes in the rate of inflation, rate of tuition, and investment rate of return on the Plan.

Recommendation

The Plan should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)

Chapter 2-B

The Plan's Investment Return Assumptions Are Higher than Those of Most Comparable Prepaid Tuition Programs and Texas's Two Largest State Retirement Systems

As Table 1 shows, the Plan's investment return assumption of 8.25 percent is higher than the assumptions made by most comparable prepaid tuition programs in other states. Using an investment return assumption that is too optimistic can result in the understatement of the Plan's deficit and inaccurate pricing of prepaid tuition contracts.

Table 1: The Plan's investment return assumptions are higher than assumptions made by most comparable plans.

Comparison of the Plan's Investment Return Assumptions with Those of Comparable Prepaid Tuition Plans		
Prepaid Tuition Plan	Allocation of Investments	Investment Return Assumption
Alabama Prepaid Affordable College Tuition Program	<ul style="list-style-type: none"> ▪ 70% equities ▪ 30% fixed income investments 	9.00%
Texas Guaranteed Tuition Plan	<ul style="list-style-type: none"> ▪ 63% equities ▪ 35% fixed income investments ▪ 2% cash and cash equivalents 	8.25%
Mississippi Prepaid Affordable College Tuition Program	<ul style="list-style-type: none"> ▪ 70% equities ▪ 30% fixed income investments 	7.80%
College Savings Plans of Maryland - Prepaid College Trust	<ul style="list-style-type: none"> ▪ 70% equities ▪ 30% fixed income investments 	7.65%
Ohio College Advantage - Guaranteed Option	<ul style="list-style-type: none"> ▪ 65% equities ▪ 35% fixed income investments 	7.50%
College Illinois 529 Prepaid Tuition Program	<ul style="list-style-type: none"> ▪ 60% equities ▪ 38% fixed income investments ▪ 2% cash and cash equivalents 	7.50%

Sources: Alabama Prepaid Affordable College Tuition Program, Texas Guaranteed Tuition Plan, Mississippi Prepaid Affordable College Tuition Program, College Savings Plans of Maryland - Prepaid College Trust, Ohio College Advantage - Guaranteed Option, and College Illinois 529 Prepaid Tuition Program.

As Table 2 shows, the Plan's investment return assumptions also are higher than assumptions made by the Teacher Retirement System and the Employees Retirement System. However, as Table 2 indicates, while the duration (time horizon) of the Plan's liabilities is approximately half that of the retirement systems', the Plan assumes it will achieve higher investment returns than the two retirement systems.

Table 2: The Plan's investment return assumptions are higher than assumptions made by two Texas pension plans.

Comparison of the Plan's Investment Return Assumptions with Those of Two Texas Pension Plans		
Plan	Average Duration of Liabilities	Investment Return Assumption
Texas Guaranteed Tuition Plan	Approximately 12 years	8.25%
Employees Retirement System	23.08 years	8.00%
Teacher Retirement System	24.8 years	8.00%

Sources: Texas Guaranteed Tuition Plan, Employees Retirement System, and Teacher Retirement System

The Plan's 8.25 percent investment return assumption was derived from an asset allocation study its investment consultant prepared in April 2000. While that assumption may have been valid in 2000, subsequent developments in the financial markets suggest that a lower return assumption may be necessary. Plan staff did not obtain formal, documented research on investment rates of return for the 2002 *Actuary's Soundness Report*. As a result, the Board, which oversees the Plan, did not have updated information to assist it in developing investment rate of return assumptions for 2002.

At present, many pension funds and prepaid plans are adjusting their expected return assumptions downwards. During our audit, we asked the Plan's investment consultant questions about the Plan's return assumption. The investment consultant then performed some recalculations and recommended in May 2003 that, based on the Plan's present asset allocation, a more appropriate investment return assumption would be 7.45 percent. The Board has not yet taken any action on that recommendation. We estimate that applying this lower return assumption to the Plan's fiscal year 2002 actuarial analysis would increase the Plan's deficit from \$226 million to \$318 million.

Recommendations

The Plan should:

- Re-examine its process for developing investment return assumptions to determine why its assumptions are higher than most other states' return assumptions for prepaid tuition plans.
- Work with its investment consultant to ensure that, at least on an annual basis, it receives formal, documented research to develop investment rate of return assumptions.
- Consider the average duration of its liabilities when developing investment return assumptions.

The Plan Lacks Certain Measures that Would Help It Manage Assets to Provide Benefits to Participants While Minimizing Future Liabilities to the State

Balancing the dual goals of providing benefits to participants and minimizing future liabilities to the State can be a difficult task. In some respects, these goals are contradictory; therefore, achieving the proper balance between them is a complex challenge. Addressing the following issues would both help the Plan to manage this challenge and strengthen the Board's fiduciary role:

- **The Board does not always formally vote when making significant decisions.** After enrolling 21,546 additional participants, the Plan attempted to mitigate the potential effect of tuition deregulation by suspending the enrollment of new participants (except for newborns). However, although the Board discussed suspending enrollment in the Plan during its meeting on June 4, 2003, it did not formally vote on this decision. In addition, enrollment was suspended without determining the actuarial consequences that action could have.
- **The Plan's investment consultant does not provide the Board with certain useful information.** We noted that the Plan's investment consultant does not provide the Board with specific types of information that would allow it to monitor compliance with its investment policy. Examples of such information include:
 - ♦ Attribution analysis that identifies the sources of investment overperformance or underperformance by measuring the relative influence of stock selection versus asset allocation.
 - ♦ Portfolio turnover information that can identify excessive portfolio turnover as the source of increased costs and reduced investment returns.
 - ♦ Information about best execution of trades, which can identify when money managers do not obtain a fair price for their trades.
 - ♦ Investment style analyses, which can identify money managers that do not stay within their assigned growth or value styles.
 - ♦ Information about average daily cash held, which can show whether the Plan is exceeding policy limits on cash holdings.
- **The Plan's investment policy lacks the following elements:**
 - ♦ Specification of whether money managers can make soft dollar arrangements to pay brokers higher-than-normal commissions in order to obtain research and other services.
 - ♦ Specification of more protective standards to emphasize safety and liquidity over investment yield when choosing cash equivalent investments. The investment policy also needs to establish minimum standards for the credit ratings on investments or collateralization requirements for investments.

- ♦ A formal and detailed policy for investment manager review and retention. Such a policy should provide guidelines for monitoring investment managers' performance, address the frequency and standards by which performance is monitored, and specify standards for how much time managers should be given to improve their performance.
- **The Plan has not defined certain financial terms.** The Plan's governing statute requires that the Plan be managed in an "actuarially sound" manner and requires that action be taken if the Plan is "actuarially unsound" or "financially infeasible." These terms are not defined in law, and the Board has not established definitions for them. Without these definitions, it is not possible to determine when or if corrective action needs to be taken to strengthen the financial soundness of the Plan.

Consideration of two additional enhancements also could have the potential to improve the Plan's ability to provide benefits to participants and minimize future liabilities to the State:

- **Consider expanding staff's investment expertise.** The Plan's interim financial statements as of March 31, 2003, state that its assets total \$1.3 billion, of which \$804 million is invested in securities. Because the Plan's staff have no investment expertise, the Plan delegates the management of those investments to external money managers. The Plan then relies on its external investment consultant to monitor external money managers. Without adequate investment expertise, it could be difficult for Plan staff to ensure that the external investment consultant monitors to ensure that the external money managers comply with all policies.
- **Consider using passive asset managers to reduce fees.** The Plan has hired only active asset managers to manage its investment portfolio. While this approach added value to the Plan's investments during the last three years, there is no assurance that this level of performance will continue. Active managers generally cost more than passive managers but can generate higher investment returns. In a report titled *Special Report to the Legislature, Additional e-Texas Recommendations* (April 2003), the Comptroller recommended that the State cease using some external fund managers and have internal staff manage many of the Permanent School Fund's assets passively. The report noted that this could result in significant savings in asset management fees.

Recommendations

The Plan should:

- Ensure that its Board formally votes on significant decisions such as enrollment suspension, program modification, or program termination. In addition, the Plan should obtain actuarial analyses regarding the fiscal impact of any major decisions before making these types of decisions.
- Obtain additional, useful information from its external investment consultant or others, including information about attribution analysis, portfolio turnover, best execution of trades, investment style analysis, and average daily cash balances.

- Enhance its investment policy by:
 - ♦ Specifying provisions governing soft dollar arrangements.
 - ♦ Specifying more protective standards to emphasize safety and liquidity more than investment yield when choosing cash equivalent investments and establishing minimum standards for the credit ratings on investments or collateralization requirements for investments.
 - ♦ Establishing a money manager review and retention policy that includes guidelines for monitoring investment managers' performance.
- Define the phrases “actuarial soundness,” “sufficiently actuarially sound,” and “financially infeasible” and use them as criteria to determine when corrective action needs to be taken to ensure the financial health of the Plan.
- Consider (1) expanding its staff’s investment expertise to better manage or at least monitor its investment programs and (2) the benefits of using passive indexation strategies for the management of a portion of its investment portfolio.

Chapter 2-D

The Plan Generally Disburses Tuition Payments in an Accurate and Timely Manner

The Plan generally disburses tuition payments in an accurate and timely manner. We tested (1) refunds that contract holders had requested because their beneficiaries had received scholarships and (2) payments to higher education institutions. These refunds and payments were calculated accurately and paid in a timely manner.

We also tested refunds that contract holders had requested as a result of contract cancellation. These refunds were calculated accurately. Although we found minor discrepancies in the timeliness of some refunds, the Plan generally made the refunds within the 4–6 weeks required by its policy.

TexPool Strengthened Its Operations by Implementing All of Our 2001 Recommendations

TexPool has strengthened its operations by implementing all of our prior recommendations. Formerly managed by external vendors that were overseen by the Comptroller's Treasury Operations, TexPool is currently managed by external vendors that are overseen by the Trust Company.

Summary of Implementation Status

TexPool fully implemented each of the six recommendations we made in 2001. See Appendix 2 for those recommendations.

Examples of recommendations TexPool implemented include:

- A TexPool Advisory Board, which oversees TexPool's investment operations, now meets on a quarterly basis.
- The Trust Company monitors on a weekly basis the external vendors that manage TexPool.
- The Trust Company, rather than the external vendor that manages TexPool, is now selecting and hiring the external auditor that conducts TexPool's annual financial audit.
- TexPool is now offering another investment pool that is authorized to invest in commercial paper.

The Trust Company Did Not Consistently Follow Contract Award Procedures; the Trust Company and the Plan Also Lack Formal Contract Monitoring Policies and Procedures

Although the Trust Company has established formal policies and procedures designed to ensure that it fairly and objectively awards contracts to external investment managers, it did not consistently follow these policies and procedures. The Trust Company and the Plan also lack formal policies and procedures for monitoring contracts. In addition, unlike other state investing entities, the Plan lacks a policy requiring the members of its Board and key employees to disclose conflicts of interest regarding potential contractors.

Chapter 4-A

The Trust Company Did Not Consistently Follow Contract Award Procedures

The Trust Company did not consistently follow formal policies and procedures designed to ensure that it fairly and objectively awards contracts to external investment managers. When we reviewed the Trust Company's current contracts, which it procured in fiscal year 2001, we found that:

- The Trust Company awarded a contract to manage \$20 million in assets to a contractor that did not meet three minimum qualifications specified in the associated RFP. The RFP specified that entities that submitted proposals and did not meet minimum qualifications would be disqualified. The contractor did not meet the following minimum qualifications:
 - ♦ The RFP stated that the contractor's performance results must comply with Association for Investment Management and Research (AIMR) standards and that the contractor must note any exceptions to those standards. However, the contractor's proposal did not discuss whether it complied with AIMR standards.
 - ♦ The contractor did not manage at least \$250 million in investments as the RFP required. The contractor's proposal stated that it had invested \$15 million and had a maximum capitalization of \$20 million.
 - ♦ The contractor did not have a public fund relationship exceeding \$25 million as the RFP required.

The banking examination that the Trust Company obtained also noted that this contractor did not meet the last two minimum qualifications listed above.

In addition, although the evaluation team interviewed this contractor, there was no evidence that it had scored this contractor's proposal. Furthermore, although the RFP specified that the contract period would terminate on December 21, 2002, the actual contract period terminates on March 31, 2010.

When we brought this contract to the attention of the Comptroller's legal staff, they stated that the Trust Company should have handled this matter as an

investment in alternative assets rather than as a procurement to hire an investment manager.

- The Trust Company awarded another contract to manage \$23.6 million in assets to a contractor that the evaluation team had not interviewed, rated, or recommended.
- The Comptroller's policy is to conduct research on potential contractors' payment of franchise and sales taxes (and related reporting) and payment of child support. However, we identified one instance in which the Trust Company did not complete this research until after recommendations regarding contractors' proposals had already been made.

Recommendations

The Trust Company should follow formal policies and procedures and adhere to established criteria in evaluating proposals and awarding contracts. In particular, it should:

- Abide by the stated minimum criteria for consideration of proposals that potential contractors submit in response to RFPs.
- Separate its procurements to hire investment managers from its investments in alternative assets.
- Document its evaluation of potential contractors' proposals and related deliberations in a manner that adequately explains the basis on which resulting contract award decisions are made.
- Research potential contractors' tax and child support payment histories sufficiently early in the contractor selection process so they can use the results of that research in the evaluation of potential contractors' proposals.

Chapter 4-B

The Trust Company and the Plan Lack Formal Contract Monitoring Policies and Procedures

Neither the Trust Company nor the Plan has formal contract monitoring policies and procedures. As of March 2003, the Trust Company relied on external investment managers to manage \$2.1 billion in investments, and the Plan relied on external investment managers to manage all of its \$831 million in investments; therefore, proper monitoring of the contracts with these investment managers is critical to the success of both entities.

Plan management provided us with 20 contract performance evaluation forms it had completed for its contracts with external investment managers and other contractors. However, these forms were not used effectively to monitor these contracts. Specifically:

- The Plan conducted these 20 evaluations only on an annual basis, which limits their usefulness as a tool for the ongoing management of contracts.

- Eighteen of the 20 evaluation forms were (1) completed by a single individual and (2) dated on the same date. This indicates that these evaluations may not be as thorough as they should have been.
- All 20 of the evaluation forms rated each contractor using the same uniform criteria, regardless of the services the contractor provided or the applicability of the criteria to those services. All contractors were rated “satisfactory” in all categories, with no additional commentary. This was also true for the category “other,” for which all contractors were rated “satisfactory” with no further explanation of what “other” represented.
- All 20 of the evaluation forms recommended that the contracts be renewed for fiscal year 2003. However, two of the evaluation forms were related to outside investment managers whose performance had become a topic of concern before these evaluations were completed. The individual completing those evaluations had been present at meetings at which those concerns were discussed.

It is also important to note that the Trust Company and the Plan rely heavily on external investment consultants to monitor external investment managers’ performance. (In the case of the Plan, it does this because Plan staff do not possess investment expertise.) In addition, the Trust Company, Plan management, and external investment consultants do not monitor money managers’ and brokers’ trades to ensure that they pay fair prices.

Recommendations

The Trust Company and the Plan should:

- Develop and communicate formal policies and procedures for monitoring contractors. These policies and procedures should identify:
 - ♦ The specific monitoring activities to be performed and the frequency with which they should be performed.
 - ♦ How monitoring activities should be performed, including the information sources that should be used.
 - ♦ The individual responsible for performing each monitoring activity.
 - ♦ How monitoring activities should be documented.
 - ♦ How and to whom the results of monitoring should be communicated.
 - ♦ How monitoring results should be used, including requirements for subsequent follow-up.
- Conduct monitoring and evaluation of contractors with a frequency that sufficiently supports the continuous management of contracts. Monitoring and evaluation criteria should directly relate to the specific services each contractor provides and the key provisions of each contract.

The Plan Lacks a Policy Requiring Board Members and Key Employees to Disclose Conflicts of Interest Regarding Potential Contractors

The Plan does not have a policy requiring Board members and key employees to disclose any financial relationships or other conflicts of interest they may have regarding potential contractors. This increases the risk that conflicts of interest may go undetected and that individuals could obtain personal gain.

Requiring Board members to disclose such information helps to avoid conflicts of interest and ensure objectivity in the contractor selection process. Other state investing entities such as the Teacher Retirement System, the University of Texas Investment Management Company (UTIMCO), and the Permanent School Fund have ethics policies requiring Board members and key employees to disclose this information, in addition to making annual financial disclosures.

Recommendation

The Plan should develop and implement a formal policy requiring Board members and key employees to disclose any relationships or other conflicts of interest they may have regarding potential contractors.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

Each of the units we audited is located in the Office of the Comptroller of Public Accounts (Comptroller). Our objectives were to:

- Determine whether the Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund), the Texas Treasury Safekeeping Trust Company (Trust Company), and the Texas Local Government Investment Pool (TexPool) have implemented recommendations the State Auditor's Office made in *An Audit Report on the State Treasury and Its Trust Company, the Texas Tomorrow Fund, and TexPool* (SAO Report No. 02-007, October 2001).
- For the Plan only, additional objectives were to determine:
 - ♦ Whether the Texas Prepaid Higher Education Tuition Board (which oversees the Plan) has adopted actuarial assumptions that are consistent with other states' programs and reasonable when compared with other programs dealing with long-term liabilities.
 - ♦ Whether the Plan manages its assets to provide benefits to participants while minimizing future liabilities to the State.
 - ♦ Whether the Plan disburses tuition payments to universities and makes refunds to contract purchasers in an accurate and timely manner.
- Determine whether the Plan and Trust Company have established adequate controls over their contract management processes.

Scope

We followed up on the majority of the recommendations from our 2001 report. We primarily reviewed fiscal year 2002 data, but in some cases we reviewed data from fiscal year 2003. We analyzed the Plan's historical financial information for the past five years. Our scope also included a review of external auditor reports and related working papers from the Department of Banking and KPMG, LLP. We coordinated our work with that of the Comptroller's internal auditor and the Trust Company's internal auditor.

Methodology

Our methodology consisted of gathering information through interviews of the Trust Company, the Plan, and Comptroller management and staff; reviewing policies and procedures; testing controls and related documentation; and reviewing information technology. We also attended selected Texas Prepaid Higher Education Tuition Board and related committee meetings. To compare the Plan's investment practices

and actuarial assumptions, we contacted pension plans and endowment funds in the state and other states' prepaid tuition plans.

Information collected to accomplish our objectives included the following:

- Applicable constitutional and statutory provisions
- Agency internal audit reports
- Reports prepared by outside consultants
- Texas Tomorrow Fund Board and Board Investment Committee minutes
- Contracts with external investment managers
- Organizational charts
- Annual financial statements
- Comprehensive annual financial statements
- Ethics policies at other state investing entities
- Investment reports
- Uniform Statewide Accounting System (USAS) payment vouchers
- Beneficiary files
- Financial disclosure statements

Procedures and tests conducted included the following:

- Conducted interviews with:
 - ♦ Agency management and staff
 - ♦ Consultants who performed services for the Plan and Trust Company
 - ♦ Officials with the U.S. Department of Education
 - ♦ Officials with the College Savings Plan Network
- Reviewed prior external audits, internal audits, and other reviews
- Reviewed annual financial reports and comprehensive annual financial reports
- Observed various phases of operations to gain additional understanding
- Reviewed contractor selection and evaluation procedures
- Reviewed the Department of Banking's examination report and related work papers

- Reviewed KPMG’s management letter and related work papers
- Reviewed investment reports
- Reviewed soundness reports and annual financial reports from other states that have prepaid tuition programs
- Reviewed ethics policies
- Reviewed financial disclosures
- Reviewed Texas Tomorrow Fund interim financial statements
- Reviewed the Texas Tomorrow Fund Actuarial Review (January 27, 2003)
- Recalculated payments made to universities on behalf of beneficiaries
- Recalculated refunds made to contract holders

Criteria used included the following:

- *Trust Examination Manual*, Federal Deposit Insurance Corporation
- Texas Constitution
- Texas Government Code
- Comptroller’s Investment Policy, October 2002
- Code of Federal Regulations
- Institute of Internal Auditors (IIA) standards
- *Texas Tomorrow Fund Desk Reference for Administrative Operations*
- State Auditor’s Office Contract Manual
- *Texas Guaranteed Tuition Plan Matriculation Roster*, December 2002
- Internal Revenue Code, Title 26, Subtitle A, Chapter 1, Subchapter F, Part VIII, Section 529
- Texas Education Code
- U.S. Department of Education’s Web site (www.fafsa.ed.gov)
- Texas Tomorrow Fund’s Investment Policy, October 2002
- *Fiduciary Review of the Permanent School Fund*, Cortex Applied Research, Inc.
- *Texas Permanent School Fund, Active and Passive Management*, Callan Associates, Inc.

- *Special Report to the Legislature, Additional e-Texas Recommendations*, Comptroller of Public Accounts
- *Private Career Colleges Authorized to Offer Applied Associate Degree* prepared and maintained by the Texas Higher Education Coordinating Board

Other Information

We conducted fieldwork from June 2003 through July 2003. The audit was conducted in accordance with generally accepted government auditing standards; there were no significant instances of noncompliance with these standards.

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

- Hugh Ohn, CPA, CIA (Project Manager)
- Dave Gerber, MBA (Assistant Project Manager)
- Rob Bollinger, CPA
- Jodi Edgar
- Michelle Feller
- Jon Nelson, MBA, CISA
- Joe White, CFA
- Worth Ferguson, CPA (Quality Control Reviewer)
- Carol A. Smith, CPA (Audit Manager)
- Frank Vito, CPA (Audit Director)

Implementation Status of 2001 State Auditor's Office Recommendations

Tables 3 through 5 present the implementation status of the recommendations on which we followed up from *An Audit Report on the State Treasury and Its Trust Company, the Texas Tomorrow Fund, and TexPool* (SAO Report No. 02-007, October 2001).

Table 3: The Texas Treasury Safekeeping Trust Company fully or partially implemented these 2001 recommendations.

Implementation Status of Selected Recommendations the State Auditor's Office Made for the Texas Treasury Safekeeping Trust Company in 2001		
Recommendation (Note: References to the "Treasury" in the recommendations below were directed toward functions now operating separately within the Trust Company)	Implementation Status	State Auditor's Office Comments
The Treasury should consider adopting the FDIC's <i>Statement of Principles of Trust Department Management</i> and creating a trust committee that includes individuals with relevant expertise and experience to monitor fiduciary activities as outlined in FDIC's guidelines.	Implemented	To the extent possible under the current statute, the Trust Company had adopted most Federal Deposit Insurance Corporation (FDIC) principles, including principles on: <ul style="list-style-type: none"> ▪ Board involvement. ▪ Separate operation of trust department. ▪ Maintenance of separate books and records. ▪ Development of written policies. ▪ Designation of a qualified officer, legal counsel, and a trust committee.
The Treasury should 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.	Implemented	As authorized in Texas Government Code, Section 404.108, the Comptroller has established an Investment Advisory Board and a Trust Committee.
The Treasury should 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.	Partially Implemented	The Trust Company has established an array of investment choices for the funds it manages. Although full implementation of this recommendation did not occur because of market conditions, the Trust Company did invest portions of its portfolio in money market funds, Treasury notes, and government agency notes. According to Trust Company management, additional options will be explored after new automated systems are in place.
The Treasury should continue to establish key positions with the knowledge and experience to conduct operations in a safe and sound manner.	Implemented	The Trust Company has established new positions such as the Chief Executive Officer, Internal Auditor, and Compliance Officer.
The Treasury should 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 could be outsourced if internal expertise does not exist.	Implemented	The Comptroller analyzed and informed the Legislature about resource requirements and possible obstacles to a proposed bill during the 78th Legislative Session.

**Implementation Status of Selected Recommendations the State Auditor's Office Made
for the Texas Treasury Safekeeping Trust Company in 2001**

<p align="center">Recommendation (Note: References to the "Treasury" in the recommendations below were directed toward functions now operating separately within the Trust Company)</p>	<p align="center">Implementation Status</p>	<p align="center">State Auditor's Office Comments</p>
<p>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.</p>	<p align="center">Partially Implemented</p>	<p>According to Trust Company management, policies and procedures are continually reviewed and strengthened to meet industry best practices. However, the implementation of new automated systems will require a complete revision of the procedures manuals, and this task is currently in progress.</p>
<p>The Comptroller should ensure that Treasury and Trust Company staff understand the importance of internal control safeguards.</p>	<p align="center">Implemented</p>	<p>Employees attended internal control self-assessment training. In addition, the Trust Company established policies for minimum required annual training hours for staff. Most employees met the required minimum number of training hours (21 hours) for fiscal year 2002.</p>
<p>The Comptroller should 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.</p>	<p align="center">Implemented</p>	<p>Instead of requesting an amendment to the agreement with the Federal Reserve, the Trust Company analyzed its outgoing Fedwire transfer activities. As a result of that analysis, it developed policies to restrict the use of transfers only for investment purposes or to fund accounts of depository institutions.</p>
<p>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.</p>	<p align="center">Partially Implemented</p>	<p>The Trust Company is working with a contractor to implement new automated systems for its accounting and investment functions.</p>
<p>The Treasury and the Trust Company should 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.</p>	<p align="center">Partially Implemented</p>	<p>The Trust Company is working with a contractor to implement new automated systems for its accounting and investment functions.</p>
<p>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.</p>	<p align="center">Implemented</p>	<p>The Trust Company hired an internal auditor. Based upon risk ratings, the internal auditor developed a fiscal year 2002 audit plan that the Trust Company Investment Advisory Board approved in February 2002.</p>
<p>The Treasury and the Trust Company should ensure that the Trust Company annually obtains an unqualified opinion on its comprehensive annual financial statements from an independent auditor.</p>	<p align="center">Implemented</p>	<p>The Trust Company engaged an external audit firm to obtain an opinion on its financial statements for fiscal year 2002.</p>

Implementation Status of Selected Recommendations the State Auditor's Office Made for the Texas Treasury Safekeeping Trust Company in 2001		
Recommendation (Note: References to the "Treasury" in the recommendations below were directed toward functions now operating separately within the Trust Company)	Implementation Status	State Auditor's Office Comments
<p>The Treasury and the Trust Company should 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 :</p> <ul style="list-style-type: none"> ▪ 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. 	Implemented	<p>The Trust Company contracted with the Department of Banking to receive an examination of its operations. An overview of the results of the examination is provided in Chapter 1-B of this report. Appendix 3 of this report summarizes the Department of Banking's recommendations and the Trust Company's responses.</p>

Table 4 - The Texas Guaranteed Tuition Plan has fully or partially implemented most of our 2001 recommendations.

Implementation Status of Selected Recommendations the State Auditor's Office Made for the Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) in 2001		
Recommendation	Implementation Status	State Auditor's Office Comments
<p>When developing actuarial assumptions, Tomorrow Fund Staff and Board members should thoroughly research existing relevant trends.</p>	Partially Implemented	<p>Each year before actuarial assumptions are adopted:</p> <ul style="list-style-type: none"> ▪ The Comptroller's Research and Policy Division (Division) provides information regarding tuition trends before the actuarial assumptions are voted on. ▪ Staff considers historical data on previous contracts sold. ▪ The actuary is consulted. <p>However, Plan staff did not obtain formal, documented research on investment rates of return for the 2002 <i>Actuary's Soundness Report</i>. As a result, the Texas Prepaid Higher Education Tuition Board (Board) did not have updated information to assist it in developing investment rate of return assumptions for 2002.</p>
<p>When developing actuarial assumptions, Tomorrow Fund Staff and Board members should seek expert opinions about likely future developments.</p>	Partially Implemented	(See comment above.)
<p>When developing actuarial assumptions, Tomorrow Fund Staff and Board members should document the decision making process in the Board minutes.</p>	Implemented	<p>The decision making process was clearly documented in the Board minutes and transcripts. The actuarial assumptions for 2001 were adopted at the August 17, 2001, Board meeting; the actuarial assumptions for 2002 were adopted at the October 8, 2002, Board meeting.</p>

**Implementation Status of Selected Recommendations the State Auditor's Office Made
for the Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) in 2001**

Recommendation	Implementation Status	State Auditor's Office Comments
When developing actuarial assumptions, Tomorrow Fund Staff and Board members should incorporate key trends and supporting information in the published actuarial report so that interested public parties can better interpret the assumption used in the report.	Implemented	Each year before actuarial assumptions are adopted, the Division provides information regarding tuition trends before the actuarial assumptions are voted on.
When developing actuarial assumptions, Tomorrow Fund Staff and Board members should consider establishing a Board committee to focus on actuarial issues or add this responsibility to the Board's Investment Committee.	Implemented	The responsibilities of the Board's Investment Committee have been expanded to include discussions of actuarial issues and investment-related issues. The Investment Committee also has been meeting on a quarterly basis.
When developing actuarial assumptions, Tomorrow Fund Staff and Board members should provide training opportunities on actuarial issues for Board members.	Implemented	The Board's investment consultant conducted a day-long Board seminar on (1) current actuarial issues, trends, and methodology and (2) a governing board's typical fiduciary responsibilities in this area.
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.	Partially Implemented	The sensitivity analysis portion of the <i>2001 Actuary's Soundness Report</i> included only four scenarios; the sensitivity analysis portion of the <i>2002 Actuary's Soundness Report</i> actuarial report included eight scenarios. However, using a broader range of sensitivity testing would allow for enhanced forecasting about the effect of changes in the rate of inflation, rate of tuition, and investment rate of return on the Plan. To fully benefit from the sensitivity analysis, the Board should consider a broader range of scenarios.
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.	Implemented	Plan staff have begun working with the actuary to provide the Board more useful interim financial statements.
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.	Implemented	The Board approved an actuarial redesignation policy that requires actuarial services to be put up for bid every three years. If the Board's current actuary is redesignated for a new contract, a peer review of the actuary's work is required. A beneficial effect of the Board's redesignation policy is that it enables the actuaries to be reviewed periodically and provides for a second opinion on actuarial conclusions.
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.	Implemented	The Board has obtained a non-exclusive, perpetual license with a software vendor. In addition, all contractors have legally binding contracts that contain liquidating damage provisions to allow for the assessment of monetary damages for failure to provide required services. The Plan has taken steps to ensure that services are not interrupted if a contractor does not or is not able to fulfill the duties specified in its contract.

**Implementation Status of Selected Recommendations the State Auditor's Office Made
for the Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) in 2001**

Recommendation	Implementation Status	State Auditor's Office Comments
Management of the Tomorrow Fund should 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.	Partially Implemented	Respondents to the Plan's RFPs were required to submit (1) a written statement concerning financial stability and their ability to provide the requested services and (2) their most current audited financial statements. However, the published evaluation criteria for respondents' personnel and organization did not specifically address financial condition. It only specified skills, experience, organizational charts, and clear lines of authority. We were unable to determine whether or how financial condition is considered when evaluating respondents' proposals. In addition, staff do not periodically reassess contractors' financial condition during the life of their contracts. Performing this assessment is critical in helping to ensure the continuity of the administration of the Plan.
Management of the Tomorrow Fund should consider the risks of contracting for fundamental services when few providers offering the needed services are known to exist.	Implemented	The Plan's software vendor is the only contractor that may not have an adequate number of competitors in the industry. When developing and finalizing the contract, the Plan obtained a perpetual, non-exclusive license with the vendor.
The Tomorrow Fund should take advantage of the competitive bidding process to ensure that it is paying the best prices.	Implemented	The Plan contracted with external investment managers via RFPs. Nineteen to 43 respondents submitted proposals for each of the RFPs. The Plan factored cost (which accounted for 20 of the 100 maximum evaluation points) into the overall rating of each proposal.
The Tomorrow Fund should make efforts to ensure that multiple qualified contractors respond to RFPs.	Implemented	The Plan contracted with external investment managers via RFPs. Nineteen to 43 respondents submitted proposals for each of the RFPs.
The Tomorrow Fund should conduct and document detailed analyses to ensure that, in situations where there are only one or two respondents, the selected services represent the most cost-effective option.	Implemented	Because of the actuarial industry, there may be only a few respondents to the Board's actuary RFP. Therefore, on June 5, 2002, the Board adopted a policy that requires an independent peer review to be performed if the Board decides to redesignate the previous actuary.
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.	Implemented	The Plan's contracts were finalized within 14 to 20 days after Board approval.
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.	Implemented	The Plan completed a comparison of administrative expenses in July 2003. The Plan compared its operating expenses as a percentage of assets, marketing expenses as a percentage of assets, and marketing expenses as a percentage of operating expenses with other prepaid tuition plans in Alabama, Illinois, Maryland, Michigan, Mississippi, Virginia, and Washington.
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.	Implemented	The Plan completed a comparison of administrative expenses in July 2003. The Plan compared its operating expenses as a percentage of assets, marketing expenses as a percentage of assets, and marketing expenses as a percentage of operating expenses with other prepaid tuition plans in Alabama, Illinois, Maryland, Michigan, Mississippi, Virginia, and Washington.

**Implementation Status of Selected Recommendations the State Auditor's Office Made
for the Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) in 2001**

Recommendation	Implementation Status	State Auditor's Office Comments
<p>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:</p> <ul style="list-style-type: none"> ▪ Set a target actuarial surplus. The surplus, or net worth of the program, creates a starting point against which the Tomorrow Fund can establish measures of tolerable risk. ▪ Set a target for penetrating the prepaid tuition market. 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. ▪ Plan for contingencies. 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. 	<p>Not Implemented</p> <p>Implemented</p> <p>Partially Implemented</p> <p>Implemented</p> <p>Implemented</p>	<p>The Board has not formally adopted a policy on target surpluses. Before suspending the enrollment of new participants, Plan staff and the Board did not consider the actuarial impact of this decision and did not discuss the possibility of closing the program with the actuary.</p> <p>The Board's marketing firm has conducted a market analysis and provided statistics regarding potential customers. For example, it found:</p> <ul style="list-style-type: none"> ▪ The Plan's primary market is adults aged 25-49 with children under age 18. ▪ The Plan's secondary market is adults aged 50 and higher (grandparents). ▪ 4,697,633 (79.8%) of the children in Texas under age 18 do not live in poverty. ▪ 2,383,935 households in Texas do not live in poverty. <p>The Division monitored all legislative bills regarding tuition deregulation to determine the impact on the Plan. The Division ensured that House Bill 3015 (78th Legislature, Regular Session) limited the effect of escalating tuition rates to the Plan liabilities. Specifically, tuition and fees for the Plan will be capped at the statewide weighted average of tuition and fees. The Board's investment consultant has reviewed the performance of the investment managers and discussed fixed-income reallocation at Board meetings. However, the Board has not planned for contingencies to minimize the State's liabilities.</p> <p>The Plan completed a comparison of administrative expenses in July 2003. The Plan compared its operating expenses as a percentage of assets, marketing expenses as a percentage of assets, and marketing expenses as a percentage of operating expenses with other prepaid tuition plans in Alabama, Illinois, Maryland, Michigan, Mississippi, Virginia, and Washington.</p> <p>In accordance with Senate Bill 555 (77th Legislature), the Plan's Board created the Tomorrow's College Investment Plan, a tax-free college savings program operating under Section 529 of the Internal Revenue Code. It began accepting accounts in October 2002.</p>

Implementation Status of Selected Recommendations the State Auditor's Office Made for the Texas Guaranteed Tuition Plan (formerly the Texas Tomorrow Fund) in 2001		
Recommendation	Implementation Status	State Auditor's Office Comments
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.	Implemented	A recent trend in college savings is for states to offer tax-free college savings programs operating under Section 529 of the Internal Revenue Code. The Plan's Board identified and prepared for this trend by creating the Tomorrow's College Investment Plan. The Board's marketing strategy is that the Plan and the college savings program will complement each other.
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.	Implemented	The Plan's Board transferred custodianship of the Tomorrow Fund's fixed income investment to its custodian bank.

Table 5 - The Texas Local Government Investment Pool implemented all of our 2001 recommendations.

Implementation Status of Recommendations the State Auditor's Office Made for the Texas Local Government Investment Pool (TexPool) in 2001		
Recommendation	Implementation Status	State Auditor's Office Comments
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.	Implemented	Using a checklist, the Trust Company is performing weekly reviews of TexPool contractors.
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.	Implemented	For the fiscal year 2001 financial audit, the Trust Company issued an RFP, selected an auditor, and paid for the audit.
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.	Implemented	TexPool developed TexPool Prime, which is an investment pool that is authorized to invest in commercial paper.
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.	Implemented	The Investment Advisory Board met on August 22, 2001, and conducts quarterly meetings. The Investment Advisory Board is responsible for overseeing TexPool's investment operations.
TexPool management should, at a minimum, modify TexPool's <i>Operating Procedures Manual</i> to allow each participant to designate a primary contact who is not an authorized representative.	Implemented	TexPool has modified the "Resolution Authorizing Participation in TexPool and Designating Authorized Representatives" to allow the governing body to designate an individual to "call back"; that individual is not authorized to direct movement of money. The Trust Company will call this individual to verify that all transfer requests (except for those established as repetitive transactions) are authorized.

**Implementation Status of Recommendations the State Auditor's Office Made
for the Texas Local Government Investment Pool (TexPool) in 2001**

Recommendation	Implementation Status	State Auditor's Office Comments
<p>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:</p> <ul style="list-style-type: none"> ▪ 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. 	<p align="center">Implemented</p>	<p>TexPool revised its partnership agreement to include a statement on the first page of the agreement specifying that the State of Texas does not guarantee investments in TexPool. In addition, the TexPool Investment Policy and Information Statement specify that the \$1 net asset value is not guaranteed or insured by the State of Texas.</p>

Trust Company Banking Examination Report Recommendations and the Trust Company's Responses

Table 6 below summarizes the primary recommendations that the Department of Banking (Department) made in its banking examination of the Texas Treasury Safekeeping Trust Company (Trust Company). The Trust Company's responses are also summarized in this table. The examination covered the Trust Company's financial statements as of August 31, 2002. The examination commenced in October 2002, and the Department of Banking issued its report in May 2003.

Table 6

Summary of Trust Company Banking Examination Report Recommendations and the Trust Company's Responses		
Recommendation	Trust Company's Response	
	Agree/ Partially Agree/ Disagree	Summary of Response
With the assistance of competent counsel, Management should develop and file new articles of incorporation and develop new bylaws consistent with current Trust Company functions and the State's goals for the Trust Company. Bylaws should require regular meetings of the Board.	Disagree	The Report's statements and recommendation suggest that the failure to amend the articles of incorporation or the bylaws creates a problem without articulating the problem or the deficiency that would be addressed by amending the articles of incorporation or bylaws. Any changes to the Trust Company's enabling statutes, the Act, were incorporated by reference in the 1986 articles of incorporation. The Trust Company cannot amend its articles of incorporation or bylaws to provide a governance structure or functions not authorized or provided in the Act. In any case, the Trust Company's articles of incorporation were amended since 1986, as seen in the Articles of Incorporation (March 2003). The amendments were non-substantive: they reflect the Trust Company's enabling legislation's codification in the Government Code and the Comptroller succeeding to the Texas Treasurer's functions and duties. And the Trust Company's Investment Advisory Board does meet regularly.
The Board (and Comptroller) should strictly follow the Statement of Principles, modified to better fit the quasi-governmental nature of the Trust Company, and establish procedures to ensure adherence. All Trust Company policies and procedures should be consistent with the Statement of Principles as modified.	Disagree	The Report suggests that the Trust Company's fiduciary responsibilities can only be assured by the adoption of the Statement of Principles that the Department requires regulated private trust companies and banks to adopt. The Trust Company's management respectfully disagrees. The Report correlates official immunity with decreased concern with fiduciary responsibility. The Report suggests, without providing any evidence, that because the Comptroller, Investment Advisory Board members, and the Trust Company staff enjoy official immunity, there is no incentive to better control fiduciary responsibilities. State officers' and employees' adherence to their fiduciary responsibilities are assured by the civil and criminal laws of the state and internal policies; official immunity does not give them license to violate the law and agency policies. The Report fails to explain how the adoption of the Statement of Principles would preclude violations of the law by those determined to do so.

**Summary of Trust Company Banking Examination Report Recommendations
and the Trust Company's Responses**

Recommendation	Trust Company's Response	
	Agree/ Partially Agree/ Disagree	Summary of Response
The Comptroller should formally appoint Board members, committees, committee members, and officers, or locate and appropriately file such documentation in records of the Trust Company. Further, the Comptroller should determine whether responsibilities and duties for the Board, each committee, and each officer should be enhanced by rules, orders, or other formal action to better utilize the experience and talents of the members. The Texas Business Corporation Act establishes standards that can provide guidance by analogy for the appointment or election of directors, officers, and committees.	Partially Agree	Trust Company management agrees that when appropriate or required, the Comptroller should formally appoint individuals and document such appointments. The Comptroller cannot by rule, order, or similar action "enhance" the Investment Advisory Board's statutorily mandated advisory role to a governing role.
The Board (and Comptroller) should require, and management should develop and implement, a system of reconciliation that ensures that all cash and investments are properly booked and accounted. Management is currently negotiating with SunGard Trust Data Processing to convert to its automated trust data systems software. This conversion should resolve the difficulties of reconciliations, interface with other systems, and provide management reports necessary to monitor the integrity of reported balances.	Partially Agree	One of the primary objectives since the 2001 amendment of the Act (also recognizing the recommendation from the State Auditor's Office to obtain new systems) has been to identify, purchase, and properly install new systems. The Report acknowledges that the Trust Company is negotiating with SunGard to obtain a more adequate general ledger. The Trust Company has contracted with SunGard and is in the process of implementing SunGard Financials to replace the current antiquated general ledger system. State Street Bank and Northern Trust provide custody and accounting services for TexPool and the Trust Company's endowment accounts, respectively. These custodians served as the accounting book of record at August 31, 2002 and therefore, perform the accounting to custody reconciliations. The entries into the Trust Company's general ledger system are made using the custodians' monthly proof packages, which contain such reconciliations. Internally managed funds are reconciled against the cash and investments held at the Trust Company's bank, the Federal Reserve, or the Depository Trust Company. With the implementation of new systems, it is management's intent to automate the reconciliation process where possible and reconcile the Trust Company's accounts against source documents. However, management considers the present practice adequate.
Management should acquire a new trust data automated processing system that will interface with other data systems as necessary to reflect the activities and accurate balances of accounts. As with the Trust Company financial records, management is currently in negotiation with SunGard Trust Data Processing to convert to its trust data systems software. This conversion should resolve the difficulties of reconciliations, interface with other systems, and provide necessary management reports.	Partially Agree	As noted in the Report, the Trust Company's "general ledger and supporting systems used to keep records for corporate and fiduciary investments are antiquated and require a significant amount of manual effort." Management considers the current reconciliations timely within these constraints. The Trust Company recognizes the opportunity for enhancement to the current reconciliation process. The new systems will expedite the reconciliation process and automate much work that is currently done manually.

**Summary of Trust Company Banking Examination Report Recommendations
and the Trust Company's Responses**

Recommendation	Trust Company's Response	
	Agree/ Partially Agree/ Disagree	Summary of Response
The Board (and Comptroller) should adopt and follow the minimum requirements for sound fiduciary activities as enumerated in the Statement of Principles, and ensure that the minutes clearly reflect the actions taken by the Board.	Agree	Trust management agrees. The Comptroller has adopted and follows fiduciary standards tailored to the Trust Company's unique nature, namely, the Comptroller's Investment Policy and statutory provisions regarding the management of particular funds. A resolution evidences the adoption by the Comptroller of the Investment Policy. To the extent such adoption is not clearly reflected in the Investment Advisory Board's minutes, the Investment Advisory Board will formally recommend adoption at a future meeting.
Pursuant to Board (and Comptroller) established principles and policies, management should segregate Trust Company corporate cash and investments from Trust Company fiduciary cash and investments, as well as the Comptroller's cash and investments, and maintain separate reconciliations for each.	Disagree	The Trust Company disagrees with this finding and the recommendation to segregate "corporate" assets from "fiduciary assets." The reserve balances of the Trust Company do not constitute "corporate assets," thus negating the finding. The reserve balances of the Trust Company are assets held by the Trust Company for the State of Texas in order to accomplish its legislative mandate. Section 404.105 of the Government Code states: "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."
Each officer and employee should receive relevant trust specific training. Additionally, trust training for Board and Committee members, as required by Section 404.111(b) of the Government Code for public fund investment officers, would enhance the quality of their oversight abilities.	Partially Agree	Trust Company management agrees that the appropriate officers and employees should receive training <i>relevant to their duties and functions</i> . Section 404.111(b) of the Government Code does not require "trust training" for "Investment Advisory Board members." The statute requires a training for Investment Advisory Board members to provide the following information: (1) the role and functions of the trust company; (2) the assets managed by and programs operated by the trust company; and (3) the statutes applicable to the trust company, including Chapters 551 (Open Meeting Act), 552 (Public Information Act), and 2001 (Administrative Procedure Act). In accordance with Section 404.111(b), training for the Investment Advisory Board members was provided to each Investment Advisory Board member in early 2002.
The Board (and Comptroller) should require that a written governing instrument be developed and executed for each account that is under administration, even for an account that is governed entirely by statute.	Disagree	Management disagrees. The Trust Company has executed written agreements for a majority of the funds that it holds and manages. Also, the Trust Company's responsibilities with respect to a fund and accounts within a fund are established by the Trust Company's statutes or the statute establishing the fund. The Report fails to identify its concern with the purported lack of the documentation given that these funds are managed in accordance with the governing statutes.

**Summary of Trust Company Banking Examination Report Recommendations
and the Trust Company's Responses**

Recommendation	Trust Company's Response	
	Agree/ Partially Agree/ Disagree	Summary of Response
Management should prepare an individual file that is complete for each fiduciary relationship, organize information chronologically, develop documentation checklists, and prepare lists of documentation exceptions. Management should incorporate these lists into a recurring management report to ensure necessary effort is focused on correction of the deficiency.	Agree	The Trust Company agrees with the Department's finding. In September 2002 (one month prior to the Department's field work) the Trust Company hired its first Trust Officer. The Trust Officer's first assigned task was to prepare individual files for each client relationship. With the guidance provided by several sources including the Department, the Trust Officer has completed 99% of the client files as of the date of this response.
The Board (and Comptroller) should appoint a qualified account administrator for each fiduciary account, assign the appointed administrator the responsibility of organizing all pertinent documents, and grant the appointed administrator the authority to obtain all necessary documents.	Agree	As mentioned above, the Trust Company hired its first Trust Officer in September 2002. The Trust Officer was assigned the responsibility of establishing the trust functions of the Trust Company, which includes administering all client relationships. As of the date of this response, there are 31 separate client files that the Trust Officer administers (not including certain investment pools managed for the Comptroller). The Trust Company will continue to monitor the Trust Officer's workload to determine if and when another trust officer is necessary.
Under Board (and Comptroller) direction, management should develop written policies and procedures to address the retention of supporting trade tickets and authorizations, and ensure that internal/external audit plans include this area.	Agree	This observation is a reiteration of a comment previously noted in a report prepared by the Trust Company's Internal Auditor that a sample of trade tickets disclosed missing authorizations, inconsistent filing, and missing tickets. It also recommends that the Trust Company develop written policies and procedures. The Trust Company's Chief Investment Officer authorizes all trades and evidences such authorization by signing the trade blotter. To enhance the current process of maintaining trade tickets, the Trust Company has obtained a fax/modem line for accounting and has further limited access to all records. All broker confirmation statements will be sent directly to the fax/modem and stored electronically on a server. Accounting will be responsible for printing out a hard copy and matching it to an authorized trade ticket. This documentation will support the accounting entry into the current QED system. It is anticipated that the fax/modem will be operational within two weeks. Finally, the Trust Company has a records retention schedule with written policies and procedures. The Trust Company is currently performing its annual review of the records retention schedule and any necessary modifications and/or updates will be addressed in this process.
Pursuant to Board (and Comptroller) direction, management should periodically determine the sufficiency of collateral and capital, and the CRA (Community Reinvestment Act) rating for each participating bank, and maintain documentation supporting such evaluations.	Agree	Although the Comptroller's Treasury Division performs these functions, the Trust Company agrees that it should maintain documentation of such reviews and will do so in the future.

**Summary of Trust Company Banking Examination Report Recommendations
and the Trust Company's Responses**

Recommendation	Trust Company's Response	
	Agree/ Partially Agree/ Disagree	Summary of Response
The Board (and Comptroller) with the assistance of management should develop and adopt written fiduciary policies and procedures to govern the acceptance and administration of accounts, investment activities and other activities associated with managing fiduciary funds.	Disagree	The Report's statement and recommendation misperceive the Trust Company and its "business." First, the Trust Company manages funds or accounts as directed or authorized by the legislature. It does not generally have the option of accepting or declining "accounts." Next, the administration and investment of the accounts is generally dictated by statute. Thus, not only written policies, which the Trust Company has adopted, but statutes govern the acceptance, administration, and investment of the "accounts" managed by the Trust Company.

Management's Response and Auditor's Follow-up Comment



COMPTROLLER OF PUBLIC ACCOUNTS

P.O. BOX 13528
AUSTIN, TX 78711-3528

October 17, 2003

Hugh Ohn, CPA, CIA
Project Manager
State Auditor's Office
1501 North Congress Avenue, Suite 4.224
Austin, Texas 78711

Dear Mr. Ohn:

I am sending you the Texas Comptroller of Public Accounts' responses to your draft audit report on the Texas Treasury Safekeeping Trust Company, Texas Guaranteed Tuition Plan (the "Plan"), and Texas Local Government Investment Pool ("TexPool"), dated October 16, 2003. We appreciate the opportunity to present these responses to the recommendations made in your audit report.

Chapter 1-A:

SAO Recommendation:

The Trust Company should complete the implementation of all 2001 recommendations that it has not fully implemented.

CPA Response:

Management agrees that the SAO's 2001 recommendations outlined in Appendix 2 of this report should be fully implemented. New, automated systems necessary to complete their implementation are expected to be fully in place by the end of the 2004 fiscal year.

Chapter 1-B:

SAO Recommendation:

We acknowledge the Trust Company's position regarding the banking examination report (particularly in light of its current governing statute) but encourage it to consider the report's recommendations.

CPA Response:

Management considered the Department of Banking's (the "Department") recommendations and provided detailed responses why the recommendations regarding legal separation from the Office of the Comptroller of Public Accounts (the "Comptroller") and change in corporate governance were legally inapposite, unnecessary, or unreasonable given the nature and purpose of the Trust Company.

The Department's recommendations are premised on an inaccurate and flawed understanding of the Trust Company: that the Trust Company is similar to a private trust company, motivated by similar objectives; that it can unilaterally change its structure and governance or, more importantly, that it would better serve the state to do so; and that, like a private trust company, the restraints necessary to ensure fiduciary responsibility can only be derived from or grounded in an active governing board and corporate documents and policies.

First, the Trust Company is not a private trust company, a bank, or a corporation or a "profit-making" entity. Instead, it is a public, governmental entity legislatively authorized to perform governmental state functions. See generally TEX. GOV'T CODE ANN. §§ 404.102 (Vernon 1998), .103 (Vernon Supp. 2003). The Trust Company holds and manages funds as required by statute

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or belonging to the state, agencies of the state, political subdivisions of the state, and charitable organizations created by the state or political subdivisions of the state. *See id.* § 404.103 (Vernon Supp. 2003). While the Trust Company is required by law to charge a fee, that fee is to recover the cost of its services and provide adequate reserves. *See id.* §§ 404.103(f), .105, .106(d).

Second, the Trust Company's structure and governance is subject to the statute creating it and other laws applicable to state agencies (as provided by its enabling statute), rather than corporate documents. *See id.* § 404.102(b) (Vernon 1998). The Comptroller, a constitutional officer elected by and accountable to the voters, is the sole shareholder and manager of the Trust Company. *See id.* §§ 404.102 (Vernon 1998), .104 (Vernon Supp. 2003). This is appropriate given that the Trust Company was created in order to allow the Comptroller to directly access Federal Reserve System services and to more efficiently and economically manage funds and securities that the Comptroller is charged with managing. *See id.* § 404.102 (Vernon 1998); *see also id.* § 404.115(b) (Vernon Supp. 2003) ("The comptroller may delegate any of the comptroller's duties to the chief executive officer and trust company employees.").

Finally, unlike private trust companies, the general laws of this state and Comptroller policies ensure the Trust Company's "transparency" and accountability. The Comptroller, again, a state officer accountable to the voters, is the sole shareholder and manager of the Trust Company. The Comptroller is required to submit to the Legislative Budget Board an audited report regarding the Trust Company's operations. *See id.* § 404.104(c). The Trust Company is subject to the Texas Open Meetings Act and the Public Information Act. *See id.* § 404.103(g). And, while not strictly required, the Trust Company follows the state procurement procedures. *See id.* § 404.111(b)(3). In short, all Trust Company acts and records are subject to public scrutiny and inspection.

Chapter 1-C:

SAO Recommendation:

The Trust Company should:

- *Correct all weaknesses noted in the financial audit report.*
- *Ensure that the results of financial audits are issued in a timely manner and promptly share those results with the Trust Company's Investment Advisory Board.*

CPA Response:

The Trust Company has corrected both material weaknesses noted in the financial audit report. Since the financial statement audit, the Trust Company has addressed the comments of its external auditors set forth in their *Letter on Internal Control and Accounting Procedures* dated April 8, 2003. The following narrative outlines how the Trust Company has addressed, or is in the process of addressing, these comments.

Material weaknesses have been corrected:

Segregation of Duties

Since the financial statement audit, all investment staff have been limited to read-only access to the investment accounting systems. Accounting staff is responsible for all Trust Company data input/modification, and investment staff no longer have the ability to generate accounting entries within the system.

Reconciliations

The Trust Company has devoted a full-time staff person to reconcile cash and securities accounts within the general ledger. The general ledger accounts are reconciled to third-party banks, the DTC and the Federal Reserve. A manager has also been tasked to ensure daily and monthly reconciliations are completed and reviewed in a timely manner.

Other items:

Approval of Trades

The Chief Investment Officer's approval was not documented for some investment transactions during 2002. Since the financial statement audit, the Trust Company has hired a Director of Internal Investments. The Director of Internal Investments reviews a summary of all trades executed each day and evidences his review and approval by signing the trade blotter.

Written Disaster Recovery Plan

Since the financial statement audit, the Trust Company has accelerated its business continuity planning process and completed a draft disaster recovery plan. The Trust Company is currently working with disaster recovery specialists in the Comptroller's office to complete the plan. After the plan is completed, testing will occur at least annually. The reviews and modifications will occur periodically as needed, but no less than annually.

Completion of First Year Financial Audit

Management agrees with this recommendation, and it is the intent of the Trust Company that financial audits be issued in a timely manner and promptly shared with the Trust Company's Investment Advisory Board. It is important to recognize, however, the mitigating conditions that are unique to the completion of a first year financial audit and those that are specifically unique to the Trust Company.

The SAO also notes that the August 31, 2002 financial statement audit was not issued until August 2003. The Trust Company met with the SAO and the external audit firm to discuss the timing of the audit. The SAO not only reviewed all of the external auditor's working papers, but also discussed the timing of the audit with the firm's partner-in-charge. It was noted that the prolonged audit was due primarily to four key points:

- August 31, 2002 was a first year audit of the newly constituted organization. First year audits are typically the most difficult as financial statements needed to be created from scratch and all aspects of the business operation must be learned and understood by the audit firm.
- The Trust Company is a unique entity within state government and considerable effort was required to determine how to appropriately present the financial statements in compliance with the Governmental Accounting Standards Board (GASB).
- The Trust Company adopted the new *GASB Statement No. 34, Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, *GASB Statement No. 37, Basic Financial Statements – and Management Discussion and Analysis –for State and Local Governments: Omnibus – an Amendment of GASB Statements No. 21 and 34*, and *GASB Statement Number 38, Certain Financial Statement Note Disclosures*, effective September 1, 2001.
- Financial reporting systems (which are currently being replaced and updated) required considerable manual effort by staff to extract data and prepare audit schedules.

Further, the SAO points out that the Comptroller must submit an audit report regarding the operations of the Trust Company to the Legislative Budget Board. A copy of the August 31, 2002 audit report for the Trust Company when issued was sent to the Legislative Budget Board, the Governor's Office, the State Auditor's Office, and the Sunset Commission.

The SAO recommends that the Trust Company should ensure that the results of financial audits are issued in a timely manner and promptly share the results with the Investment Advisory Board (the "Board"). The Board was provided regular updates on the status of the Trust Company's financial statement audit at its regular quarterly meetings. The Board discussed the audit's

progress with Trust Company staff and requested that the partner-in-charge of the audit present the unqualified opinion at its August 20, 2003 meeting.

Chapter 1-D:

SAO Recommendations:

The Trust Company should:

- *Continue working to implement its new financial accounting and investment accounting systems.*
- *Monitor to ensure that the new investment accounting system fulfills business and functional requirements.*
- *Correct the password and access authorization weaknesses in the current investment accounting system and ensure that they are not duplicated in the new financial accounting and investment accounting systems. Specifically, the Trust Company should:*
 - *Implement a process requiring users to change their passwords on a regular basis and follow the Comptroller's requirements for establishing passwords.*
 - *Ensure that user passwords are not available to division security coordinators for viewing. Passwords should be hidden or encrypted.*
 - *Ensure that access authorization is documented and fully supported for all users of the investment accounting system.*
 - *Periodically review access authorization for all users, including division security coordinators, to ensure that access rights match job duties and responsibilities.*

CPA Response:

The Trust Company is continuing to implement its new financial accounting and investment accounting systems. Upon completion of this year's audit, the Trust Company plans to devote additional accounting resources to bringing the system up and running parallel with existing systems. The Trust Company continually monitors and reviews functionality of the new systems as they are implemented to ensure the systems meet the Trust Company's business needs. To the extent feasible, the Trust Company has implemented the SAO's recommendations regarding system access controls.

The Trust Company advised the SAO that while some of the SAO's system security recommendations are feasible and have been implemented, others cannot be implemented because of the inherent limitations of the Trust Company's current, older financial and accounting systems. For instance, the current investment accounting system will not allow the encryption of passwords available to security coordinators. The new system that is being installed does offer this feature and it will be utilized once the system is put into production. This is one of the reasons the Trust Company is working to develop new automated systems for its accounting and investment functions. Below is an outline of current efforts to implement the feasible SAO recommendations pertaining to system security.

Automatic Password Requirement

The Trust Company has implemented a required 60-day change in passwords to the investment accounting system. This will be monitored and reported on by the Trust Company's security coordinator.

Creation of New Passwords

Users are required to comply with requirements in the Comptroller's *Security Coordinator Reference Guide* for establishing passwords. The Trust Company's security coordinator will be responsible for reporting on compliance with this requirement.

Access Authorization Documentation

The Trust Company has access authorization documentation for all users of the system. Further, removal of authorization is automatic for any departing employee. An authorized signature form must be completed and submitted to the Trust Company's security coordinator prior to any system access changes.

Full Access to the Investment Accounting System

The Trust Company allows full access to the investment accounting system to its system analysts because of the small size of the information technology ("IT") staff. The IT staff is just two system analysts. The system analysts have a key role in the current development of new systems, so the Trust Company frequently has only one analyst on-site. Without full access to the system, the on-site analyst would not be able to serve the Trust Company's daily needs. The Trust Company will ensure, once the new systems are fully installed, that each system analysts' access is limited to either the data tables or the code, but not both.

Periodic Review of Access Authorization

The CFO and/or his/her designee(s) will review access rights to the investment accounting system each time there is a change in personnel but no less than semi-annually. The Trust Company will ensure that access is based upon a need-to-know related to job duties. The review, and any modifications, of access rights will be evidenced by an authorized signature and maintained by the Trust Company's security coordinator.

Chapter 2-A:

SAO Recommendation:

The Plan should complete the implementation of all 2001 recommendations that it has not fully implemented.

CPA Response:

Plan management will reexamine any outstanding recommendations from the SAO's 2001 report. A number of these recommendations concern issues of board governance. Pursuant to the requirements of the Open Meetings Act, management will present these recommendations to the Board's Investment Committee, and then to the Board, for its consideration. Upon Board action, management will either implement these recommendations or submit further management response to the State Auditor.

Specifically, the following update should be noted:

Investment Rates for the 2002 Soundness Report

The Board's actuary consulted with the Board's investment consultant on the expected investment return prior to preparing the 2002 soundness report. The Board looks to its investment consultant—and not to Plan staff—for qualified recommendations on the expected investment return. Management will coordinate with the Board's investment consultant to document this process in more detail in the future.

Contractors' Financial Condition

Contractors are currently required in the RFP process to provide a statement of their financial condition. In addition, contractors are required to notify the Board of ownership changes and any ongoing legal proceedings.

Management will explore with legal counsel the possibility of incorporating new requirements in agency Requests for Proposals and contracts to require contractors to provide annual certification of financial soundness, including annual reports or other appropriate documentation, for continuing verification.

Sensitivity Testing

Management agrees and will work with the Board's actuary to include an even broader range of sensitivity testing to measure the effect of changes in the rate of inflation, rate of tuition increase, and investment yield.

Chapter 2-B:

SAO Recommendation:

The Plan should:

- *Re-examine its process for developing investment return assumptions to determine why its assumptions are higher than most other states' return assumptions for prepaid tuition plans.*
- *Work with its investment consultant to ensure that, at least on an annual basis, it receives formal, documented research to develop investment rate of return assumptions.*
- *Consider the average duration of its liabilities when developing investment return assumptions.*

CPA Response:

The Board's actuary consulted with the Board's investment consultant on the expected investment return prior to preparing the 2002 soundness report. Management will coordinate with the Board's investment consultant to document this process in more detail in the future.

These recommendations pertain to issues of board governance. Pursuant to the requirements of the Open Meetings Act, management will present these recommendations to the Board's Investment Committee, and then to the Board, for its consideration. Upon Board action, management will either implement these recommendations or submit further management response to the State Auditor.

Chapter 2-C:

SAO Recommendation:

The Plan should:

- *Ensure that its Board formally votes on significant decisions such as enrollment suspensions, program modification, or program termination. In addition, the Plan should obtain actuarial analyses regarding the fiscal impact of any major decisions before making these types of decisions.*
- *Obtain additional, useful information from its external investment consultant or others, including information about attribution analysis, portfolio turnover, best execution of trades, investment style analysis, and average daily cash balances.*
- *Enhance its investment policy by:*
 - *Specifying provisions governing soft dollar arrangements.*
 - *Specifying more protective standards to emphasize safety and liquidity more than investment yield when choosing cash equivalent investments and establishing minimum standards for the credit ratings on investments or collateralization requirements for investments.*
 - *Establishing a money manager review and retention policy that includes guidelines for monitoring investment managers' performance.*
- *Define the phrases "actuarial soundness," "sufficiently actuarially sound," and "financially infeasible" and use them as criteria to determine when corrective action needs to be taken to ensure the financial health of the Plan.*
- *Consider (1) expanding its staff's investment expertise to better manage or at least monitor its investment programs and (2) the benefits of using passive indexation strategies for the management of a portion of its investment portfolio.*

CPA Response:

The Board routinely votes on significant decisions and consults its actuary for his expertise. At its open meeting of June 4, 2003, the Board agreed a new enrollment period should not be set until the effects of tuition deregulation became clear. Based on prior discussion, the Board well understood the potential actuarial risk of selling prepaid tuition contracts in a newly deregulated, unpredictable environment. Further, the Board considered the potential effects of public university deregulation on the actuarial soundness of the program at its open meetings of October 8, 2002 and March 5, 2003.

The Board's discussion on June 4 followed the recent act of the 78th Legislature (Regular Session) amending the Education Code, Section 54.619, which authorizes the Board to temporarily suspend new enrollment in the prepaid tuition program on the request of the Comptroller as the Comptroller considers necessary to ensure the actuarial soundness of the fund. The Comptroller suggested to the Board that she formalize their decision with a letter to the Plan's 140,000 purchasers, assuring them that their Plan benefits remained secure while explaining the suspension of new enrollment. With unanimous agreement in the June 4 meeting from Board members, the Comptroller's Office subsequently mailed this letter to each account owner and published it in the June 2003 edition of two agency publications, *Fiscal Notes* and *Texas Innovator*.

The remaining recommendations concern issues of board governance. These recommendations address: 1) the responsibilities of the Board's investment consultant; 2) possible revisions to the Plan's investment policy; 3) the definitions of certain key actuarial terms; 4) Plan staff's lack of investment expertise; and 5) the use of passive asset managers to reduce fees. Pursuant to the requirements of the Open Meetings Act, management will present these recommendations to the Board's Investment Committee, and then to the Board, for its consideration. Upon Board action, management will either implement these recommendations or submit further management response to the State Auditor.

Chapter 4-A:

SAO Recommendation:

The Trust Company should follow formal procedures and adhere to established criteria in evaluating proposals and awarding contracts. In particular, it should:

- *Abide by the stated minimum criteria for consideration of proposals that potential contractors submit in response to RFPs.*
- *Separate its procurements to hire investment managers from its investments in alternative assets.*
- *Document its evaluation of potential contractors' proposals and related deliberations in a manner that adequately explains the basis on which resulting contract award decisions are made.*
- *Research potential contractors' tax and child support payment histories sufficiently early in the contractor selection process so they can use the results of that research in the evaluation of potential contractors' proposals.*

CPA Response:

Management disagrees with SAO's finding in Chapter 4-A. Management agrees with SAO's recommendations under 4-A, having already implemented those prior to this audit. The Trust Company has adopted formal contract evaluation and award procedures and does adhere to established criteria in evaluating and awarding contracts.

SAO's 4-A finding is unsupported. SAO isolates a single Request for Proposal (RFP) issued by the Trust Company in 2000 and then compares it to formal procedures adopted thereafter in 2001 through 2003 to make an unsupported conclusion. To support its finding, SAO notes a deviation from published specifications in a single RFP issued by the Trust Company in 2000, the first ever issued to engage money management firms on behalf of the Trust Company. The 2000 RFP was issued prior to the separation of the Trust Company from the Comptroller's office (September 1, 2001) and prior to the Trust Company's adoption of formal contract procedures in 2001 and prior to the Trust Company's adoption of its Plan of Operation in 2002 as required by the 77th Legislature in enacting Section 404.103(g) of the Texas Government Code.

SAO's 2003 finding is that the Trust Company should not have awarded in 2000 an alternative investment contract under its 2000 investment management RFP. Prior to the SAO's audit, the Trust Company arrived at this same conclusion due to practical difficulties it encountered in implementing the 2000 contract for its alternative investment in an investment management context. The Trust Company's present approach to alternative investments is reflected in its 2002 Plan of Operation. SAO's 2003 finding does not consider the changes the Trust Company made in its procedures from 2001 through 2003 and therefore incorrectly makes this finding.

The Trust Company's 2001 formal contract procedures, which parallel those of the Comptroller and Trust Company's Plan of Operation address, and addressed prior to the SAO audit, each of the recommendations resulting from the Trust Company's single 2000 RFP.

Regarding the particular Trust Company file cited in the third finding in Chapter 4-A, the Trust Company notes that partial tax research was conducted on August 7, 2000, prior to the evaluation committee's recommendation on August 29, 2000. Tax research was performed and completed on September 28, 2000, nearly four full months prior to contract execution on January 22, 2001. Tax research was performed and completed again on January 19, 2001, just prior to contract execution, in accordance with applicable law.

Regarding the final recommendation in Chapter 4-A, the Trust Company agrees and affirms that under current procedures, tax research is diligently conducted, completed, and provided to an evaluation team for its consideration at the outset of the selection process.

Chapter 4-B:

SAO Recommendation:

The Trust Company and Plan should:

- *Develop and communicate formal policies and procedures for monitoring contractors. These policies and procedures should identify:*
 - *The specific monitoring activities to be performed and the frequency with which they should be performed.*
 - *How monitoring activities should be performed, including the information sources that should be used.*
 - *The individual responsible for performing each monitoring activity.*
 - *How monitoring activities should be documented.*
 - *How and to whom the results of monitoring should be communicated.*
 - *How monitoring results should be used, including requirements for subsequent follow-up.*
- *Conduct monitoring and evaluation of contractors with a frequency that sufficiently supports the continuous management of contracts. Monitoring and evaluation criteria should directly related to the specific services each contractor provides and the key provisions of each contract.*

CPA Response:

Management believes that the Trust Company and the Plan have adequate systems in place to ensure that its contractors are adequately monitored and evaluated. Nonetheless, Comptroller personnel are currently working with the SAO and others to develop statewide contract monitoring standards. As provided by SB311, 77th Legislature, and HB3042, 78th Legislature, Comptroller personnel are joining SAO, Texas Building and Procurement Commission, Department of Information Resources and other agencies to develop statewide formal contract monitoring standards. Once such statewide standards are established, they will be implemented by the Trust Company and the Plan.

The most significant contracts maintained by the Trust Company and the Plan are those with its external money managers and custodial bank. Trust Company management effectively monitors these contracts by "living the contracts."

Money management contracts are monitored for compliance with investment policies daily by the Trust Company's automated compliance monitoring screening system. The system monitors all trades and screens for restricted securities, position concentration limits, and cash levels. Manager investment performance is monitored monthly with the assistance of the Trust Company's performance measurement consultant. Failure by a contractor to comply with contractual requirements or performance benchmarks would be evident in the routine course of business.

Similarly, services provided by the Trust Company's custodial bank are integrated into daily accounting workflows. The custodial bank's failure to perform contracted services would, likewise, be evidenced by disruption in daily operations.

Further, the Trust Company and the Plan are in the process of building a database containing essential contract information. The database will be structured to alert management when some action may be necessary, such as, for example, contract expiration dates.

In September 2003, the Plan Board awarded a new contract for investment consulting services to a recognized institutional investment adviser. The consultant's monitoring will include:

- Performance review, including quarterly and monthly performance reports.
- Performance attribution, determining the primary sources of investment returns in the total fund as well as in each individual portfolio.
- Ongoing evaluation and review of investment managers, including regular updates to the Board on any issues or concerns with each Plan managers.
- Portfolio review for guideline compliance.
- Review of impact of portfolio changes and trading.

Chapter 4-C:

SAO Recommendation:

The Plan should develop and implement a policy requiring Board members and key employees to disclose any relationships or other conflicts of interest they may have regarding potential contractors.


Hugh Ohn, CPA, CIA
October 17, 2003
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CPA Response:

Management will present to the Board for their consideration a policy requiring Board members and key Plan employees to disclose any financial relationships or other conflicts of interest they may have regarding potential contractors. This recommendation pertains to an issue of board governance. Pursuant to the requirements of the Open Meetings Act, management will present this recommendation to the Board's Investment Committee, and then to the Board, for its consideration. Upon Board action, management will either implement this recommendation or submit further management response to the State Auditor.

Please let me know if I can provide any further information.

Sincerely,

A handwritten signature in black ink that reads "Billy Hamilton". The signature is written in a cursive, flowing style.

Billy Hamilton
Deputy Comptroller

Auditor's Follow-up Comment to Management's Response

Management's response to Chapter 2-C provides additional information regarding the decision to suspend enrollment in the Texas Guaranteed Tuition Plan. We reiterate, however, that our specific concern was that the Board did not formally vote on this decision.

Several items in management's responses to Chapter 4-A, in which we specify that the Trust Company did not consistently follow contract award procedures, also require clarification:

- Management asserts that we compared the contract procurements we reviewed against new procedures developed after those contracts were awarded. That was not the case. As our report indicates, we analyzed those contract procurements using criteria in the associated requests for proposals. Therefore, management's assertion that new procedures were established after these contracts were awarded is not relevant to the issues we identified.
- We reviewed Trust Company contracts awarded during fiscal year 2001 because, during our audit fieldwork, those were the Trust Company's current contracts. As of the time of our audit fieldwork, the Trust Company had not awarded any contracts under its new procedures.
- Management's responses provide additional details that further support the fact that the Trust Company did not *complete* its tax research until after recommendations regarding contractors' proposals had already been made.
- Management stated that it disagreed with the issues in Chapter 4-A. However, it did not provide any details outlining its disagreement regarding the contract awarded to manage \$23.6 million in assets to a contractor that the evaluation team had not interviewed, rated, or recommended.

Management's response to Chapter 4-B, in which we specify that the Trust Company and Plan lack formal contract monitoring policies and procedures, indicates that management intends to develop contract monitoring standards. We commend management for this effort and encourage it to develop the formal policies and procedures we recommended.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Tom Craddick, Speaker of the House, Chair
The Honorable David Dewhurst, Lieutenant Governor, Vice Chair
The Honorable Teel Bivins, Senate Finance Committee
The Honorable Bill Ratliff, Senate State Affairs Committee
The Honorable Talmadge Heflin, House Appropriations Committee
The Honorable Ron Wilson, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Office of the Comptroller of Public Accounts

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

Members of the Texas Treasury Safekeeping Trust Company Investment Advisory Board

Members of the Texas Prepaid Higher Education Tuition Board

Members of the Texas Local Government Investment Pool Advisory Board



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