



JOINT MEETING OF THE
BOARD OF TRUSTEES
AND
INVESTMENT ADVISORY COMMITTEE



May 17, 2016

EMPLOYEES RETIREMENT SYSTEM OF TEXAS
JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE
ERS Building – Board Room
200 E. 18th Street, Austin, Texas 78701
May 17, 2016 – 8:15 a.m.

Meeting of the ERS Board of Trustees Audit Committee

1. Review and Approval of the minutes to the February 23, 2016 ERS Audit Committee Meeting
2. Presentation, Discussion and Consideration of Internal Audit Reports
3. **ADJOURNMENT OF THE ERS BOARD OF TRUSTEES AUDIT COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES**– Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.

Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee

4. Review and Approval of the Minutes to the February 23, 2016 Joint Meeting of the Board of Trustees and Investment Advisory Committee
- 5.* Review and Discussion of the Investment Performance for First Calendar Quarter 2016
6. Review and Discussion of the Fiscal Year 2015 Global Investment Performance Standards Compliance Performance Report
7. Review, Discussion and Consideration of the ERS Investment Policy
- 8.* Review, Discussion and Consideration of the Fixed Income Program:
 - a. Market Update and Program Overview
 - b. Review of Securities Lending Program
- 9.* Review, Discussion and Consideration of Real Estate Program:
 - a. Market Update and Program Overview
 - b. Proposed Private Real Estate Annual Tactical Plan for Fiscal Year 2017
10. Recognition of Investment Advisory Committee Members
11. **ADJOURNMENT OF THE JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES** – Following a temporary recess, the Board of Trustees will reconvene to take up the remaining Board of Trustee agenda items.

Meeting of the ERS Board of Trustees

12. Review and Approval of the minutes to the February 23, 2016 Meeting of the Board of Trustees
13. Review, Discussion and Consideration of the Rules of the Board of Trustees, Texas Administrative Code, Title 34, Part IV, Required Rule Reviews and Amendments to:
 - a. Chapter 71 (Creditable Service)
 - b. Chapter 85 (Flexible Benefits)

14. Review, Discussion and Consideration of the Texas Employees Group Benefits Program:
 - a. Selection of the Pharmacy Benefit Managers for the HealthSelectSM of Texas Prescription Drug Plan and the HealthSelectSM of Texas Medicare Pharmacy Plan beginning January 1, 2017
 - b. Selection and Contract Award Recommendation for Vision Care Services Administration beginning September 1, 2016
15. Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2017:
 - a. Basic and Optional Term Life, Accidental Death and Dismemberment Proposed Rates
 - b. Texas Income Protection Plan Proposed Rates
 - c. State of Texas Dental Discount Plan, Dental Choice and Dental Health Maintenance Organization Proposed Rates
 - d. Health Maintenance Organizations Proposed Rates
 - e. GBP Financial Status Update and Rate Proposals for HealthSelect of TexasSM and Consumer Directed HealthSelect
 - f. TexFlex Program Proposed Fees and Rates
16. Review, Discussion and Selection of Contract Award Recommendation for Actuarial Services for Insurance
17. Review, Discussion and Consideration of the Incentive Compensation Plan
18. Review and Discussion of Sunset Commission Report Findings
- 19.* Review and Discussion of Board Policy on Pension Funding Priorities and Guidelines
20. Executive Director Agency Update
21. Set Date for the Next Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee, the Next Meeting of the Board of Trustees and the Next Meeting of the Audit Committee
22. **ADJOURNMENT OF THE BOARD OF TRUSTEES**

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. These agenda items may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

NOTES: 1. Persons with disabilities who plan to attend this meeting and who may need special assistance are requested to contact Kelley Davenport at (512) 867-7772 three to five (3-5) working days prior to the meeting date so that appropriate arrangements can be made.

2. The Employees Retirement System of Texas Board of Trustees Audit Committee is scheduled to meet from 8:15 a.m. to approximately 8:50 a.m. on Tuesday, May 17, 2016. The Board of Trustees and Investment Advisory Committee are scheduled to meet jointly from approximately 8:50 a.m. to 11:45 a.m. on Tuesday, May 17, 2016. The Board of Trustees may take up the remaining board agenda items from approximately 12:15 p.m. to 5:25 pm on Tuesday, May 17, 2016, but may hear those items before or after the anticipated time frame. Meetings are tentatively scheduled to follow each other consecutively, but they may start earlier or later than the posted time depending on the length of the discussions within each agenda item and meeting and other circumstances not presently anticipated. Please note that the estimated times and sequence of agenda items are only approximate, and the time reflected in the posted agenda item, order of meetings or agenda items may be moved or adjusted as necessary.

PUBLIC AGENDA ITEM - # 1

1. Review and Approval of the Minutes to the February 23, 2016
Audit Committee Meeting

May 17, 2016

BACKGROUND:

The minutes to the Employees Retirement System of Texas Audit Committee meeting held on February 23, 2016 are included with this agenda item as Exhibit A. The minutes are submitted to the Board for review and approval.

PROPOSED MOTION:

Staff recommends the following motion to the Board of Trustees:

I move that the Board of Trustees of the Employees Retirement System of Texas approve the minutes to the Audit Committee meeting held on February 23, 2016.

ATTACHMENT – 1

Exhibit A – Proposed Minutes to the ERS Audit Committee Meeting of February 23, 2016



Audit Committee Meeting

February 23, 2016



Presented for Review and Approval

May 17, 2016

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

**February 23, 2016
ERS Board Room
ERS Building – 200 E. 18th Street
Austin, Texas 78701**

TRUSTEES PRESENT

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

TRUSTEES NOT PRESENT

Frederick E. Rowe, Jr., Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Catherine Terrell, Deputy Executive Director
Shack Nail, Special Projects and Policy Advisor
Paula A. Jones, General Counsel and Chief Compliance Officer
Tony Chavez, Internal Auditor
Robert Kukla, Director of Benefit Contracts
Machelle Pharr, Interim Chief Financial Officer
DeeDee Sterns, Acting Director of Human Resources
Tom Tull, Chief Investment Officer
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Liz Geise, Benefits Communications
Beth Gilbert, Internal Audit
Sharmila Kassam, Investments
Karen Norman, Internal Audit
Jonathan Puckett, Internal Audit
Leighton Shantz, Investments
John Streun, Investments
Glenda Workman, Benefits Communications
Keith Yawn, Enterprise Planning Office

ALSO PRESENT

Joel Brous, Franklin Templeton Institutional
David Dorman, AHM
Verma Elliott, State Auditor's Office
Reed Hutchens, Franklin Templeton Institutional
Seth Hutchison, Texas State Employees Union
Emily Johnson, Sunset
Emily Morganti, Legislative Budget Board
Nora Velasco, Legislative Budget Board
Steve Voss, Aon Hewitt

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

“A public notice of the Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 9:23 a.m. on Thursday, February 11, 2016 as required by Chapter 551, Texas Government Code, referred to as “The Open Meetings Law.”

Chairman Hester announced the resignation of Trustee Shad Rowe, submitted January 21, 2016, and thanked Trustee Rowe for his service.

The Board of Trustees then convened as a committee of the whole at 8:20 to consider Audit Committee agenda items.

I. REVIEW AND APPROVAL OF THE MINUTES TO THE DECEMBER 4, 2015 ERS AUDIT COMMITTEE MEETING

Audit Committee Chair, Ms. Cydney Donnell, opened the floor for a motion on the approval of the minutes from the Audit Committee Meeting held December 4, 2015.

MOTION made by Mr. Brian Ragland, and carried unanimously by the present members of the Audit Committee approved the minutes to the meeting held on December 4, 2015

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

a. External Audit Reports – Ms. Cydney Donnell, Chair of the ERS Audit Committee, recognized Mr. Tony Chavez, ERS Director of Internal Audit. Mr. Chavez then introduced Ms. Verma Elliott, audit manager with the State Auditor’s Office (SAO), to present audits relating to the 2015 CAFR Financial Audit and Pension schedules. Ms. Elliott stated the SAO issued an unqualified opinion on ERS financial statement for FY 2015 and reported internal controls over financial reporting were in compliance with *Government Auditing Standards*.

One significant deficiency relating to active employee census data was identified. Mr. Chavez confirmed the Finance Division was addressing the deficiency relating to census data. Additional review for the fiscal year showed deficiencies did not materially affect the calculation of the system’s pension liability.

New guidelines by AICPA require a review pension schedules and net liability components. For audit work performed over FY2013, and FY2015 Pension Schedules, the SAO concluded an unqualified opinion with no material weakness or significant deficiencies in internal controls. FY2013 audit work was performed to comply with auditing standards related to the beginning balances of FY2014 financial statements previously audited by the SAO in the prior year.

Ms. Cydney Donnell, Chair of the ERS Audit Committee, asked about the cooperation of ERS staff with SAO. SAO replied that cooperation was positive and unfettered. In answer to board questions regarding procedural changes to correct problems with reporting census data, ERS staff noted new procedures had been implemented.

There being no further questions or discussion, the Board then took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Mr. Brian Ragland and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas accept the financial audit reports as prepared by the State Auditor’s Office and presented in this agenda item.

b. Internal Audit Reports – Mr. Chavez reported Internal Audit had two deliverables, quarterly compliance procedures and the status of audit recommendations. Mr. Chavez presented Investment Compliance Procedures highlighting Securities Lending and Proxy Voting. There were no questions or further discussion, and no action was required on this item.

Mr. Chavez introduced Ms. Beth Gilbert, ERS Senior Auditor, who presented results on the follow-up of audit recommendations. Ms. Gilbert noted 100% implementation on all audit observations. There were no questions or further discussion, and no action was required on this item.

c. Internal Audit Administrative Item – Mr. Chavez reported the Internal Audit Charter is reviewed annually to determine if revisions are necessary. Based on his review Mr. Chavez recommended no changes to the Audit Charter at this time. Mr. Chavez did note the Audit Charter did require updated signatures of the current Board Chair and ERS Executive Director.

There being no further questions or discussion, and since no changes were made to the Audit Charter, no action was taken by the Board.

III. ADJOURNMENT OF THE ERS BOARD OF TRUSTEES AUDIT COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES

Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.

PUBLIC AGENDA ITEM - #2

Presentation, Discussion and Consideration of Internal Audit Reports

May 17, 2016

BACKGROUND:

Internal Audit completed two engagements, GBP Procurement Follow-Up and Investment Compliance Agreed-upon Procedures (AUP) as part of the Fiscal Year 2016 audit plan. These reports are included in this agenda as Exhibit A-B.

STAFF RECOMMENDATION:

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

ATTACHMENTS – 2

Exhibit A – GBP Procurement Follow-Up

Exhibit B – Investment Compliance Agreed-upon Procedures Memo



ERS INTERNAL AUDIT DIVISION

To provide independent and objective assurance on the effectiveness of controls and operations to meet ERS' strategic direction.

GBP Procurement Follow-up Audit #2016-02

April 26, 2016

FROM THE DIRECTOR

Internal Audit has completed its Group Benefits Program (GBP) Procurement Follow-up audit at the Employees Retirement System of Texas.

Based on the audit scope areas reviewed, internal controls require improvement in order to provide reasonable assurance that key goals and objectives will be achieved. The current system of internal controls only partially address risk factors considered significant to operational execution and compliance. Significant improvements are required to correct the below control gaps that may result in negative impacts to ERS.

- 1. Evaluation scoring matrix does not effectively support and document how best value was obtained. (Significant)
2. Evaluation and award procedures do not ensure all intended objectives are met. (Significant)
3. Management has taken action to implement Texas State Auditor's Office recommendations but work remains. (Moderate)

Detailed results and observations are included in subsequent pages. Other matters deemed less significant were communicated with management directly. We thank management and staff of the Benefit Contracts and Legal Services divisions for their courtesy and cooperation extended to us during the review.

Sincerely

Handwritten signature of Anthony Chavez

Anthony Chavez, CIA, CGAP, CRMA
Director, Internal Audit Division

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OBJECTIVE

The overall objective of the audit was to determine whether corrective actions have been implemented to address prior audit observations and recommendations related to the Group Benefits Program procurement process. The sub-objectives of the audit were:

Compliance:

- a. Have processes been updated to reflect SAO recommendations?
- b. For recommendations not implemented, has rationale been documented, communicated and accepted by management?

Planning and Development:

- a. Do bid development activities ensure criteria aligned with services to be provided and best value principles?
- b. Do bid development activities ensure all evaluation criteria, requirements and scope of work are included in the published RFP?
- c. Do planning activities ensure RFP criteria is incorporated within evaluation scoring tools?

Procurement, Selection and Recommendation:

- a. Are scoring tools appropriately utilized to ensure accuracy of evaluation scores?
- b. Are scoring tools properly updated and maintained to reflect information source?
- c. Are award recommendations communicated to key stakeholders consistent with evaluation results, including “best value” rationale?

CONCLUSION AND SUMMARY RESULTS

OVERALL ASSESSMENT		NEEDS IMPROVEMENT
SCOPE AREA	RESULT	RATING
Compliance	Observation #3: Management has taken action to implement Texas State Auditor’s Office recommendations but work remains. (Moderate)	Satisfactory
Planning and Development	Planning activities were updated to include all required elements while utilizing best value principles Bid development activities were updated to ensure published criteria align with evaluation criteria.	Satisfactory
Procurement, Selection and Recommendation	Observation #1: Evaluation scoring matrix does not effectively support and document how best value was obtained. (Significant) Observation #2: Evaluation and award procedures do not ensure all intended objectives are met. (Significant)	Needs Improvement

EXEMPLARY CONTROLS

The Benefit Contracts Division has established several strong points that can be described as “best practices” for procurement development and planning:

- Procurement planning documentation, including the Project Charter and Communication Plan, are detailed and well documented
- High level of coordination across agency allowing active involvement of subject matter experts throughout process
- Employees involved in the planning, procurement and monitoring of contracts meet State training and certification requirements
- Two Certified Texas Procurement Managers are employed in the Benefit Contract Division and participate on all bid developments
- Best Value principles are used when developing bid proposals

BACKGROUND

Statute allows ERS to acquire goods and services by any procurement method approved by the Board of Trustees that provides the best value to the retirement system. To obtain best value, ERS procurements generally adhere to requirements set forth by the State of Texas Contract Management Guide and the State of Texas Procurement Manual both published by the Texas Comptroller of Public Accounts.

“Contracting” or “Contract Management” refers to the entire contract management cycle. Each contracting element has its own unique risks and related control activities subject to audit. This audit engagement covers the entire framework, with primary focus on GBP procurement activities.

Contracting Elements

Plan—Identifying contracting objectives and strategy

Procurement—Selection of a vendor to provide goods and services

Contract Formation—Ensures contract contains provisions holding the contractor accountable for desired results

Contract Oversight—Monitor and enforce the terms of the contract



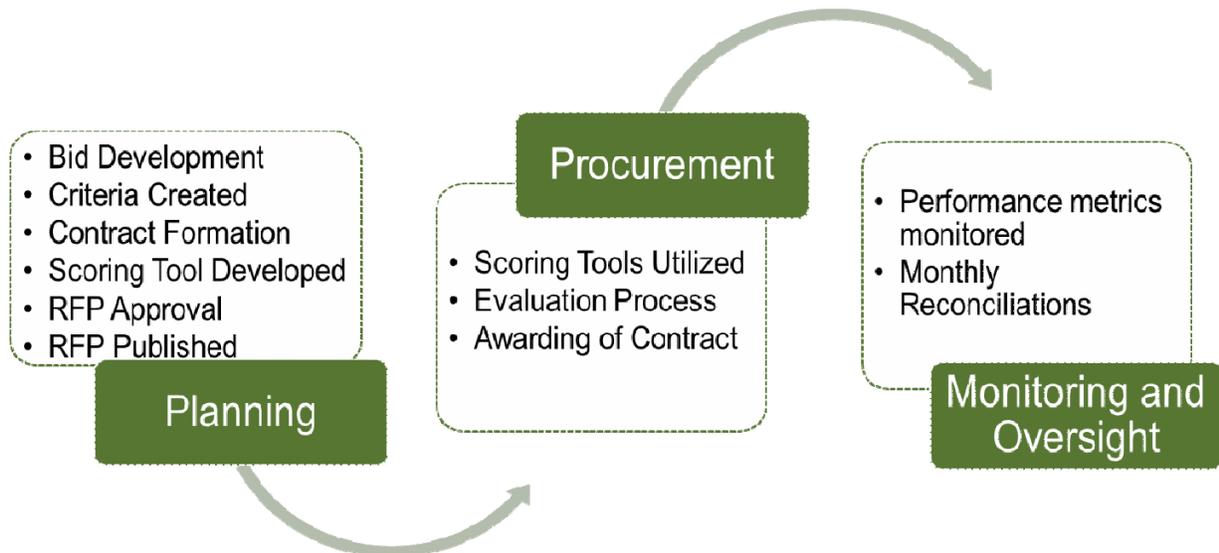
GROUP BENEFIT PROGRAM PLANNING & PROCUREMENT PROCESS

Until recently, the Benefit Contracts division was responsible for the creation, publication and distribution of Group Benefit Program (GBP) goods and services including, but not limited to, all healthcare, dental and life insurance products. Their responsibilities include all contract areas starting with bid development and ending with contract oversight.

The procurement process involves an evaluation team comprised of subject matter experts from various divisions including Legal Services, Customer Benefits, Finance and Information Systems. The evaluation team helps identify scope of work requirements and then score proposals based on weighted attributes and criteria established during the planning and development phase. Attributes include operational, regulatory and financial considerations. Microsoft Excel worksheets are used to document individual evaluation scores, summarize evaluator scores for comparison, solicit clarification requests and assist the Benefit Contracts Division to determine best value to ERS for recommendation to the Board.

The staff evaluates bid responses and provides contracting recommendations to ERS' Board of Trustees and Executive Office. Once a contract is awarded, Benefit Contracts staff is responsible for monitoring vendor performance, contract compliance and contract enforcement.

BENEFIT CONTRACTS CONTRACTING PROCESS



New ERS Office of Procurement and Contract Oversight

Effective April 1, 2016, Executive Management established the Office of Procurement and Contract Oversight. Led by the Director of Procurement and Contract Oversight, the division is responsible for developing and overseeing the planning and procurement process for the entire agency, including Group Benefit Programs. The division's staff includes procurement related individuals from Legal Services and Benefit Contracts.

Day to day activities of Group Benefit Programs will remain with the Benefit Contracts Division.

SCOPE AND METHODOLOGY

We performed this audit in accordance with the Fiscal Year (FY) 2016 annual audit plan. Internal control activities reviewed include those in place during FY 2015 and at the time of audit fieldwork testing that ended on March 11, 2016. Request for proposals covered included the Health Savings Account Administrative Services and portions of the Pharmacy Benefit Management, including the planning and procurement process for each. Audit coverage over the HealthSelect contract included the monitoring and oversight process only.

We conducted this audit in accordance with Generally Accepted Government Auditing Standards and in conformance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

Audit work covered the contracting process within the Benefit Contracts Division

A defined set of control objectives was utilized to focus on operational goals for the identified scope. The Committee of Sponsoring Organizations of the Treadway Commission Internal Control — Integrated Framework Control was the basis for internal control assessment. Our Internal Audit opinion is an assessment of the condition of the overall control environment based on the effectiveness of internal control activities through the audit period and the degree to which defined control objectives are being met. Our Internal Audit opinion is not a guarantee of operational effectiveness or regulatory compliance, particularly in areas not included in the scope of this audit.

This audit included a review of internal controls considered relevant to audit objectives including review of statutes, policies and procedures, interviews with management and staff, data analysis and testing procedures.

Contracting functions outside the Benefit Contracts Division were not part of the scope of this engagement and separate audit engagements have or will be performed over those areas.

RELATED AUDITS

Internal Audit Report 2015-02 General Procurement (December 2015)

SAO Report 15-007 HealthSelect Contract at the Employees Retirement System (November 2014)

Internal Audit Report 2014-03 Legal Services Contract Administration (May 2014)

Internal Audit Report 2013-02 Group Benefits Program Procurements (August 2013)

Group Benefit Program Related Contracts

- Health Care—HealthSelect, Health Savings Account
- Prescription Drug—HealthSelect, Medicare
- Dental Care—PPO, DHMO, Discount
- Flexible Spending—Health Care, Child Care, Commuter Spending
- Health Maintenance Organization (HMO)
- Medicare Advantage—HMO, PPO
- Term Life Coverage—Life, AD&D, Dependent
- 401(k) & 457—Record Keeper, Advice Service, Custodian
- Audits of vendors providing above services

OBSERVATIONS AND RECOMMENDATIONS

1. Evaluation Scoring Matrix does not effectively support and document how best value obtained. (Significant)

To support the subjective nature of best value in contracting, documentation must be present to effectively communicate and support best value determination. The nature and extent of documentation is influenced by regulatory requirements and complexity of operations. Per the Contract Management Guide (CMG) “a scoring matrix is used by the evaluation team members to score the individual responses based on the evaluation criteria defined in the solicitation document.” The scoring matrix documents performance factor ratings and assist decision makers in analyzing the “**trade-off**” between price and performance. Review of the scoring matrix for the Health Savings Account Administrative Services RFP found the scoring matrix to be unclear and inconsistent in documenting performance factor ratings. The practice of scoring each RFP item individually and the associated scoring methodology led to obscure results that did not clearly support best value determination. (See Appendix A for further details regarding the scoring matrix and methodology.) Specifically the following was identified impacting support for how best value obtained:

Effective Documentation Elements

- Persuasive enough to show that components and relevant principals are present and functioning to meet objectives
- Provide clarity around roles and responsibilities, which promotes consistency in adhering to practices, policies, and procedures
- Assists in capturing the design of the process and communicating the who, what, when, where, and why

Source: COSO Internal Controls—Integrated Framework

- **Inconsistent and incomplete scoring**—The CMG notes evaluators should complete scores in their assigned area. For the HSA RFP, a relatively small RFP, scoring of each individual RFP item resulted in over 2,500 individual scores for the five vendors evaluated. This level of scoring activity contributed to errors including:
 - 20 instances evaluators did not score all criteria for all vendors
 - 8 instances evaluators did not score all vendors
 - 5 instances summary score did not reconcile to source scoring document
 - 3 instances evaluator scores not include in summary scoring sheet
 - 3 instances vendor weighted score inaccurate

However, because of the large data set (2,500 individual scores), errors did not result in a negative impact to final outcome.

Best Value Regulatory Guidance

Best Value is defined as **factors** to be considered in determining lowest overall cost and value in making certain purchases.¹

The best value selection of a contractor is based on a determination of which proposal offers the best **trade-off** between price and performance, where quality is considered an integral performance factor.¹

In determining the best value for the state, the purchase price and whether the goods or services meet specifications are the most important considerations.²

1—State of Texas Contract Management Guide

2—Govt. Code 2155.07—Best Value Standard for Purchase of Goods or Services

- No individual performance factor ratings to support overall assessment—Performance evaluation RFP criteria items were summarized into one single category identified as “*Operational Capabilities*”. For the HSA RFP seven performance factors were noted and communicated to the Board as considered in determining best value selection. However, the scoring matrix did not include a score or rating for each performance factor. A documented score for performance factors assists in supporting the determination of “**best trade-off**” between performance and price and additional value obtained with selected vendor. Although individual performance ratings could be recreated, documentation should be present to support the specific reasons why a vendor received the highest overall performance rating.
- Score documented by evaluator versus performance factor— Evaluators are assigned RFP criteria items to review. Scores for each RFP criteria item are then summed by evaluator and posted to the overall performance category “*Operational Capabilities*”. Consequently different performance factors and attributes are documented into an evaluator rating versus performance factor rating. This makes it difficult to support which performance factors each vendor excelled at and support reasons for vendor selection as it relates to performance. (See Appendix A for further details.)
- Under-utilizing evaluator expertise—Evaluators are selected and assigned to specific performance areas based on their subject matter expertise. However, because evaluators are required to score individual RFP items, it does not allow them the flexibility to provide an overall assessment based on that expertise. An evaluators overall assessment is of greater value than scoring of individual RFP items.
- RFP criteria items did not align with the category—Cost considerations were included in the performance category “*Operational Capabilities*”. Price and performance attributes should be scored and maintained separately to clearly support the overall vendor scores given.

HSA Performance Factors

- Communication
- Operational Capabilities and Services
- Financial, Banking and Investment Services
- Administrative and Technological Services
- Account Management
- Financial & Data Reporting
- Data Information Services and Systems (Technology)

Source: February 2016 Board Meeting—Agenda Item #13c

Inherent Risk Factors in Communicating How Best Value Obtained:

- Best Value is subjective
- No single definition for best value
- Stakeholders, both internal and external, may disagree with staff determinations including performance factors prioritized (weighting)
- Select Group Benefit Programs complex with multiple deliverables and multiple pricing points
- Winning bid may not rate the highest in all performance factors or be lowest cost
- Picking winners and losers—someone will be displeased with final result

RECOMMENDATIONS

The Benefit Contracts and Procurement Division should continue to improve RFP evaluation scoring tools. Scoring tools should incorporate elements recommended in the Texas Contract Management Guide (specifically Appendix 12) including:

- Scoring of each individual performance factor identified in planning
- Separate scoring for performance factors and cost factors
- Scoring emphasis on individual performance factor versus individual evaluator
- Allow evaluators (subject matter experts) to provide an overall score for each individual performance factor including comments to support final assessment
- Utilize additional information obtained through bid activities such as interviews and site-visits to assist in scoring individual performance factors as oppose to a separate vendor performance score
- Include individual performance factor weights in scoring tool

MANAGEMENT ACTION PLAN

The Office of Procurement and Contract Oversight is in the process of developing a less complex scoring matrix, consistent with Internal Audit's recommendations. Specifically, the scoring matrix will be more closely aligned with the sample at Appendix 12 of the Contract Management Guide. The Office of Procurement and Contract Oversight is also considering how interviews and site visits can better support the individual performance factors.

Responsible Position: Director of Procurement and Contract Oversight

Implementation Date: August 31, 2016

OBSERVATIONS AND RECOMMENDATIONS

2. Evaluation and award procedures do not ensure all intended objectives are met. (Significant)

The evaluation and award process is the decision making element of the contract management framework. To ensure a fair, impartial and efficient process the Contract Management Guide (CMG) suggests a multistep approach to narrow bids. The Benefit Contracts Division has developed a phased approach to incorporate this guidance in its evaluation process. Each phase has its own objective and corresponding procedures. Review of the Health Savings Account Administration Services RFP found procedures were not consistently performed and did not always meet intended objectives including:

Phase Close-out—Each phase is a step in the process intended to be completed before proceeding to the next one. Instances were identified that procedures were not finalized for all vendors before proceeding to next phase procedures. Instances identified include:

- One vendor's minimum requirements review began in Phase II
- Two vendors were removed midway during the bid proposal evaluation, leaving incomplete evaluation scores (Phase II)
- For one finalist, the bid proposal scores (Phase II) were still being updated after completing the finalist round (Phase III)
- No documentation retained summarizing events and actions that occurred to close that phase

The above could lead to the perception that the process is not fair and impartial.

Phase Objectives—Review of Benefit Contracts process identified inconsistencies with the procedures being performed and the intended objective of each phase. Specifically the following was identified:

- The summary evaluation matrix gives the impression minimum requirements are being evaluated and rated. Reviewing for completion and reviewing for scoring are separate objectives. (See Appendix B for CMG minimum requirements checklist)
- Deviations scored as a separate attribute rather than considered as additional performance factor information during bid proposal evaluation. This contributes to instances of vendors receiving a greater number of scores than a vendor who noted no deviations. In addition, the deviation score does not distinguish factor evaluated.
- Face-to-face interviews and site visits are scored as separate vendor attributes rather than additional performance factor information. The CMG recommends these procedures to provide vendors an opportunity to highlight responses and address questions an agency may have. Review of the scoring matrix could not determine if the vendor's presentation or the additional information received, represented the scoring.

Evaluation Phases

Phase I (Minimum Requirements) - Determine the submitted proposals are complete and meet minimum requirements

Phase II (Bid Proposal Evaluation) - Subject Matter Experts evaluate the vendors proposals; scoring the vendor's characteristics to perform the contract's objective

Phase III (Finalist Presentations) - Finalists are given the opportunity to highlight aspects of their response and provide answers to set questions the agency has prepared.

Although procedures performed are documented, an external reviewer would have difficulty determining the reasonableness and purpose for some of the steps.

RECOMMENDATIONS

The Benefit Contracts and Procurement Division should evaluate current procedures to ensure control objectives are met and procurement phases are properly closed-out including:

- Define evaluation phase objectives, including the expected outcome
- Finalize and document each phase before proceeding to the next one, including appropriate approvals
- Consider deadlines where no additional vendor initiated information will be accepted or considered to streamline the evaluation process
- Ensure procedures performed to evaluate bidders are not scored and documented as performance attributes

MANAGEMENT ACTION PLAN

The Office of Procurement and Contract Oversight is currently reviewing the evaluation and award procedures. As the Office of Procurement and Contract Oversight refines the process, it will take into consideration all of Internal Audit's recommendations. The Office of Procurement and Contract Oversight appreciates the importance of more clearly documenting close out of one phase before beginning the next evaluation phase. And the Office of Procurement and Contract Oversight is focused on simplifying the clarification process. Furthermore, it will be more clearly documented that minimum requirements are not scored items.

Responsible Position: Director of Procurement and Contract Oversight

Implementation Date: August 31, 2016

3. Management has taken action to implement Texas State Auditor’s Office recommendations but work remains. (Moderate)

Statute requires compliance with all recommendations made by the State Auditor's Office in its November 2014 report (Report No. 15-007) to the Employees Retirement System to improve the planning, procurement, formation and oversight of the HealthSelect third-party administrator contract. Management has taken action to address each recommendation. However additional action is needed, particularly over scoring tools utilized to document evaluation results.

Implementation status is designated by the following levels:

- **Fully Implemented** – Sufficient and appropriate evidence to support all reported management action items
- **Partially Implemented** – Management has implemented some management action items but not all to fully address reported risk
- **No Action Taken** – No management action taken and/or evidence provided to support management action
- **Management Acceptance** – Executive management has accepted the risk of not fully implementing reported management action plan.

SAO Finding 1A-1 The system should ensure that key staff involved in procurements meet state training and certification requirements

Recommendation	Status	Action Taken
Ensure that its Purchasing Department is involved in the planning and procurement of all contracts as required by the State of Texas Contract Management Guide	Fully Implemented	Effective April 1, 2016 a new Procurement Division was created and responsible for the oversight of all competitive procurements across ERS including group benefit programs.
Ensure that key employees involved in the planning, procurement and monitoring of contracts obtain and maintain the training and certifications required by the State of Texas Contract Management Guide, the Texas Government Code and the State of Texas Procurement Manual	Fully Implemented	Within Benefit Contracts Division, eight individuals were verified as having the Certified Texas Contract Manager (CTCM) and two having the Certified Texas Procurement Manager (CTPM) certification.
Adopt procedures for resolving contractor protests required by Texas Government Code, Section 2155.076 and consider including information about its protest process in all RFPs.	Fully Implemented	Effective December 2015, ERS adopted rules governing bid protest process. The ERS public website has the information posted.

SAO Finding 1B-1 The System should enhance its planning documentation for Procurements

Recommendation	Status	Action Taken
Strengthen its planning process for procurements to help ensure that its planning activities, including risk and stakeholder identification and needs assessment, are complete	Fully Implemented	The Project Charter and Communication Plan for GBP procurement have been updated and include all required elements for contract management, risk assessment and external stakeholders
Perform and maintain adequate documentation of the procurement planning activities required by the State of Texas Contract Management Guide and System policies	Fully Implemented	SharePoint, the document management platform, retains all planning documentation.
Comply with Texas Government Code requirements related to consulting the Contract Advisory Team (CAT) when planning major contracts	Partially Implemented	Controls have been implemented to approve submission of contracts estimated above \$10 million to the CAT. However no controls are in place to approve or confirm for appropriateness when a contract is not submitted to the CAT. Risk of non-compliance relates to those contracts not submitted to the CAT when required.

SAO Finding 1C-1 The system should enhance its planning documentation for Procurements

Recommendation	Status	Action Taken
Develop and implement a policy defining best value and how best value will be determined and considered for each procurement	Fully Implemented	Best Value Principles procedures have been implemented and were used during the engagement period.
Strengthen its controls to ensure that all criteria in its RFPs are complete, defined, explained, and include the associated evaluation weights as required by the State of Texas Contract Management Guide and System policies	Fully Implemented	The HSA RFP included the major criteria and associated weighting. The weighting of the criteria went through an approval process and match the evaluation criteria.

SAO Finding 1D-1 The System should improve its Contract Formation and Amendment Processes

Recommendation	Status	Action Taken
Ensure that it includes all required essential contract clauses in its contracts in accordance with state statute and the State of Texas Contract Management Guide.	Partially Implemented	During the engagement, Legal updated procedures on documenting and reviewing clauses not included in contracts prior to publishing
Ensure that the Office of Attorney General (OAG) reviews a final contract before the System executes that contract as required by Texas Government Code.	Fully Implemented	Controls have been implemented to approve submission of contracts estimated above \$250 million to the OAG. However no controls are in place to approve or confirm for appropriateness when a contract is not submitted to the OAG. Risk of non-compliance relates to those contracts not submitted to the OAG when required.
Maintain documentation of the System's approvals of contract amendments in accordance with System policies.	Fully Implemented	Contract amendments are documented and routed prior to inclusion into the contract.

SAO Finding 2A-1 The system should improve its process for developing scoring tools

Recommendation	Status	Action Taken
Improve its process for developing scoring tools to help ensure consistency between the criteria included in solicitation documents, such as RFPs, and those included in scoring tools	Partially Implemented	See Observations #1 and #2
Ensure that all criteria used to evaluate respondent proposals are included in the related RFPs and scoring tools as required by the State of Texas Contract Management Guide	Partially Implemented	See Observations #1 and #2.
Approve all scoring tools prior to publishing the solicitation document or, at a minimum, prior to the opening and review of proposal responses.	Fully Implemented	Scoring tools have a documented approval process

SAO Finding 2B-1 The System should establish processes and guidelines to ensure that evaluators are consistent in their use of the scoring tool

Recommendation	Status	Action Taken
Develop and approve an evaluation guide for each of its procurements that identifies the size and composition of the evaluation team, the detailed scoring matrix and criteria definitions, and the decision making structure for the evaluation of responses and award of any resulting contracts.	Fully Implemented	Planning documentation includes the evaluation team process.
Establish processes to help ensure that all scores on its evaluation scoring tools are adequately supported, consistently completed, and mathematically accurate, and that a sufficient and consistent number of evaluators score each criterion.	Partially Implemented	See Observations #1 and #2
Develop and implement a process for addressing significant discrepancies among evaluator scores.	Partially Implemented	An evaluator scoring review procedure was established and occurring, although the review did not happen timely.

SAO Finding 2C-1 The System obtained additional information and performed analysis as part of its evaluation; however, it should improve its process to describe how it used that information

Recommendation	Status	Action Taken
Update its policies and procedures to describe all aspects of the evaluation process and how information such as site visits, interviews, and financial analysis should be incorporated into the evaluation scoring tools and final decision document	Partially Implemented	See Observations #1 and #2
Maintain documentation for all of its proposal evaluation analysis and enhance its evaluation process to help ensure the completeness and accuracy of its analysis.	Fully Implemented	SharePoint, the document management platform, retains all procurement documentation.

SAO Finding 2D-1 The System should develop a process to address additional factors it identifies during its proposal evaluations and negotiations

Recommendation	Status	Action Taken
The System should establish a formal process for handling evaluation factors that the System considers relevant to its recommendation for awarding a contract but were not included in its RFP and/or anticipated during planning for the contract.	Partially Implemented	See Observations #1 and #2

SAO Finding 3A-1 The System did not have a process to reconcile reimbursement payments to detailed claims data

Recommendation	Status	Action Taken
The System should ensure that it approves and processes all claims reimbursement payments in accordance with its policies and should consider modifying its process for recording reimbursement payments to make them transparent to the public	Fully Implemented	Reimbursements are reconciled on a timely basis using current payment information.

SAO Finding 3B-1 The System monitors the Contractor’s Performance; however it should improve the timeliness and effectiveness of its monitoring process

Recommendation	Status	Action Taken
Ensure that health care claims accuracy and the results of internal control audits of the contractor are reviewed in a timely manner	Fully Implemented	The vendor audit review schedule is reviewed at least annually.
Ensure that it updates the scope of work for its external agreed upon procedures engagements to address current risks associated with the HealthSelect contract	Fully Implemented	The vendor audit review scheduled is reviewed at least annually
Adequately monitor its other HealthSelect related provider contracts.	Fully Implemented	The vendor audit review scheduled is reviewed at least annually.
Include all contract deliverables in its monitoring tools.	Fully Implemented	Monitoring tools have been updated to include all deliverables
Process all performance guarantee changes through contract amendments.	Fully Implemented	Procedures were updated to include amendment changes.

MANAGEMENT ACTION PLAN

The Office of Procurement and Contract Oversight will work with the appropriate Divisions to ensure appropriate compliance with the SAO recommendations. Furthermore, ERS will comply with the requirements in the GAA Budget Rider specific to the HealthSelect contract and documentation of compliance or deviation from SAO recommendations.

Responsible Position: Director of Procurement and Contract Oversight

Implementation Date: August 31, 2016

APPENDIX A—GBP Scoring Matrix Example

Exhibit A—Summary Vendor Scoring Sheet

		Vendor A																				Weighted Score							
		Evaluator #1	Evaluator #2	Evaluator #3	Evaluator #4	Evaluator #5	Evaluator #6	Evaluator #7	Evaluator #8	Evaluator #9	Evaluator #10	Evaluator #11	Evaluator #12	Evaluator #13	Evaluator #14	Evaluator #15	Evaluator #16	Evaluator #17	Evaluator #18	Evaluator #19	Evaluator #20	Evaluator #21	Evaluator #22	Evaluator #23	Evaluator #24	Evaluator #25	Evaluator #26	Evaluator #27	
Ranking: 0 = Requires More Information (Clarification - Did not Answer Question) 1 = Poor, Insufficient Response and/or Capabilities OR Does Not Meet Requirements (Clarification) 2 = Fair 3 = Adequate/Meets Criteria 4 = Good 5 = Excellent/Exceeds Criteria																													
Compliance With RFP Compliance/Adherence to RFP & Contract Compliance Pass or Fail								2.94	2.94	2.94																			2.94
Proposal Evaluation Criteria (PEC) Compliance/Adherence to Minimum Requirements PEC Minimums Pass or Fail								3.00	3.00	3.00	3.00	3.00																	3.00
Price Proposal and Investment Options	Weight																												
Vendor Admin Fee	50%	5.00																											2.50
Cost Related to Investment Services	25%	3.00																											0.75
Investment Access Fee	25%	5.00																											1.13
Subtotal Price Proposal and Investment Options (Weighted Group)	100%																												4.38
Subtotal Price Proposal and Investment Options Final Weight	50%																												2.19
Operational Capabilities and Services	Weight																												
Legal Requirements	5%																												0.14
Health Savings Account Provisions, Eligibility and Program Requirements	5%																												0.15
Operational Specifications	55%																												1.67
Financial Considerations	35%	3.00																											1.05
Subtotal Interrogatories (Weighted Group)	100%																												3.02
Subtotal Interrogatories Final Weight	40%																												1.21
Subtotal to Determine Finalists																													3.39
Vendor Service Verification	Weight																												
Face-to-Face Interview	50%	4.00	4.00	4.00	4.00	3.00	4.00	4.00	4.00	4.00	4.00	3.00																	1.98
References (ERS Experience & Positive Reference Responses)	30%																												1.02
Site Visit	20%	5.00																											0.87
Subtotal References (Weighted Group)	100%																												3.87
Subtotal References Final Weight	10%																												0.39
Final Score	100%																												3.78

Exhibit B—Evaluator Vendor Scoring Sheet

Operational Specifications Interrogatories		
Source	Score	Comments
J.1. Provide the full legal name of the Organization	3	
J.1.a. If Vendor is a subsidiary or affiliate of another company, provide a full disclosure	3	
J.1.b. Provide a copy of the insurance declaration pages	3	
J.2. If Vendor propose to utilize subcontractors in the performance, delivery and provision	3	
J.3. Provide the name, title, mailing/email address(es), and telephone number(s) of	3	
J.3.a. In the event Vendor is selected as a Finalist, ERS may request a site visit to the	3	
J.4. Describe the Vendor's customer service unit in detail.	4	
J.4.a. Describe the Vendor's call center telecommunications system.	4	
J.4.b. Describe the Vendor's procedure for managing written inquiries.	4	
J.4.c. How does the Vendor's customer service system support Account Participants with	3	
J.4.d. Describe Vendor's procedures for handling customer service complaints and	3	
J.4.d.i. Provide a copy of Vendor's problem resolution policies and procedures.	3	Tab C only contained the
J.4.e. Provide a copy of Vendor's call center metrics for a program the size of the GBP.	3	Tab C only contained the
J.5. Describe all reports that Vendor can provide to ERS	3	
J.6. Please identify any other products or services that the Vendor provides	3	
Total	3.23	

Evaluator Scoring Process

1. Individual RFP item criteria assigned to evaluators (Exhibit B)
2. Evaluators score each item and an average score calculated (Exhibit B)
3. Average score updated in summary sheet by evaluator (Exhibit A)
4. Evaluator average scores averaged to determine score for performance category (Exhibit A)

Documentation Challenges

- Different performance factors and attributes consolidated into one single performance category
- Different performance factors and attributes summarized into one evaluator score
- No individual performance factor score
- Limited comments as to evaluators overall assessment of performance

APPENDIX A.1—CMG Sample Scoring Methodology

Exhibit A—Summary Scoring Sheet

Evaluation Results

Cost - Score Calculation Points awarded based on the least expensive awarded the maximum points and other offers prorated based on difference their offer price and low offer. (See breakout of cost in attached schedules.)

Acme Project Evaluation Matrix – EXAMPLE

RFO Evaluation Criteria [Section A, Item 20 of RFO]

	Weight	Max Points	Company A	Company B
Costs	30	30	22.5	25
Qualifications & Methodology (Indicators of Probable Vendor Performance)	30			
Experience [Section C, Parts 1 through 6 of RFO and Appendix A of Offer]	50.0%	15	12	10.5
Proposed Work plan and Approach [Section B, Items 8 through 20 of RFO and Appendix B of Offer]	25.0%	7.5	6	5.25
Personnel [Section C, Items 7 through 10 of RFO and Appendix C of Offer]	25.0%	7.5	5.25	5.63
		30	23.25	21.38
Technical Functionality	40			
Minimum Functions [Section B, Items 1 through 20 of RFO and Appendix D of Offer]	75.0%	30	21	24
Additional Functions [Section B, Items 21 through 40 of RFO and Appendix D of Offer]	25.0%	10	7	8
		40	28	32
Total	100%	100	74	78

Exhibit B—Performance Factor Scoring Sheet

	Max Points	30	Vendor Response/Evaluation	
			Company A	Company B
Experience	50.0%	15.0	Rating 8	7
Proposed Work Plan	25.0%	7.5	Score 12	10.5
			Rating 8	7
Personnel	25.0%	7.5	Score 8	5.25
			Rating 7	5.25
			Score 5.25	7.5
Total Points			23.25	21.38

Notes:

Rating From 1 to 10, 10 reflecting highest / best possible

Score Allocated points awarded based on rating (10 rating receives maximum score)

Evaluator Scoring Process

1. RFP item criteria for performance factor evaluation identified and communicated (Exhibit A)
2. Evaluators provide one overall score by each performance factor (Exhibit B)
3. Score updated in summary sheet by performance factor (Exhibit A)

Documentation Benefits

- Score for each performance factor documented and clearly identifiable
- Emphasis on performance factor score versus evaluator score
- Clarity regarding trade-off between price and performance
- Fewer data points (scores) decreasing likelihood of error

APPENDIX B—CMG Sample Administrative Review



Appendix 4 Administrative Review Checklist

[Solicitation No.]
[Solicitation Title]

[Respondent Name]

	<u>Yes</u>	<u>No</u>
1. Execution of Proposal – Signed	<input type="checkbox"/>	<input type="checkbox"/>
2. HUB Subcontracting Plan	<input type="checkbox"/>	<input type="checkbox"/>
3. Submitted original and required # of copies	<input type="checkbox"/>	<input type="checkbox"/>
4. Addenda Acknowledged	<input type="checkbox"/>	<input type="checkbox"/>
5. Mandatory Pre-Bid Conference Attendance (if applicable)	<input type="checkbox"/>	<input type="checkbox"/>
6. Proposal Content		
Company Information	<input type="checkbox"/>	<input type="checkbox"/>
Experience and Qualifications	<input type="checkbox"/>	<input type="checkbox"/>
Compensation and Fees	<input type="checkbox"/>	<input type="checkbox"/>
References	<input type="checkbox"/>	<input type="checkbox"/>
Licenses/Certificate	<input type="checkbox"/>	<input type="checkbox"/>

	<u>Yes</u>	<u>No</u>
SOLICITATION RESPONSIVE	<input type="checkbox"/>	<input type="checkbox"/>

Documentation Benefits

- A tool for ensuring the proposals are responsive
- Emphasis on meeting minimum requirements
- Yes/No checklist. No ratings



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April 26, 2016

Members of the ERS Board of Trustees
Mr. Porter Wilson, Executive Director
Mr. Tom Tull, Chief Investment Officer

Re: Quarterly Investment Agreed-upon Procedures

Internal Audit has completed quarterly procedures to test compliance with ERS' Investment Policy in accordance with the *Fiscal Year 2016 Annual Audit Plan*.

We have performed the procedures listed in the attached Appendix A, which were agreed to by ERS management, to assist in monitoring Investment Policy compliance for the quarter ended March 31, 2016. This agreed-upon procedures engagement was performed in accordance with generally accepted government auditing standards contained in the Government Auditing Standards issued by the Comptroller General of the United States. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not conduct an examination, the objective of which would be to determine whether internal controls are effectively designed and operating to comply with ERS' Investment Policy. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use by the Board of Trustees and ERS management, and is not intended to be and should not be used by anyone other than the specified party. This report is a matter of public record and its distribution is not limited.

Sincerely

A handwritten signature in black ink, appearing to read "Anthony Chavez", written in a cursive style.

Anthony Chavez, CIA, CGAP, CRMA
Director, Internal Audit Division

APPENDIX A – AGREED-UPON PROCEDURES AND RESULTS

Portfolio Compliance – Proper Investment risk maintained based on approved investment strategy and asset allocation		
Procedures Agreed-Upon	Finding Description	Management Response
Investment Custodian Bank <i>Diversification Reports</i> reviewed to ensure beneficial ownership in a single security is within Investment Policy diversification thresholds.	No exceptions were found as a result of applying this procedure.	Noted
Investment Custodian Bank <i>Fixed Income Quality Reports</i> reviewed to ensure fixed income and short-term securities credit ratings above Investment Policy limits.	No exceptions were found as a result of applying this procedure.	Noted
FactSet <i>Daily Tracking Error Reports</i> reviewed to ensure risk tolerance within established constraints per Investment Policy.	No exceptions were found as a result of applying this procedure.	Noted
Review the daily report provided by BNY Mellon to identify instances of investments in prohibited countries.	No exceptions were found as a result of applying this procedure.	Noted

APPENDIX A – AGREED-UPON PROCEDURES AND RESULTS

Personal Trading – <i>Employees may not have an interest in or financial gain from investments by ERS</i>		
Procedures Agreed-Upon	Finding Descriptions	Management Responses
At quarter-end, Covered Persons list pulled from personal trading system and compared to designated Covered Persons division listing for completeness.	No exceptions were found as a result of applying this procedure.	Noted
Covered Persons personal brokerage trading confirmations reconciled to compliance system executed personal trades for completeness.	No exceptions were found as a result of applying this procedure.	Noted
Reported compliance system executed trades reviewed to verify existence of pre-approval from designated party.	No exceptions were found as a result of applying this procedure.	Noted
Confirm all quarterly affirmations to be submitted by Covered Persons affirming understanding of Investment Policy personal transactions rules including submission of all required personal trading information.	No exceptions were found as a result of this procedure. One employee is out of the office for an extended length of time and was not able to complete the affirmation.	Noted

APPENDIX A – AGREED-UPON PROCEDURES AND RESULTS

Proxy Voting – Votes should be cast in accordance with ERS' economic best interest		
Procedures Agreed-Upon	Finding Description	Management Responses
Review Institutional Shareholder Services (ISS) system <i>Un-voted Report</i> for missing votes.	No exceptions were found as a result of applying this procedure.	Noted
Review Institutional Shareholder Services (ISS) system Voted Against Report for votes made against ERS proxy voting guidelines. Verify any votes against ERS guidelines are appropriately documented as to rationale.	Eight proxy votes against Investment Policy identified in March 2016 voting period. Votes related to the removal and replacement of four board members. Vote rationale documented in accordance with ERS guidelines.	Noted

APPENDIX A – AGREED-UPON PROCEDURES AND RESULTS

Securities Lending – Lendable securities base and individual securities are not under-collateralized or over-utilized per program policies		
Procedures Agreed-Upon	Finding Description	Management Responses
Review the monthly <i>Securities Lending and Performance Summary</i> to ensure the ERS utilization rate for Securities Lending is below 25% of the lendable base.	No exceptions were found as a result of applying this procedure.	Noted
Review the daily report provided by Deutsche Bank to identify instances of collateralization falling below 100% based on end-of-day market values.	Three (3) instances were identified during the quarter of collateralization falling below 100% based on end-of-day market values. One instance went unresolved for four (4) business days. All other instances were resolved within two business days.	The apparent under collateralization was the result of the different timing recognition of a corporate action.
Review the daily report provided by Deutsche Bank to identify instances where more than 95% of any single security is loaned out.	Seven (7) instances were identified during the quarter of identify instances where more than 95% of any single security is loaned out. One instance went unresolved for three (3) business days. All other instances were resolved within two business days.	There was a corporate action pending. In these instances the custodian “locks the shares” from trading and does not include them in the securities lending calculation. The 95% limit was met when these shares are included.
Review the daily report provided by Deutsche Bank to identify instances where the rebate rates for loans are above the Federal Funds Open rate.	One (1) instance was identified during the quarter where the rebate rate was above the Federal Funds Open Rate. This instance was resolved within one business day.	Noted
Review the daily report provided by Deutsche Bank to identify instances where counterparties are above the 10% diversification limit for Eurozone borrowers.	Seven (7) instances were identified during the quarter where the diversification limit for Eurozone counterparties was above 10%. One instance went unresolved for four (4) business days. Another instance went unresolved for twenty-four (24) business days. All other instances were resolved within three business days. See Appendix B for further details.	The securities lending program is temporarily being suspended. As we get down to immaterial residual loan balances outstanding, diversification limits may be breached. See Appendix B for further details.

Review the daily report provided by Deutsche Bank to identify instances where counterparties are above the 20% diversification limit for non-Eurozone borrowers	Six (6) instances were identified during the quarter where the diversification limit for non-Eurozone counterparties was above 20%. One instance went unresolved for ten (10) business days. Another instance went unresolved for thirty-two (32) business days. All other instances were resolved within two business days. See Appendix B for further details.	The securities lending program is temporarily being suspended. As we get down to immaterial residual loan balances outstanding, diversification limits may be breached. See Appendix B for further details.
Review the daily report provided by Deutsche Bank to identify instances where counterparties are collateralized below 101% U.S. or 104% non-U.S.	Three (3) instances were identified during the quarter where a counterparty was below the 104% non-U.S. collateralization limit. All instances were resolved within one business day.	Noted

APPENDIX B - SECURITIES LENDING PROGRAM

Securities Lending Program Suspension's Impact to Investment Compliance Monitoring

Beginning in January 2016, the credit default swap (CDS) spread, an indicator of solvency risk, began to rise sharply for ERS's securities lending counterparty, Deutsche Bank. The spread continued to increase dramatically into February 2016, which caused the Securities Lending program to be temporarily suspended. Investments Division does not believe that Deutsche Bank will face any solvency issues, but they determined that the returns the securities lending program generates were not worth the risks. The recall was done in steps, first causing the borrowed exposure to decrease from \$400 million to \$26 million in February, with the last borrowed security returning in April. Since the total number of borrowed securities decreased significantly, daily audit flags were triggered throughout February and March 2016 for the diversification limits in the Investment Compliance Program.

PUBLIC AGENDA ITEM - # 3

3. Adjournment of the ERS Board of Trustees Audit Committee and
Recess of the Board of Trustees

May 17, 2016

Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.

PUBLIC AGENDA ITEM - #4

4. Review and Approval of the Minutes to the February 23, 2016 Joint Meeting of the Board of Trustees and Investment Advisory Committee

May 17, 2016

BACKGROUND:

Attached under separate cover, are the minutes to the February 23, 2016 Joint Meeting of the Board of Trustees (Board) and Investment Advisory Committee (IAC). These minutes are submitted to the IAC and Board for review and, if no amendments, are recommended for approval.

PROPOSED MOTIONS:

The ERS staff recommends the following motion to the **Investment Advisory Committee:**

I move that the Investment Advisory Committee of the Employees Retirement System of Texas approve the minutes to its Joint Meeting with the Board of Trustees held on February 23, 2016.

Contingent upon adoption of the above motion by the IAC, staff recommends the following motion to the **Board of Trustees:**

I move that the Board of Trustees of the Employees Retirement System of Texas approve the minutes to its Joint Meeting with the Investment Advisory Committee held on February 23, 2016.

ATTACHMENT – 1

Exhibit A – Minutes of the February 23, 2016 Joint Meeting of the Board of Trustees and Investment Advisory Committee



JOINT MEETING OF THE
INVESTMENT ADVISORY COMMITTEE
AND
BOARD OF TRUSTEES



Presented for Review and Approval
May 17, 2016

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**JOINT MEETING OF THE
BOARD OF TRUSTEES AND
INVESTMENT ADVISORY COMMITTEE
EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**February 23, 2016
ERS Auditorium
200 E. 18th Street
Austin, Texas 78701**

COMMITTEE MEMBERS PRESENT

James Hille, Chair
Caroline Cooley, Vice-Chair
Robert Alley, Member
Monty Jones, Member
Ken Mindell, Member
Laura Starks, Member
Lenore Sullivan, Member

COMMITTEE MEMBERS ABSENT

Vernon Torgerson, Member

TRUSTEES PRESENT

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

TRUSTEES MEMBERS ABSENT

Frederick E. (Shad) Rowe, Jr., Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Tom Tull, Chief Investment Officer
Catherine Terrell, Deputy Executive Director
Sharmila Kassam, Deputy Chief Investment Officer
Paula Jones, General Counsel and Chief Compliance Officer
William Nail, Special Projects and Policy Advisor
Tony Chavez, Director of Internal Audit
DeeDee Sterns, Acting Director of Human Resource
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Machelle Pharr, Finance
Pablo de la Sierra Perez, Investments
Leah Erard, Governmental Affairs
Elizabeth Geise, Benefits Communications
Robin Hardaway, Customer Benefits
Neil Henze, Investments
Andrew Hodson, Investments
Lauren Honza, Investments
Scott Hodgson, Investments
June Kim, Investments
Robert Lee, Investments
Mark Long, Investments
Mike McCrary, Investment

Jonathan Puckett, Internal Audit
Tim Reynolds, Investments
Tanna Ridgway, Investments
Leighton Shantz, Investments
Ben Schumann, Investments
Robert Sessa, Investments
John Streun, Investments
Chris Tocci, Investments
Mary Jane Wardlow, Governmental Affairs
Karla West, Investments
Keith Yawn, Office of Management Support
Beth Gilbert, Internal Audit

ALSO PRESENT

Brad Young, Altius Associates
Jay Yoder, Altius Associates
Brian Sweeney, Altius Associates
Steve Voss, Aon Hewitt
Suzanna Sanchez, Invesco
David Doctor, AHM
Joel Brous, FTI
Reed Hutchens, FTI
Emily Morganti, Legislative Budget Board
Nora Veloseo, Legislative Budget Board
Joel Pardue, Aetna
Andrew Clark, Office of Speaker Joe Straus

Mr. Craig Hester, Chair of the Investment Advisory Committee for the Employees Retirement System of Texas (ERS), called the meeting to order and read the following statement:

“A public notice of the Joint Meeting of the Board of Trustees and Investment Advisory Committee containing all items on the proposed agenda was filed with the Office of the Secretary of State at 9:23 pm on Thursday, February 11, 2016 as required by Chapter 551, Texas Government Code, referred to as ‘The Open Meetings Law.’”

IV. REVIEW AND APPROVAL OF THE MINUTES TO THE DECEMBER 3, 2015 JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Ken Mindell, seconded by Ms. Caroline Cooley and carried unanimously by the members present that the Investment Advisory Committee approve the minutes of the December 3, 2015 Joint Meeting of the Board of Trustees and Investment Advisory Committee.

The Board of Trustees then took the following action:

MOTION made by Mr. Brian Ragland, seconded by Ms. Cydney Donnell, and carried unanimously by the members present that the Board of Trustees approve the minutes of the December 3, 2015 Joint Meeting of the Board of Trustees and Investment Advisory Committee.

V. REVIEW AND DISCUSSION OF PENSION EXPERIENCE STUDY AND ASSET ALLOCATION STUDY

Ms. Jennifer Jones, Retirement Policy analyst, and Ms. Sharmila Kassam, Deputy Chief Investment Officer presented the review and discussion of the pension experience study and asset allocation study.

This agenda item is presented as a result of the ERS Board of Trustees (Board) asking ERS staff to develop a plan to coordinate development and adoption of the two studies.

Ms. Jones began by explaining the retirement system follows best practices in plan administration for retirement and investment programs. This requires periodic review of the assumptions and experience for retirement, such as assumptions about when members will retire, or if they will withdraw their contributions. On the investment side, the plan makes market and economic assumptions as well as risk assessments. Certain economic assumptions, such as inflation rate and expected market returns are important to both investment and retirement programs. In December 2016, the agency will begin the pension experience and the asset allocation studies, both of which are scheduled for board approval in February 2018.

Ms. Jones explained the pension experience study is a periodic study required at least every five years by statute, of all valuation related assumptions and plan experience in the most recent years. The study will be led by ERS' consulting actuaries at Gabriel Roeder Smith (GRS). An experience study compares actual plan experience to expected plan experience. It will also compare the plan's assumptions to national trends. Any assumptions should reflect past experience and future expectations. In addition, an experience study provides an opportunity to review any current methodologies, such as the actuarial cost method and the asset smoothing method. The pension experience study approved by the board in February 2013 covered fiscal years 2007-2011. This study was completed and presented to the board in February 2012, and the related assumptions were adopted in February 2013 (to coincide with the asset allocation adoption).

It is staff's intent, beginning with the February 2018 adoption of the new experience study, that a new study be completed and new assumptions adopted every four years. Typically every 4-5 years has been the ERS practice. Because the long-term investment return assumption is a key component of the valuation process, ERS' actuaries prefer that the return assumption be reviewed in conjunction with the adoption of the asset allocation study.

Ms. Kassam next explained the asset allocation study is a study to determine the most appropriate asset allocation – or allocation of the ERS trust funds among various asset classes – based on the current investment policy, funding priorities and risk tolerance of the Board. The most important component of an investment strategy is the asset mix. This component sets long-term asset allocation targets or ranges that will prudently meet the needs of the plan beneficiaries. Formal asset allocation studies are conducted by the Board with the assistance of the Investment Advisory Committee (IAC) at least every five years as further detailed in the ERS Investment Policy. The current asset allocation was adopted February 26, 2013.

The process of reviewing the asset allocation will be conducted by the ERS plan consultant, Aon, and ERS staff in coordination with the pension experience study. The timeline is expected to begin at the end of calendar year 2016 to continue through calendar year 2017 and be adopted in February 2018.

There were no questions or further discussion, and no action was required on this item.

VI. REVIEW AND DISCUSSION OF THE INVESTMENT PERFORMANCE FOR FOURTH CALENDAR QUARTER OF 2015

Ms. Sharmila Kassam, Deputy Chief Investment Officer, and Mr. Steve Voss, consultants from Aon Hewitt presented the review and discussion of the investment performance for the fourth calendar quarter of 2015.

Mr. Voss began the presentation of the performance of the total Trust. The ERS Fund returned 1.6% and the benchmark return was 1%. The Fund began the year at \$25.6 billion. There were net benefit payments of \$1.1 billion, investment gains of about \$402 million, and the Trust ended the year at \$24.9 billion. Global equities added considerable value of 71 basis points. While the returns were negative on an absolute basis, staff along with external managers added value during the quarter.

Mr. Voss discussed the concept of tracking error and its introduction to the quarterly dashboard. Tracking error is the volatility or the standard deviation of the total fund return minus the benchmark. The tracking error is a little over 1% on a rolling 36-month basis. ERS' tracking error has evolved and behaved over time fairly consistent with a public pension fund of ERS' size. He explained that it is difficult to significantly increase the tracking error of a public pension fund.

The Trust fund performance continues to be compared against a static long term public benchmark that was introduced at the February 23, 2016 Joint Meeting of the Board of Trustees (Board) and the Investment Advisory Committee (IAC).

Mr. Voss presented the performance of the asset classes for the quarter, and then concluded his presentation with a look at how ERS is performing compared to the global market. Given the volatility of the marketplace, the total Fund's return of 60 basis points of excess return relative to the benchmark was a good performance. During the 2008 financial crisis and also in other market downturns, ERS internal staff has been able to strategically create alpha. Additionally, ERS is close to the Board-adopted asset allocation targets and has continued to create diversification within asset class portfolios.

There were no questions or further discussion, and no action was required on this item.

VII. REVIEW AND DISCUSSION OF THE GLOBAL PUBLIC EQUITY PROGRAM:

a. Market Update and Program Overview - Mr. John Streun, Director of Global Public Equity, Mr. Chris Tocci, Deputy Director of Global Public Equity, Mr. Andrew Hodson, Supervision Portfolio Manager, Mr. Tim Reynolds, Supervision Portfolio Manager, and Mr. Neil Henze, Chief Equity Trader presented the review and discussion of the Global Public Equity program.

Mr. Streun introduced all the speakers and then discussed the overview of the Global Public Equity program. As stated in the Global Public Equity Policy and Procedures in the ERS *Investment Policy*, the investment objective for this asset class is to outperform the Global Public Equity benchmark over rolling five-year periods, while maintaining compliance with the Active Risk Budget. The investment strategy is to combine lower risk internal portfolio strategies and higher risk external portfolio strategies to produce a stable excess return with a target tracking error of 150 basis points (bps) and an excess return ratio of 0.25 or better.

The Global Public Equity asset class outperformed the policy benchmark by 131 bps in calendar year 2015. Returns on a five-year basis were also positive as the Global Public Equity asset class outperformed the policy benchmark by 54 bps per year.

The equities group consists of 24 analysts/portfolio managers and an in-house trading team. The Global Public Equity leadership team is Mr. John Streun, Mr. Chris Tocci, Mr. Andrew Hodson, and Mr. Tim Reynolds. There were some notable staff role changes in 2015. Mr. Keith Lyons was promoted to

portfolio manager of the Asia portfolio. In addition, Mr. Kelley Hewell joined Mr. Darrell Jackson as the co-portfolio manager of the large cap active portfolio. Finally, the team added four new analysts over the last year to provide fundamental research in the consumer, technology and energy sectors.

In addition to the analysts and portfolio managers on the Global Public Equity team, the asset class also receives assistance from Ms. Sharmila Kassam, Deputy Chief Investment Officer, Ms. Lauren Honza, External Advisor Portfolio Manager, and Mr. Michael McCrary, External Advisor Investment Analyst, on selection and oversight of external managers.

Mr. Hodson began the presentation about the internal investment process. The Global Public Equity division is responsible for managing \$12 billion in assets. Internal public equities manage 71% of these assets at a cost of less than 10 bps. The active portion of these assets is primarily managed within six portfolios: domestic large cap, mid cap and small cap and internationally in the Asia, Europe and Emerging Markets portfolios.

Mr. Hodson explained the “bottom-up” stock picking process. Analysts research, select and then recommend stocks with the best risk/reward under their coverage that they believe will outperform their respective benchmark. Then position size is discussed based on the relative risk/reward characteristics and the level of analyst conviction.

ERS analysts’ also focus on “active share” within the portfolios. Active share is a measure of how a portfolio differs from its benchmark. A portfolio that is identical to the benchmark would have 0% active share, while a portfolio with no holdings in common with the benchmark would have 100% active share. Depending on the portfolio, staff strives for 40% to 60% active share with internally managed portfolios and a much higher active share with externally managed portfolio.

Over the past three years staff has placed an increased emphasis on communication amongst the entire Global Public Equity division, increased regularly scheduled meetings and have encouraged all members of the team to increase the level of communication.

Mr. Tocci discussed the Global Public Equity portfolio structure and positioning. The \$12.0 billion Global Public Equity composite as of December 31, 2015, consisted of eight domestic portfolios, two domestic fund-of-funds’ portfolios, nine international portfolios, and a global equity tactical portfolio that serves to manage overall program exposures on a region, country, sector, and style basis. During calendar year 2015, one portfolio was added to the program and two portfolios were defunded in the international portion of program to increase the active risk of the program and improve risk adjusted returns.

The Global Equity composite is currently in line with the 52%/48% split between domestic and international as represented by the MSCI ACWI IMI benchmark. The market value of the domestic equity program was \$6.1 billion at the end of calendar 2015. Internally managed portfolios account for 87% of the domestic equity assets. The market value of the international equity program was \$5.9 billion at the end of the calendar year 2015.

Mr. Tocci indicated that staff continues to monitor each portfolio’s sector exposures and regional exposures. The portfolios have slightly decreased its largest sector underweight in utilities and slightly increased underweights in financials and staples. Offsetting these underweights, there are overweight positions in healthcare, information technology, industrials, consumer discretionary, and telecommunications.

Regarding the regional exposures, the global equity composite had an increase in the overweight to the UK and a significant decrease to the overweight in the United States. In addition, the composite is now underweight emerging markets and remains underweight Asia and Japan.

Mr. Streun began his presentation about the developed markets global equity economic outlook. Unfortunately, the slow growth and low return environment is likely to persist and the US is continuing to be a low return market. Europe is the preferred region in the developed markets as it has lagged other

markets and is more attractive on a valuation basis and a profit margin improvement basis. Japan has also seen outperformance, especially in the last three years, which has benefited from monetary stimulus. Additionally, improved corporate governance and consideration of shareholders has encouraged investors in Japan.

Mr. Streun touched on the growth outlook of the emerging markets compared to developed markets. Emerging markets represent over 30% of global GDP and have recently accounted for a higher percentage of global growth, even though growth is historically slower in 60% of emerging market countries. Finally, Mr. Streun discussed risks to consider in the global equity space. There are still concerns about the Chinese market due to recession and deflation fears. The upcoming US presidential election may cause volatility in the market as election years have historically reported flat returns. Possible interest hikes imposed by the Federal Reserve continue to be a concern in the market.

Mr. Reynolds began his presentation about the outlook of emerging markets for 2016. Emerging markets appeal to investors because they make up 80% of the population and 30% of global market capitalization and global gross domestic product (GDP). However, emerging markets fund flows have been consistently and meaningfully negative during 2015. He discussed issues that heavily impact emerging markets, such as declines in currencies, oil prices and commodities. Emerging markets are also concerned about an interest rate hike imposed by the Federal Reserve. China is also impacting its GDP as it changes from a producing economy to one that is run by consumption and services. Consumption and service in China are not traditionally tracked, but are noticeably on the rise.

Next Mr. Reynolds explained the Best Ideas Program portfolios. The Best Ideas Program currently has two portfolios. The Spinoff portfolio was launched May 1, 2014 and currently stands at \$300 million while the Capitol Hill portfolio started on September 1, 2014 and currently has \$200 million. Both portfolios outperformed their benchmark by over 100 bps. A previous Best Ideas portfolio, the Focused Value portfolio was closed in 2015.

Regarding the Spinoff portfolio, 2015 was a record year with over 50 corporate spinoffs. This approach can lead to greater short-term volatility as portfolio companies establish a track record with investors, but can also lead to higher long-term returns as management executes their strategy and improves earning power. Since fund inception, seven portfolio companies that were acquired were mergers and acquisitions, usually at significant premiums. The Spinoff portfolio has an extremely high active share of 98% versus the S&P Mid Cap benchmark. The Capitol Hill fund added to its very strong performance versus the S&P 500 since inception (outperforming by 400 bps). The Capitol Hill portfolio also has a very high active share of 83% versus the S&P 500. The Best Ideas Program has been a successful program for global public equity. To continue the program, numerous strategies are being discussed and the committee has heard, but passed on two formal presentations for additional Best Idea strategies in 2015.

Mr. Henze explained the trading update for the global public equity program. For calendar year 2015 total trade commissions were 1% less than 2014. ERS continues to be fiscally responsible by utilizing in-house trading. The average "all-in" blended commission rate paid by US institutions to brokers on domestic shares was 3.0 cents-per-share; however, ERS has a competitive average commission of 2.0 cents-per-share. ERS emerging managers paid 2.7 cents-per-share average commission. Mr. Henze concluded that the total internal portfolios account for 72% of total commissions, while the externally managed portfolios account for 28% of total commissions.

Mr. Streun concluded the Global Public Equity program presentation by discussing goals and objectives for 2016. Staff will continue to strive to outperform the relative benchmark, while maintaining compliance with the ERS *Investment Policy*. Staff plans to continue to build out the options overlay program. The external advisor team will begin a search for an international small cap manager to complement internal staff. In addition, staff will also explore new portfolios and ideas for the Best Ideas Program. To maintain staff satisfaction and ambition, leadership plans to enhance the career path for internal staff by developing sector portfolio manager positions.

There were no questions or further discussion, and no action was required on this item.

b. Review and Discussion of Global Public Equity Advisor Program – Ms. Sharmila Kassam, Deputy Chief Investment Officer, Ms. Lauren Honza, Portfolio Manager, and Mr. Michael McCrary, Investment Analyst presented the review and discussion of the Global Public Equity External Advisor Program.

Ms. Kassam began the presentation by explaining the External Advisor Program. The investment process for the Global Public Equity External Advisor Program is managed by this team in coordination with the Global Public Equity Team. Because ERS has a mission to achieve competitive returns at a reasonable cost, they utilize external advisors that complement internal management efforts and provide diversification benefits for risk reduction and increased returns. As of the end of 2015, 75% of the asset class was internally managed and 25% was externally advised.

Mr. McCrary discussed the investment approach used by the External Advisor Team. The multifaceted approach is comprised of five phases: (1) *Research*, (2) *Select*, (3) *Implement*, (4) *Monitor* and (5) *Rebalance*. During the *Research* phase, the External Advisor Team and strategic partners conduct research about strategies and sourcing that may complement internal portfolios. The *Select* Phase is the process of conducting the procurement process with a formal RFP, due diligence completed on managers to make recommendations to the Internal Investment Committee (IIC), then the firm is placed into the Select Pool where it is funded or continued to be monitored for future funding. The IIC includes the Executive Director, the Chief Investment Officer (CIO), and at least one IAC member. By focusing manager selection at the staff level, the ERS Investment Program provides a better alignment of the Board and IAC roles relative to staff.

The Select Pool was first introduced at the November 19, 2009 Joint Meeting of the Board and IAC, and formalized in the ERS *Investment Policy* at the February 26, 2013 Joint Meeting and has since been presented and reviewed annually by the Board and IAC with routine interim reporting.

During the *Implement* phase staff constructs a portfolio consisting of both external and internal strategies and recommends funding decisions. The *Monitoring* phase refers to the monitoring of the Select Pool, both operational and investment performance. This monitoring phase of the select Pool firms includes refreshing when firms no longer meet ERS' needs. Finally, the *Rebalance* phase reviews the internal/external mix and staff adjusts and rebalances the mix based on need.

Ms. Honza provided detailed investment performance and data for the five funded external advisors of the Select Pool. The currently funded external advisors are Barrow, Hanley, Mewhinney & Strauss, BlackRock, Fisher Investments, Lazard Asset Management, and Templeton. All external advisors have outperformed their benchmark during calendar year 2015, except Lazard Asset Management. However, Lazard has outperformed the annualized benchmark since inception.

Ms. Kassam concluded the presentation by discussing initiatives for the External Advisor Program. In April of 2015, Mr. Michael McCrary, Investment Analyst, joined the team to assist with all aspects of the Investment Process. In calendar year 2016, staff will continue to develop expertise in manager selection and due diligence and will focus on seeking out industry best practices. Staff continues to utilize Backstop, a customer relationship management (CRM) system, to more efficiently manage the monitoring of external relationships. Ms. Kassam detailed the three main initiatives for next year. First, staff is going to review and refresh allocation of funded and unfunded managers of the Select Pool. Additionally, the performance fees and fee structures of external advisors will be considered and reviewed. Second, staff will continue research on customized investment strategies. Third, this quarter the External Advisor team is also focused on a pending search for long only international small cap strategies with a RFP in development.

There were no questions or further discussion, and no action was required on this item.

c. Proposed Revisions to the ERS Investment Policy - Ms. Sharmila Kassam, Deputy Chief Investment Officer, and John Streun, the Director of Public Equity presented the proposed revisions to the ERS investment Policy. The Employees Retirement System of Texas (ERS) *Investment Policy* is determined by the Board of Trustees (Board). In accordance with Section 2.3 of the ERS *Investment Policy*, staff will recommend changes as needed to the Investment Advisory Committee (IAC) and Board.

The External Advisor Program has expanded and as a result, the proposed revisions further clarify the process that has evolved in the body of the ERS *Investment Policy* and add more details about the process to the Global Public Equity Policies and Procedures.

The first proposed revision is to the main body of the ERS *Investment Policy*, Section 4.5B: Select Pool. The paragraph was edited to clarify that ERS investment staff makes recommendations, but they are not on the Internal Investment Committee (IIC) which is limited to only the Executive Director and Chief Investment Officer from internal staff. The IIC also includes at least one IAC member. The third revision was also proposed to clarify the IIC, but in Addendum XI: Global Public Equity Policies and Procedures, III.C. Global Public Equity Internal Investment Committee.

The second revision is to Addendum XI: Global Public Equity Policies and Procedures, Section 1.B. Asset Allocation of the ERS *Investment Policy*. The allocation limits were adjusted to be consistent with changes in asset class benchmark and new searches will increase the external advisors exposure primarily on the international side.

The final revision is the creation of Addendum XI: Global Public Equity Policies and Procedures, Section III.F Procedures for Investments. This section described the multi-faceted Investment Process used in the Select pool for External Advisors.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Bob Alley, seconded by Ms. Caroline Cooley and carried unanimously by the members present that the Investment Advisory Committee approve the proposed revisions to the ERS Investment Policy as presented in this agenda item.

The Board of Trustees then took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser, and carried unanimously by the members present that the Board of Trustees approve the proposed revisions to the ERS Investment Policy as presented in this agenda item.

VIII. ANNUAL REVIEW AND DISCUSSION OF PROXY VOTING AND CORPORATE GOVERNANCE

Mr. Scott Hodgson and Ms. Tejal Patel from Institutional Shareholder Services (ISS) presented the annual review and discussion of proxy voting and corporate governance.

As stated in Section 4.18 of ERS' *Investment Policy*, the right to vote proxies for securities held by ERS has economic value, and the fiduciary act of managing ERS' securities includes the management of the voting rights appurtenant to those securities. ERS Investment staff maintains and annually reviews the ERS Proxy Voting guidelines effective February 22, 2011, which are detailed instructions based upon the ERS Proxy Voting Policy.

In voting proxies, ERS only considers factors related to the economic value of ERS' investment and cast votes in accordance with ERS' economic best interest. ERS uses the services of ISS to process proxy votes. The ISS system allows is an automatic rules based program, but ERS retains the ability to override the vote. Votes are referred to staff if the ERS' guidelines do not address the topic of the proposal. During 2015, 2.6% of all proposals were referred to ERS for internal case-by-case analysis.

Mr. Hodgson explained that ERS' voting policy and guidelines are organized by the following subgroups: Board of Directors, Shareholder Rights and Defenses, Capital/Restructuring, and Compensation.

Mr. Hodgson detailed the ERS voting results and trends regarding proxy voting. In 2015, ERS voted in 22,728 proposals out of 22,962 votable proposals and ERS voted in 2,002 meetings worldwide in 2015. Overall, ERS voted with management 90% of the time, which was in line with 2014.

Say-on-Pay was implemented in 2011 as part of Dodd Frank, which gives shareholders the right to vote on management's pay. While the vote is non-binding, it can still influence management compensation packages. Management Say-on-Pay, ("MSoP"), proposals decreased 12.4% versus 2014, driven by the fact that many companies adopted triennial MSoP voting frequency in 2011. ERS focused on compensation plans that pay for performance with independent compensation committees that provided disclosure of the structure of compensation plans. Mr. Hodgson also discussed compensation and how the votes change depending on the market. The energy industry saw a rise from 6.2% to 8.8% on weak shareholder support. Shareholders look at compensation more when an industry's is on the decline.

Activism continues to be successful in proxy voting. Activism investing is where an investor or a group of investors band together to try to effect a change within the company. Recently activist success rates have been 70% and has led to greater Board engagement.

The "Social/Environmental Issues" category held steady with 67% of votes with management versus 69% in 2014. In recent years, we've seen an increased percentage of shareholder proposals calling for disclosure of political contributions and lobbying payments and policies, which ERS supports. These proposals represent about one third of all "Social/Environmental Issues" proposals ERS voted on. Regarding social and environmental issues, about 20% of this category includes political contributions and, lobbying activities, which ERS tends to vote for more disclosure and often results in ERS voting. Regarding shareholder proposals, ERS voted with management 48% of the time.

Environmental and Social Governance ("ESG") is primarily comprised of the following areas: board diversity, climate change, human rights, lobbying activity, and sustainability reporting. Sustainability (climate change/greenhouse gas emissions) saw the greatest number of proposals at 72, driven by the carbon bubble campaign. A record 474 proposals were filed during the 2015 proxy season versus the previous high of 460 in 2014.

Board nominee support continued to rise this year to 96.3%, largely driven by strong equity markets and greater investor engagement.

Mr. Hodgson concluded his portion of the presentation by discussing governance-related shareholder resolutions. These issues include board declassification, independent chairs, majority voting and director election and proxy access. A moratorium was enacted by the US Securities and Exchange Commission ("SEC") on Rule 14a-8(i)(9) which had disallowed shareholder proposals on a proxy ballot if the proposal conflicted with a board proposal. Due to widespread adoption by S&P 500 companies, board declassification and majority voting proposals have continued to decline.

Ms. Patel discussed topics and trends in proxy voting for 2016. There will continue to be a large number of proxy votes in 2016. The focus in the next years is going to be pay for performance or votes on compensation. Investors may decrease outsized pay packages in relation to the overall performance of the company if it is a negative performance. Participation and responses to votes will be monitored. Council on Institutional Investors (CII) recently published a Recidivist List of companies that have failed to respond or have low MSOP votes, majority shareholder-approved proposals, and/or any majority withholds on directors. So the focus is whether companies are engaging with shareholders on the lowest-filed votes in certain topics. Environmental and Social Governance issues continue to be a focus, given the election year.

There were no questions or further discussion, and no action was required on this item.

IX. REVIEW, DISCUSSION AND CONSIDERATION OF THE PRIVATE INFRASTRUCTURE PROGRAM:

a. Market Update and Program Overview – Mr. Pablo de la Sierra Perez, Assistant Director of Private Real Assets, and consultants from Altius Associates, Mr. Jay Yoder, Head of Real Assets and Mr. Bryan Sweeney, Principal Real Assets, presented the review, discussion and consideration of the Private Infrastructure program.

The Private Infrastructure portfolio is comprised of privately held infrastructure and other real assets with similar characteristics. As approved at the May 19, 2015 Joint Meeting, public infrastructure no longer had a separate allocation within the Trust, and publicly traded/listed infrastructure securities are managed within the Global Equities team as part of the overall ERS' Public Equities portfolio. During the May 2015 Joint Meeting of the Board and IAC, the Board approved ERS' fiscal year 2016 private infrastructure commitment target of \$300 million with a commitment range of +/- 25% (\$225 million – \$375 million). Staff will continue to provide a review of ERS' Private Infrastructure program at least annually.

Mr. De la Sierra Perez described the infrastructure portfolio. Since inception through December 31, 2015, ERS has closed on three private infrastructure funds and six co-investments with commitments totaling \$528 million. As of December 31, 2015, the private infrastructure portfolio net asset value ("NAV") is \$295.9 million, or about 1.2% of the Trust's assets.

ERS' private infrastructure investments have performed as expected and have produced a Total Value to Paid In Capital ("TVPI") of 1.16x, Distributed to Paid in Capital ("DPI") of 0.06x, and an Internal Rate of Return ("IRR") of 7.18% since inception¹; however, at this early stage of the program, this metric may not be meaningful. The Infrastructure team is expecting two or three new commitments in Fiscal Year 2016.

He discussed fundraising in the private infrastructure market. The first fundraising wave for private equity was around 2006 and the funds are coming to the end of their terms in the next five years. In the ten-year period from 2005 to 2015, infrastructure fundraising activity has tripled to around \$44 billion in 2015. The average fund size has also increased and some of the most successful managers have been able to significantly increase the size of their new funds. Staff does not foresee a decrease in fundraising in infrastructure.

Energy, such as power generation, power transmission, utilities, etc, continues to be the largest component in infrastructure. Other areas in the infrastructure space include telecommunication and transportation. ERS infrastructure staff finds that the infrastructure sector continues to be highly competitive and more significantly in core assets, or assets that present a perceived lower risk profile. Also, scale and size provide a competitive advantage to larger investment managers, who are able to enter into larger deals and more efficiently and actively manage added layers of risk. Consequently, ERS continues to explore ways to pool capital with similarly minded investors to increase the universe of suitable and appropriate co-investments and direct investments through limited liability company ("LLC") or limited partner ("LP") vehicles that ERS can prudently manage.

Mr. de la Sierra Perez concluded his portion of the presentation by discussing goal and objectives for 2017. Staff would like to continue to establish key relationships in the sector. Additionally, the team will continue to seek direct investments or co-investments and to look for strategic ways to pool capital with other investors.

Mr. Yoder and Mr. Sweeney begin their portion of the presentation. They discussed the infrastructure portfolio's investments and geographical diversification. Mr. Yoder explained that various additional commitments will create a more diversified portfolio.

¹ TVPI = (NAV + Distributions) / Paid in Capital
DPI = Distribution / Paid in Capital

The consultants discussed the outlook and performance of the private infrastructure market. They showed that the market has made relatively positive returns and that the need for capital in the infrastructure market will continue for the next couple decades. Ms. Cydney Donnell asked about exit strategy in infrastructure. Mr. Yoder said that assets could be sold to larger consolidators of assets or sell attractive producing assets, like a greenfield. However, exits are not always like private equity and may lend to a longer holding period.

They concluded their presentation by explaining some challenges in the infrastructure market and suggestions for the ERS Infrastructure program. The consultants recommended an increase in diversification by adding core and value-added exposures in global markets. However, due to geopolitical risk, Altius promotes caution if investing in emerging markets.

There were no questions or further discussion, and no action was required on this item.

b. Proposed Private Infrastructure Annual Tactical Plan for Fiscal year 2017- Mr. Pablo de la Sierra Perez, Assistant Director of Private Real Assets, and consultants from Altius Associates, Mr. Jay Yoder, Head of Real Assets and Mr. Bryan Sweeney, Principal Real Assets presented the proposed Private Infrastructure Annual Tactical Plan for Fiscal Year 2017.

Staff, along with consultants Altius Associates, is charged with preparing and presenting to the Board for its review and approval an Annual Tactical Plan ("Plan"). The Plan reviews the current status of the private infrastructure portfolio, recent historical and prospective market conditions and proposes steps to be taken over the following 12-18 months to continue implementing the private infrastructure program.

Mr. De la Sierra Perez explained that staff recommends that the Fiscal Year 2017 Private Infrastructure Annual Tactical Plan target a commitment of \$250 million with a range of +/- 25% (\$187.5-312.5 million) for Fiscal Year 2016. For the full Fiscal Year 2017, ERS will target commitments totaling \$300 million with a range of +/- 25% (\$225-325 million).

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Ken Mindell, seconded by Ms. Lenore Sullivan and carried unanimously by the members present that the Investment Advisory Committee approve the proposed ERS Private Infrastructure Portfolio Annual Tactical Plan for Fiscal year 2017, as presented in Exhibit A.

The Board of Trustees then took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Ms. Cydney Donnell, and carried unanimously by the members present that the Board of Trustees approve the proposed ERS Private Infrastructure Portfolio Annual Tactical Plan for Fiscal year 2017, as presented in Exhibit A.

X. REVIEW, DISCUSSION AND CONSIDERATION OF INVESTMENT POLICY CHANGES

Mr. Tom Tull, Chief Investment Officer, presented the review, discussion and consideration of investment policy changes. In accordance with Section 2.3 of the ERS *Investment Policy*, staff will present recommended changes to the ERS *Investment Policy* as needed to the Investment Advisory Committee (IAC) and Board of Trustees (Board). The proposed changes were first addressed at the December 3, 2015 Joint Meeting of the Board and IAC and are now being resubmitted to the Board and IAC for consideration after incorporating input from the discussion at that meeting.

The two proposed revisions are regarding clarifications to ERS' co-investment programs in Private Equity and in Real Estate. The proposed changes target opportunities outside existing ERS general partners (GPs) ERS will vet new relationships with GPs with the same due diligence expected of all private equity and real estate investments and meet the requirements of their Policies and Procedures as outlined in the ERS *Investment Policy*. These changes also formalize staff due diligence standards for new GPs. The proposed revisions make certain other changes to the co-investment programs based on staff recommendations.

The Investment Advisory Committee then took the following action:

MOTION made by Mr. Bob Alley, seconded by Ms. Carolyn Cooley and carried unanimously by the members present that the Investment Advisory Committee approve proposed revisions to the ERS investment policy as presented in the agenda item.

The Board of Trustees then took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser, and carried unanimously by the members present that the Board of Trustees approve proposed revisions to the ERS investment policy as presented in the agenda item.

XI. ADJOURNMENT OF THE JOINT MEETING OF THE BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES

The February 23, 2016 Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee adjourned at 12:55 pm CT.

PUBLIC AGENDA ITEM - #5*

5. Review and Discussion of the Investment Performance for the First Calendar Quarter

May 17, 2016

BACKGROUND:

In accordance with the contract for performance evaluation services and Section 3 of the Employees Retirement System (ERS) *Investment Policy*, Aon Hewitt (Aon) reviews and evaluates, on a quarterly basis, the Employees Retirement System of Texas (ERS) investment performance as calculated by ERS custodian BNY Mellon.

Summary of Investment Markets:

Regional equity returns were notably varied over the quarter, with North American equities performing strongly relative to other developed regions.

The quarter saw a loosening of monetary policy from central banks in Europe and Japan, and a more dovish tone from the US Federal Reserve. The MSCI All Country World IMI returned 0.4%. US equities (S&P 1500) returned 1.6% over the quarter. Canada (11.3%), Emerging Markets (5.7%) and Australia were the strongest performers as commodity prices began to stabilize and the currencies of commodity exporting nations strengthened versus the dollar. Japan was the weakest performing region despite significant yen strength, with the UK and Europe also returning negatively in dollar terms. 12 month global equity returns (MSCI AC World IMI) was -4.2%. US equities (S&P 1500) returned 1.2% over the 12 months ending March 31, 2016.

Core inflation picks up in the US, but manufacturing remains weak

Economic data indicated that the US manufacturing sector was still struggling, although the outlook improved marginally compared to the previous quarter. The ISM Purchasing Managers' Manufacturing Index reached its lowest reading since 2009 in the fourth quarter of 2015, but saw an upturn in the first two months of 2016. The index remains below the crucial level of 50, above which indicates the sector is growing. The improvement in the sector is correlated with a slight weakening in the US dollar, whose strength had been impacting U.S. manufacturers' competitiveness. Despite recent upward revisions, US GDP growth has been slowing for six months. The U.S. labor market remained strong, with the unemployment rate remaining low at 5.0%, despite more people looking for jobs.

The Federal Reserve strikes a notably more dovish tone

In March, the Fed maintained the target rate for the Federal Funds rate at 0.25-0.5%, in line with market expectations. The Fed lowered expectations of how many rate rises to expect in 2016, from 4 to 2. Previously, the Fed was much more hawkish than the market with regards to interest rate rises, and they remain somewhat so, although the more dovish nature of their recent comments has brought them more in line with the market expectations.

Threats remain to the Eurozone recovery, but the European Central Bank continues to support accommodative policy

The Eurozone economy remains weak, but cyclical recovery is expected to continue. Eurozone GDP growth was estimated to be 0.3% for the fourth quarter, and 1.6% for the year. Germany and Spain have been driving Eurozone growth, with recent improvements in France. The jobless rate has been declining, and recently reached its lowest level in three years. Industrial production surprised positively in February, after a disappointing January. The European Central Bank loosened monetary policy over the quarter, cutting rates and increasing the quantitative easing program from EUR 60bn to EUR 80bn per month. European economic sentiment and consumer confidence indicators have moved lower recently. Furthermore, there is the threat of the UK referendum to leave the EU.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

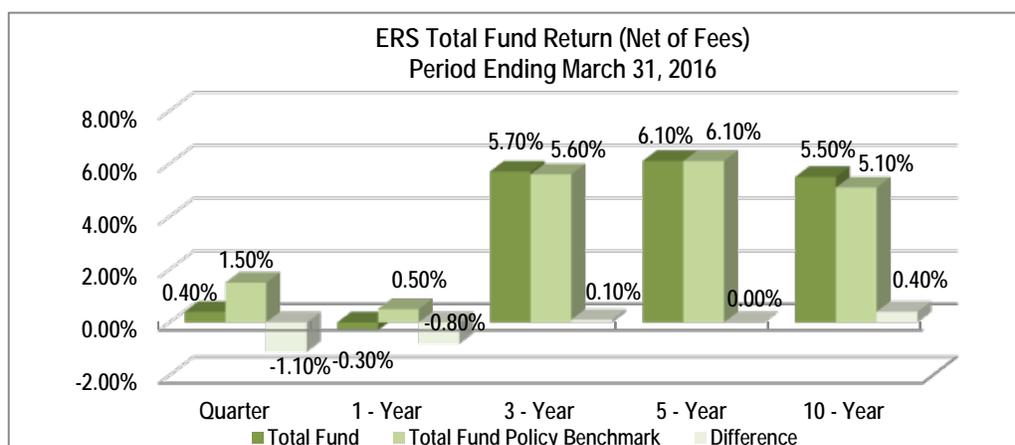
Emerging market headwinds are starting to fade

Economic growth continued to stabilize across emerging markets, although Chinese manufacturing remains weak. Both the official and the Caixin manufacturing PMIs for February disappointed expectations, indicating the contraction in manufacturing was greater than anticipated. Chinese policy has turned more stimulatory which is supportive of growth, but the RMB devaluation highlights policy risks. The broad commodity index (S&P GSCI Commodity Index) is down 2.5% since the start of the year, as Energy (S&P GSCI Energy) has been a drag on performance (-6.2%), but we have seen Industrial Metals (S&P GSCI Industrial Metals) return 1.9% over Q1 2016. Stabilizing commodity prices, and the marginally more positive stance from Chinese policy makers has relieved some of the pressure on Emerging market assets and currencies.

Yields fall to near historic lows

10 year US treasury yields fell over the first quarter by 49bps to 1.78%, close to historic lows and at levels not seen since 2012. The falls were driven by fears of a global growth slowdown and dovish tones from the Federal Reserve were increasingly priced in over the quarter. The Barclays US Treasury 30 year returned 8.9%, meanwhile the Barclays Intermediate Treasury Index returned 2.3%. In the corporate sector, high yield marginally underperformed credit, returning 3.4% (Barclays High Yield Index), versus 3.9% for investment grade credit (Barclays Credit Index).

Summary of ERS Performance:

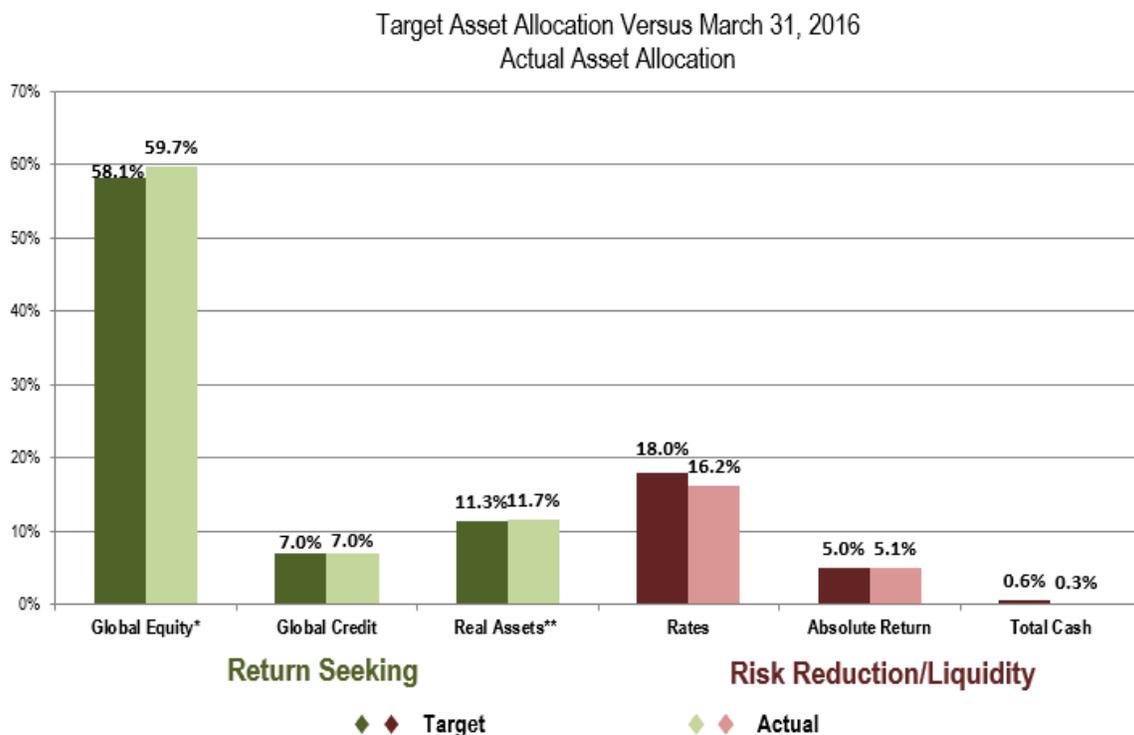


Below is a summary of ERS investment performance, net of fees, by asset class relative to policy benchmarks for the periods ending March 31, 2016:

ERS Return Summary (Net of Fees) Ending March 31, 2016							
		First Quarter	FY-To-Date	1-Year	3-Year	5-Year	10-Year
Return Seeking	Domestic Equity	-0.16%	1.92%	-1.42%	10.70%	10.70%	6.55%
	<i>Domestic Equity Benchmark</i>	1.57%	5.48%	1.18%	11.59%	11.37%	7.07%
	International Equity	-1.63%	-2.72%	-8.75%	0.88%	0.98%	2.16%
	<i>International Equity Benchmark</i>	-0.38%	-1.91%	-9.19%	0.32%	0.31%	1.47%
	Private Equity	1.29%	1.64%	10.71%	13.59%	11.58%	--
	Global Credit	1.66%	-2.03%	-3.09%	--	--	--
	<i>Global Credit Benchmark</i>	3.35%	-1.37%	-3.66%	--	--	--
	Real Assets	2.97%	6.89%	9.81%	9.96%	--	--

ERS Risk Summary (Net of Fees) Ending March 31, 2016							
		First Quarter	FY-To-Date	1-Year	3-Year	5-Year	10-Year
Risk Reduction	Rates	2.28%	2.28%	2.26%	1.77%	--	--
	Rates Benchmark	2.35%	2.24%	2.25%	1.53%	--	--
	Hedge Funds	-1.07%	-1.63%	-0.44%	4.19%	--	--

ERS continues to work toward its strategic and long-term allocation targets as reflected in the following chart.



*Includes Domestic and International Equity, along with Global Equity Tactical, Directional Growth Portfolio, Global Public Special Situations, and Private Equity.

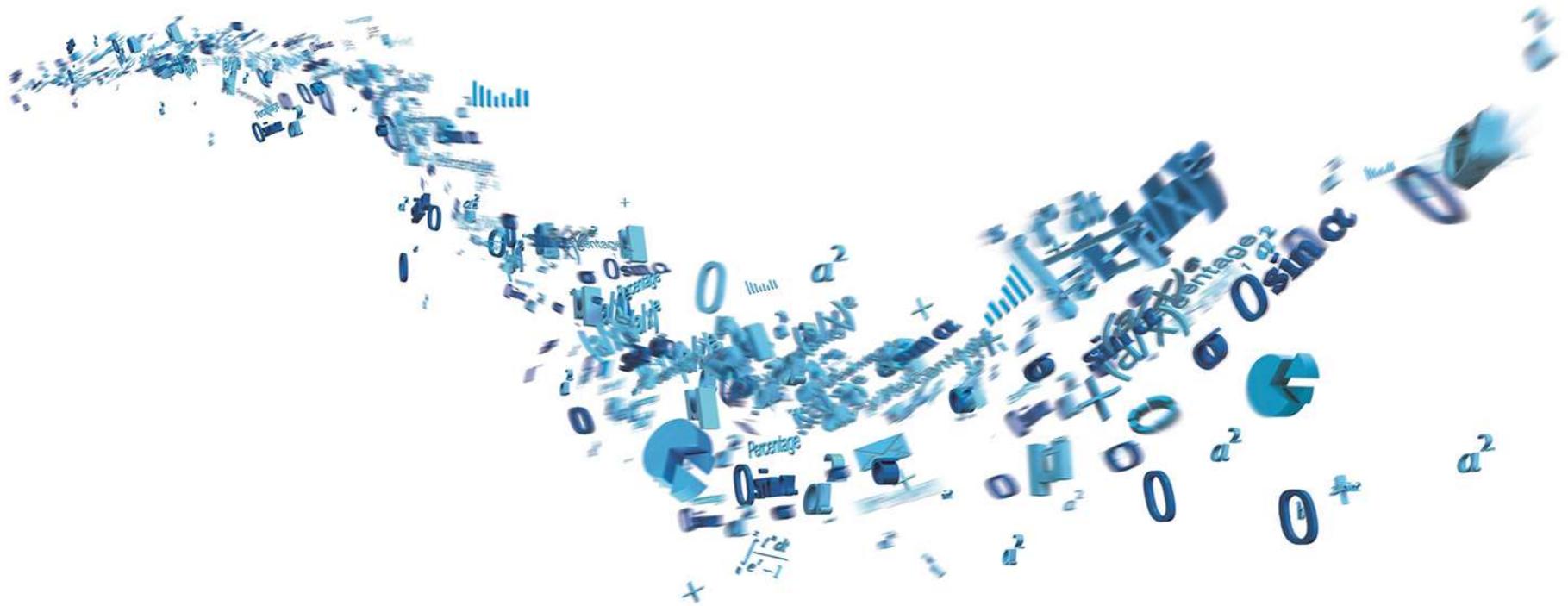
**Includes Public Real Estate, Private Real Estate, and Infrastructure

STAFF RECOMMENDATION:

This agenda item is provided for informational and discussion purposes only. No action is required.

ATTACHMENT – 1

Exhibit A – Employees Retirement System of Texas Performance Report, First Calendar Quarter Ending March 31, 2016 by Hewitt EnnisKnupp (Included under separate cover)



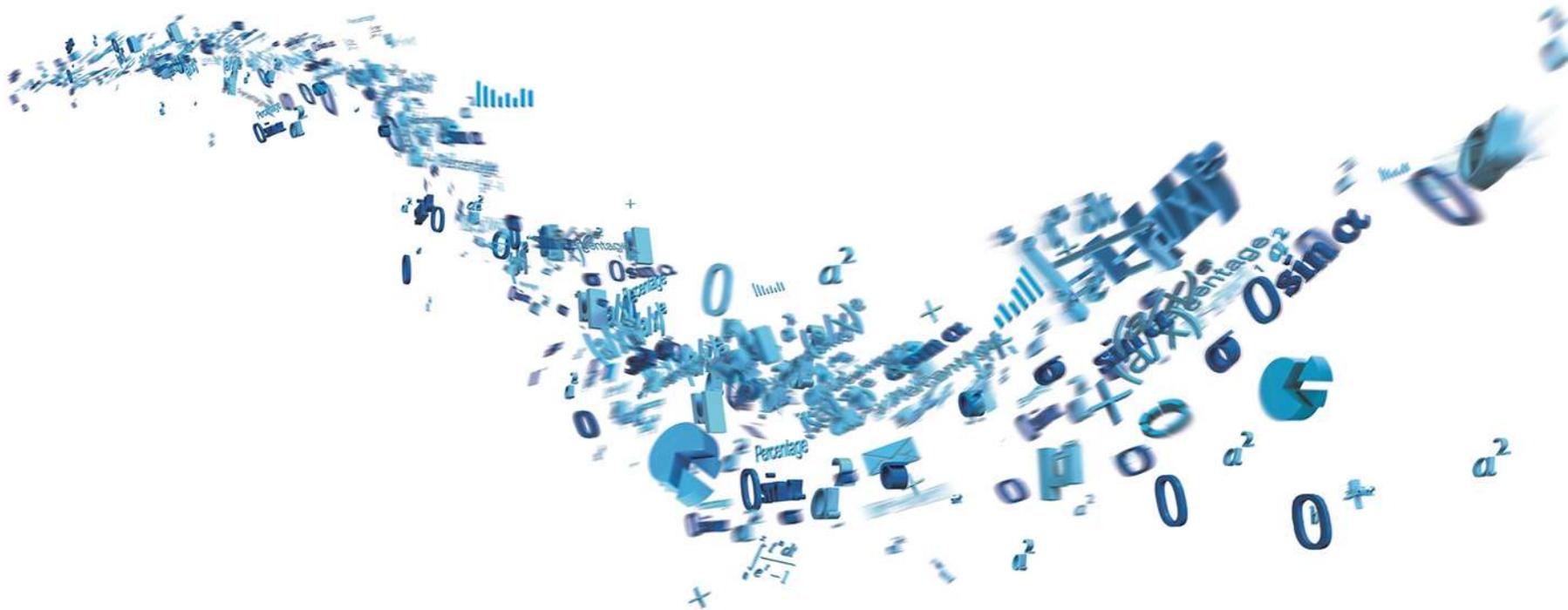
Employees Retirement System of Texas | First Quarter 2016

Quarterly Investment Review

Visit the Aon Hewitt Retirement and Investment Blog (<http://retirementandinvestmentblog.aon.com>); sharing our best thinking.

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Total Fund

Rebalancing in Volatile Markets

To clients of Aon Hewitt Investment Consulting:

2016 started with a heavy dose of market volatility. In an interview with Asset TV¹, Warren Buffet gave investors two pieces of advice for managing portfolios through volatility:

- “In terms of what’s going to happen [in markets] in a day or a week or a month or a year even, I’ve never felt that I knew it, and I’ve never felt it was important.”
- “We’re always a buyer of stocks, and we’re a more aggressive buyer when they’re going down.”

Asset TV summarized the first piece of advice as “don’t try to time the markets” and the second as “don’t be afraid to buy the dips.” These two views may seem to conflict. How can we reconcile them?

Though markets are mostly unpredictable over short periods, for medium- and long-term horizons, they are meaningfully influenced by valuations. So buying when valuation levels are attractive can increase the odds of strong returns over the long-term. This aligns well with our firm’s investment beliefs, which state “Prevailing market conditions and outlook should influence portfolio construction in the long and medium term... the rewards for taking different types of market risk, such as equity risk, are more attractive in some market environments than others.”² This is supported by our research.³

A thoughtful rebalancing approach is an effective way investors can minimize market-timing while buying the dips. Sometimes this means staying close to target allocations, but not always. We also develop Medium-Term Views on asset classes to guide modest tilts relative to target allocations, which can also be part of a thoughtful rebalancing approach. These tilts can be thought of as a form of value investing.

We most commonly use this type of advice for our clients managing full portfolios, but rebalancing can also apply to participant-directed defined contribution plans. The benefits of rebalancing are best achieved through pre-mixed portfolios like target date funds, which is one reason we often recommend defaulting and reenrolling assets to these strategies.

Rebalancing is a time-tested, best-practice way to manage portfolios through volatility. There are multiple ways to implement rebalancing in an investment program, depending on the investor’s unique circumstances, governance, and views. Your AHIC consulting team can assist you in determining the most appropriate path forward.

Aon Hewitt Investment Consulting

¹ <https://www.assettv.com/video/warren-buffetts-five-tips-long-term-investing>

² <https://retirementandinvestmentblog.aon.com/BlogHome/Blog/May-2015/Aon-Hewitt-Global-Investment-Beliefs.aspx>

³ http://www.aon.com/attachments/human-capital-consulting/2015_Asset-Allocation-through-Changing-Market-Environments_WP.pdf

Aon Hewitt | Retirement and Investment

Proprietary and Confidential

Investment advice and consulting services provided by Aon Hewitt Investment Consulting, Inc., an Aon Company.

Market Highlights

Regional equity returns were notably varied over the quarter, with North American equities performing strongly relative to other developed regions.

The quarter saw a loosening of monetary policy from central banks in Europe and Japan, and a more dovish tone from the US Federal Reserve. The MSCI All Country World IMI returned 0.4%. US equities (S&P 1500) returned 1.6% over the quarter. Canada (11.3%), Emerging Markets (5.7%) and Australia were the strongest performers as commodity prices began to stabilize and the currencies of commodity exporting nations strengthened versus the dollar. Japan was the weakest performing region despite significant yen strength, with the UK and Europe also returning negatively in dollar terms. 12 month global equity returns (MSCI AC World IMI) was -4.2%. US equities (S&P 1500) returned 1.2% over the 12 months ending March 31, 2016.

Core inflation picks up in the US, but manufacturing remains weak

Economic data indicated that the US manufacturing sector was still struggling, although the outlook improved marginally compared to the previous quarter. The ISM Purchasing Managers' Manufacturing Index reached its lowest reading since 2009 in the fourth quarter of 2015, but saw an upturn in the first two months of 2016. The index remains below the crucial level of 50, above which indicates the sector is growing. The improvement in the sector is correlated with a slight weakening in the US dollar, whose strength had been impacting U.S. manufacturers' competitiveness. Despite recent upward revisions, US GDP growth has been slowing for six months. The U.S. labor market remained strong, with the unemployment rate remaining low at 5.0%, despite more people looking for jobs.

The Federal Reserve strikes a notably more dovish tone

In March, the Fed maintained the target rate for the Federal Funds rate at 0.25-0.5%, in line with market expectations. The Fed lowered expectations of how many rate rises to expect in 2016, from 4 to 2. Previously, the Fed was much more hawkish than the market with regards to interest rate rises, and they remain somewhat so, although the more dovish nature of their recent comments has brought them more in line with the market expectations.

Threats remain to the Eurozone recovery, but the European Central Bank continues to support accommodative policy

The Eurozone economy remains weak, but cyclical recovery is expected to continue. Eurozone GDP growth was estimated to be 0.3% for the fourth quarter, and 1.6% for the year. Germany and Spain have been driving Eurozone growth, with recent improvements in France. The jobless rate has been declining, and recently reached its lowest level in three years. Industrial production surprised positively in February, after a disappointing January. The European Central Bank loosened monetary policy over the quarter, cutting rates and increasing the quantitative easing program from EUR 60bn to EUR 80bn per month. European economic sentiment and consumer confidence indicators have moved lower recently. Furthermore, there is the threat of the UK referendum to leave the EU.

Emerging market headwinds are starting to fade

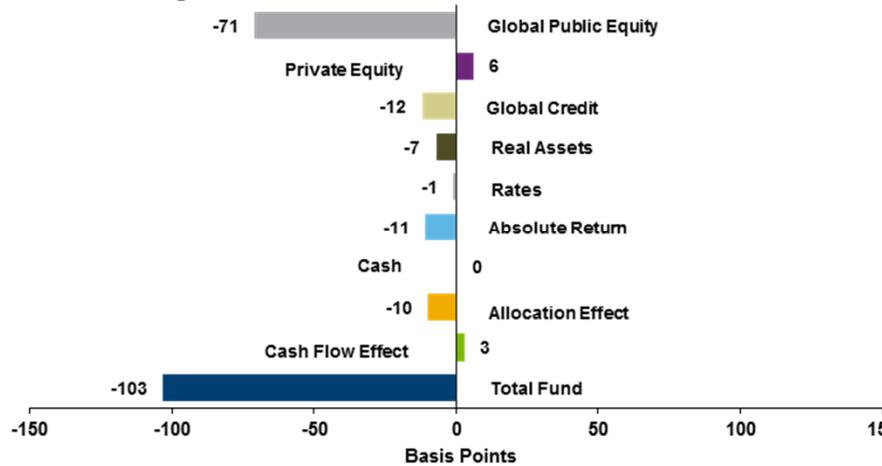
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Yields fall to near historic lows

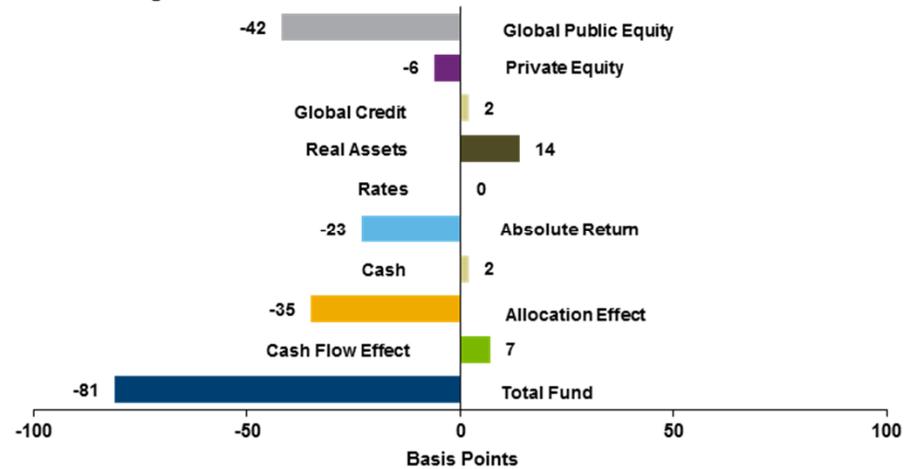
10 year US treasury yields fell over the first quarter by 49bps to 1.78%, close to historic lows and at levels not seen since 2012. The falls were driven by fears of a global growth slowdown and dovish tones from the Federal Reserve were increasingly priced in over the quarter. The Barclays US Treasury 30 year returned 8.9%, meanwhile the Barclays Intermediate Treasury Index returned 2.3%. In the corporate sector, high yield marginally underperformed credit, returning 3.4% (Barclays High Yield Index), versus 3.9% for investment grade credit (Barclays Credit Index).

Attribution

Total Fund Attribution Analysis
3 Months Ending 3/31/16



Total Fund Attribution Analysis
1 Year Ending 3/31/16



Plan Performance

The attribution graphs above illustrate the Fund's performance by asset class during the quarter and one-year periods. The "Asset Class Effects" (Global Public Equity, Private Equity, Global Credit, Real Assets, Rates, Absolute Return, and Cash) are based on the weight of each asset class multiplied by the amount of its outperformance (or underperformance).

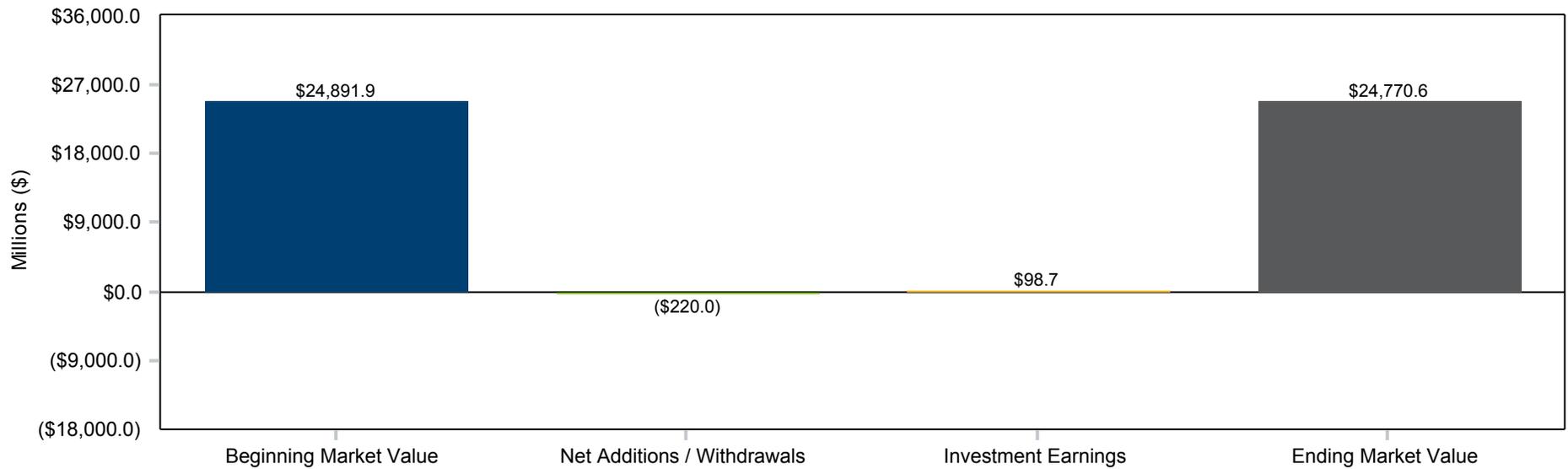
The bar labeled "Allocation Effect" represents the impact of actual allocation deviations from the policy targets on the Total Fund's relative performance.

The bar labeled "Cash Flow Effect" illustrates the effects on the Fund's performance from the timing of cash contributions, withdrawals, and asset movements between accounts. Performance for the remainder of a month following a contribution will be magnified to reflect a larger allocation. The opposite is true for withdrawals, as performance will be diminished with a reduced allocation.

During the first quarter, the Total Fund underperformed the Total Fund Policy Benchmark by approximately 103 basis points. For the quarter, the private equity component contributed positive relative value. The public equity, credit, real asset, rates, and absolute return components detracted from relative performance during the period. The Total Fund underperformed the Total Fund Policy Benchmark by 81 basis points over the previous 1-year period.

Total Plan Asset Summary

**Change in Market Value
From January 1, 2016 to March 31, 2016**

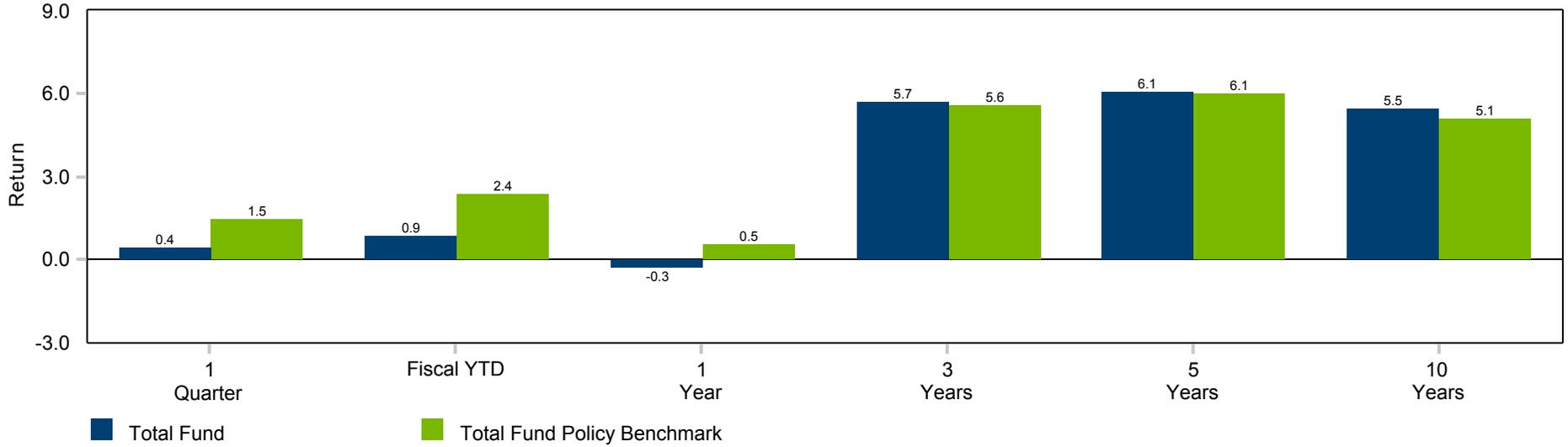


Summary of Cash Flow

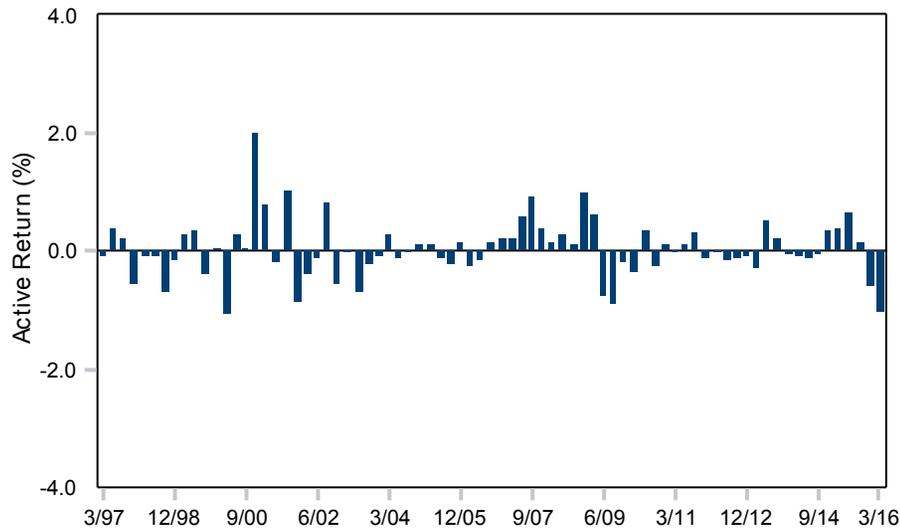
	1 Quarter	Fiscal YTD	1 Year
Total Fund			
Beginning Market Value	24,891,929,422	25,177,941,024	25,886,213,890
+ Additions / Withdrawals	-220,002,168	-543,828,952	-1,052,419,950
+ Investment Earnings	98,710,525	136,525,707	-63,156,160
= Ending Market Value	24,770,637,779	24,770,637,779	24,770,637,779

Total Plan Performance Summary

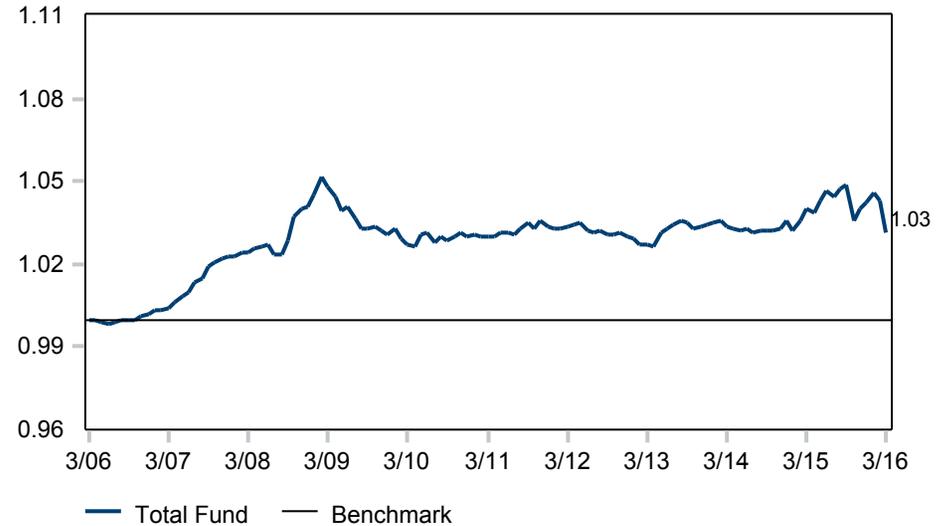
Return Summary



Quarterly Excess Performance



Ratio of Cumulative Wealth - 10 Years



As of March 31, 2016

Asset Allocation & Performance

	Allocation		Performance(%)					
	Market Value (\$)	%	1 Quarter	Fiscal YTD	1 Year	3 Years	5 Years	10 Years
Total Fund	24,770,637,779	100.0	0.4	0.9	-0.3	5.7	6.1	5.5
Total Fund Policy Benchmark			1.5	2.4	0.5	5.6	6.1	5.1
Return Seeking	19,440,938,906	78.5	0.0	0.6	-1.0	6.7	-	-
Global Public Equity	11,886,915,563	48.0	-1.1	-0.6	-5.1	-	-	-
Global Public Equity Benchmark			0.4	1.6	-4.2	-	-	-
Domestic Equity	5,550,477,417	22.4	-0.2	1.9	-1.4	10.7	10.7	6.5
Domestic Equity Benchmark			1.6	5.5	1.2	11.6	11.4	7.1
ERS S&P 500 Index Fund	1,100,766,856	4.4	1.3	5.7	1.8	11.8	11.6	7.1
S&P 500 Index			1.3	5.8	1.8	11.8	11.6	7.0
ERS Large Cap Core	2,407,207,592	9.7	-0.9	1.4	-1.5	10.8	10.9	7.1
S&P 500 Index			1.3	5.8	1.8	11.8	11.6	7.0
Large Cap Growth Quant	285,925,153	1.2	0.1	4.9	3.0	-	-	-
S&P 500 Growth			0.5	6.1	3.5	-	-	-
Barrow Hanley Mewhinney & Strauss	636,916,711	2.6	-1.4	0.0	-4.0	10.0	9.9	-
S&P 500 Value			2.2	5.4	-0.3	9.4	10.0	-
ERS Mid Cap Core	672,513,020	2.7	2.2	0.1	-4.6	9.2	9.3	-
S&P MidCap 400			3.8	3.1	-3.6	9.5	9.5	-
ERS Small Cap Core	357,237,451	1.4	-0.7	-0.9	-3.3	10.6	9.8	7.0
S&P SmallCap 600			2.7	2.8	-3.2	10.4	10.4	7.0
Emerging Manager Composite	89,910,633	0.4	-1.0	0.8	-3.6	9.5	9.8	-
S&P Composite 1500			1.6	5.5	1.2	11.6	11.4	-
International Equity	5,234,989,115	21.1	-1.6	-2.7	-8.7	0.9	1.0	2.2
International Equity Benchmark			-0.4	-1.9	-9.2	0.3	0.3	1.5
ERS International EAFE Composite	2,229,397,177	9.0	-3.5	-3.9	-7.9	2.2	2.8	2.5
MSCI EAFE Index (Net)			-3.0	-3.6	-8.3	2.2	2.3	1.8
ERS Canada	263,211,954	1.1	11.4	0.9	-9.2	-2.8	-3.4	-
MSCI Canada (Net)			11.3	0.6	-10.2	-3.6	-4.4	-
Fisher Investments	552,868,502	2.2	-2.0	-1.1	-9.9	2.2	1.5	-
Fisher Performance Benchmark			-0.4	-1.9	-9.2	0.3	0.3	-

As of March 31, 2016

Asset Allocation & Performance

	Allocation		Performance(%)					
	Market Value (\$)	%	1 Quarter	Fiscal YTD	1 Year	3 Years	5 Years	10 Years
Templeton	714,475,966	2.9	-2.6	-4.7	-9.6	2.5	2.3	2.9
Templeton Performance Benchmark			-0.4	-1.9	-9.2	0.3	0.3	1.5
Lazard Asset Management	444,598,192	1.8	-0.4	-1.1	-5.9	5.2	-	-
MSCI EAFE Index (Net)			-3.0	-3.6	-8.3	2.2	-	-
Blackrock International Focus	367,761,854	1.5	-3.8	-5.2	-6.0	-	-	-
MSCI AC World ex USA Index (Net)			-0.4	-1.9	-9.2	-	-	-
ERS Emerging Markets	662,333,181	2.7	2.3	1.2	-10.3	-3.5	-3.9	-
MSCI EM (Net)			5.7	3.2	-12.0	-4.5	-4.1	-
JP Morgan Emerging Markets	342,290	0.0						
Global Public Equity Special Situations	516,609,985	2.1	1.7	3.3	-2.7	-	-	-
Directional Growth Portfolio	287,197,745	1.2	-8.7	-9.0	-5.7	-	-	-
Global Equity Tactical	244,495,862	1.0	-6.8	-7.6	-10.8	-	-	-
Global Risk Management	53,145,439	0.2						
Private Equity	2,908,069,067	11.7	1.3	1.6	10.7	13.6	11.6	-
Total Global Credit	1,737,250,962	7.0	1.7	-2.0	-3.1	-	-	-
Barclays U.S. High Yield 2% Issuer Cap			3.4	-1.4	-3.7	-	-	-
ETF Fixed Income Emerging Markets	31,440,111	0.1	5.2	6.5	6.8	4.9	-	-
ETF Fixed Income EM Performance Benchmark			3.4	-1.4	-3.7	-0.1	-	-
ETF Fixed Income High Yield	349,613,492	1.4	2.5	-1.7	-3.9	1.5	-	-
Barclays U.S. High Yield 2% Issuer Cap			3.4	-1.4	-3.7	1.9	-	-
ERS Internal High Yield	1,098,508,282	4.4	3.2	0.0	-1.3	-	-	-
Barclays U.S. High Yield 2% Issuer Cap			3.4	-1.4	-3.7	-	-	-
Private Credit	255,305,623	1.0	-6.0	-11.3	-10.5	-	-	-
Barclays U.S. High Yield 2% Issuer Cap (1 month lag)			-3.5	-7.2	-8.3	-	-	-
High Yield Risk Management	2,383,453	0.0						

As of March 31, 2016

Asset Allocation & Performance

	Allocation		Performance(%)					
	Market Value (\$)	%	1 Quarter	Fiscal YTD	1 Year	3 Years	5 Years	10 Years
Total Real Assets	2,908,703,314	11.7	3.0	6.9	9.8	10.0	-	-
Real Estate	2,585,370,760	10.4	3.2	7.6	10.5	10.4	10.6	4.6
Global Public Real Estate	730,947,950	3.0	4.4	9.1	-1.2	4.9	7.5	3.5
Public Real Estate Performance Benchmark			5.4	10.2	0.8	6.0	8.3	3.2
Internal Public Real Estate	730,947,950	3.0	5.1	11.7	1.6	6.3	8.5	4.0
Internal Public Real Estate Performance Benchmark			5.4	11.4	1.1	6.1	8.4	3.2
Domestic REIT	397,672,266	1.6	5.4	17.3	4.8	11.0	12.1	7.1
Domestic Real Estate Performance Benchmark			5.6	16.8	4.0	10.5	11.7	6.1
International REIT	333,275,684	1.3	4.7	5.5	-2.1	1.6	5.1	-
FTSE EPRA/NAREIT Global ex-U.S. Index			5.2	5.6	-1.7	2.1	5.3	-
Private Real Estate	1,854,422,810	7.5	2.9	7.0	17.1	13.5	13.4	-
Private Real Estate Performance Benchmark			3.1	6.6	14.0	8.6	-	-
Total Infrastructure	323,332,554	1.3	1.1	1.2	3.9	7.4	-	-
Private Infrastructure	323,332,554	1.3	1.1	1.2	2.4	6.4	-	-
Risk Reduction	5,329,698,873	21.5	1.4	1.3	1.6	1.9	-	-
Total Rates	4,012,042,944	16.2	2.3	2.3	2.3	-	-	-
Barclays U.S. Treasury Float Adjusted: Intermediate			2.3	2.2	2.2	-	-	-
Absolute Return	1,253,283,750	5.1	-1.1	-1.6	-0.4	4.2	-	-
91 Day T-Bill + 4% (1 month lag)			1.0	2.4	4.1	4.1	-	-
Total Cash	64,372,180	0.3						

* Please see Appendix for benchmark descriptions

As of March 31, 2016

Asset Allocation & Performance

	Allocation		Performance(%)											
	Market Value (\$)	%	Fiscal 2015	Fiscal 2014	Fiscal 2013	Fiscal 2012	Fiscal 2011	Fiscal 2010	Fiscal 2009	Fiscal 2008	Fiscal 2007	Fiscal 2006	Fiscal 2005	Fiscal 2004
Total Fund	24,770,637,779	100.0	0.4	14.6	9.9	8.0	12.4	6.5	-6.7	-4.7	13.8	8.8	12.6	11.6
Total Fund Policy Benchmark			-1.0	15.0	9.5	8.1	12.0	6.8	-7.5	-5.5	12.1	9.0	12.5	11.8
Return Seeking	19,440,938,906	78.5	-0.2	18.1	12.7	9.3	-	-	-	-	-	-	-	-
Global Public Equity	11,886,915,563	48.0	-3.5	20.0	-	-	-	-	-	-	-	-	-	-
Global Public Equity Benchmark			-6.3	21.4	-	-	-	-	-	-	-	-	-	-
Domestic Equity	5,550,477,417	22.4	1.5	24.2	19.2	17.5	19.6	5.9	-18.4	-11.6	14.9	8.3	15.2	11.2
Domestic Equity Benchmark			0.5	24.9	19.4	17.5	19.1	5.6	-18.4	-11.1	15.1	8.9	12.6	11.5
ERS S&P 500 Index Fund	1,100,766,856	4.4	0.5	25.2	18.8	18.0	18.6	4.8	-17.8	-10.8	15.1	9.2	12.8	11.5
S&P 500 Index			0.5	25.2	18.7	18.0	18.5	4.9	-18.3	-11.1	15.1	8.9	12.6	11.5
ERS Large Cap Core	2,407,207,592	9.7	0.7	26.2	18.9	18.3	18.6	6.4	-17.7	-10.0	15.3	10.4	12.7	10.2
S&P 500 Index			0.5	25.2	18.7	18.0	18.5	4.9	-18.3	-11.1	15.1	8.9	12.6	11.5
Large Cap Growth Quant	285,925,153	1.2	5.7	28.7	-	-	-	-	-	-	-	-	-	-
S&P 500 Growth			3.9	27.5	-	-	-	-	-	-	-	-	-	-
Barrow Hanley Mewhinney & Strauss	636,916,711	2.6	1.0	21.8	24.7	16.1	-	-	-	-	-	-	-	-
S&P 500 Value			-3.3	22.8	22.9	17.3	-	-	-	-	-	-	-	-
ERS Mid Cap Core	672,513,020	2.7	0.8	23.3	25.9	12.3	21.5	13.9	-17.5	-	-	-	-	-
S&P MidCap 400			0.0	23.2	23.7	12.7	22.9	11.9	-18.2	-	-	-	-	-
ERS Small Cap Core	357,237,451	1.4	5.8	17.5	26.7	14.6	26.4	10.6	-20.8	-8.4	15.1	6.3	32.7	15.5
S&P SmallCap 600			1.8	18.7	26.7	16.9	24.4	7.8	-20.7	-6.2	14.3	7.1	26.5	14.8
Emerging Manager Composite	89,910,633	0.4	0.4	21.8	20.7	16.7	-	-	-	-	-	-	-	-
S&P Composite 1500			0.5	24.9	19.4	17.5	-	-	-	-	-	-	-	-
International Equity	5,234,989,115	21.1	-10.0	16.1	13.8	-0.1	11.8	2.2	-14.3	-12.3	19.5	20.8	23.5	21.3
International Equity Benchmark			-12.4	17.7	13.0	-1.9	10.3	2.9	-14.4	-14.4	18.7	24.3	23.6	22.6
ERS International EAFE Composite	2,229,397,177	9.0	-6.3	14.5	18.3	2.0	11.1	-0.3	-14.3	-12.4	18.1	24.5	22.7	21.5
MSCI EAFE Index (Net)			-7.5	16.4	18.7	0.0	10.0	-2.3	-14.9	-14.4	18.7	24.3	23.6	22.6
ERS Canada	263,211,954	1.1	-24.9	24.5	3.5	-4.5	17.4	-	-	-	-	-	-	-
MSCI Canada (Net)			-25.3	23.2	2.0	-5.7	17.0	-	-	-	-	-	-	-
Fisher Investments	552,868,502	2.2	-7.3	15.7	14.2	-2.4	17.8	4.2	-13.2	-10.5	18.8	-	-	-
Fisher Performance Benchmark			-12.4	17.7	13.0	-1.9	10.3	2.9	-13.8	-14.4	18.7	-	-	-

As of March 31, 2016

Asset Allocation & Performance

	Allocation		Performance(%)											
	Market Value (\$)	%	Fiscal 2015	Fiscal 2014	Fiscal 2013	Fiscal 2012	Fiscal 2011	Fiscal 2010	Fiscal 2009	Fiscal 2008	Fiscal 2007	Fiscal 2006	Fiscal 2005	Fiscal 2004
Templeton	714,475,966	2.9	-8.0	15.6	19.5	3.6	10.0	-0.7	-14.3	-15.1	25.2	22.5	25.4	21.5
Templeton Performance Benchmark			-12.4	17.7	13.0	-1.9	10.3	2.9	-13.8	-14.4	18.7	24.3	23.6	22.6
Lazard Asset Management	444,598,192	1.8	-5.0	18.8	23.3	-	-	-	-	-	-	-	-	-
MSCI EAFE Index (Net)			-7.5	16.4	18.7	-	-	-	-	-	-	-	-	-
Blackrock International Focus	367,761,854	1.5	-	-	-	-	-	-	-	-	-	-	-	-
MSCI AC World ex USA Index (Net)			-	-	-	-	-	-	-	-	-	-	-	-
ERS Emerging Markets	662,333,181	2.7	-19.2	18.8	1.3	-7.0	9.6	19.9	-	-	-	-	-	-
MSCI EM (Net)			-22.9	20.0	0.5	-5.8	9.1	18.0	-	-	-	-	-	-
JP Morgan Emerging Markets	342,290	0.0	-	-	-	-	-	-	-	-	-	-	-	-
Global Public Equity Special Situations	516,609,985	2.1	-1.7	-	-	-	-	-	-	-	-	-	-	-
Directional Growth Portfolio	287,197,745	1.2	20.2	-	-	-	-	-	-	-	-	-	-	-
Global Equity Tactical	244,495,862	1.0	-	-	-	-	-	-	-	-	-	-	-	-
Global Risk Management	53,145,439	0.2	-	-	-	-	-	-	-	-	-	-	-	-
Private Equity	2,908,069,067	11.7	11.0	20.8	17.1	2.3	14.7	-3.7	-23.6	-2.6	-	-	-	-
Total Global Credit	1,737,250,962	7.0	-1.4	11.2	-	-	-	-	-	-	-	-	-	-
Barclays U.S. High Yield 2% Issuer Cap			-2.9	10.6	-	-	-	-	-	-	-	-	-	-
ETF Fixed Income Emerging Markets	31,440,111	0.1	1.4	16.4	-7.5	-	-	-	-	-	-	-	-	-
ETF Fixed Income EM Performance Benchmark			-2.9	10.6	-2.8	-	-	-	-	-	-	-	-	-
ETF Fixed Income High Yield	349,613,492	1.4	-2.6	10.0	5.2	-	-	-	-	-	-	-	-	-
Barclays U.S. High Yield 2% Issuer Cap			-2.9	10.6	7.6	-	-	-	-	-	-	-	-	-
ERS Internal High Yield	1,098,508,282	4.4	-1.6	-	-	-	-	-	-	-	-	-	-	-
Barclays U.S. High Yield 2% Issuer Cap			-2.9	-	-	-	-	-	-	-	-	-	-	-
Private Credit	255,305,623	1.0	2.3	-	-	-	-	-	-	-	-	-	-	-
Barclays U.S. High Yield 2% Issuer Cap (1 month lag)			0.4	-	-	-	-	-	-	-	-	-	-	-
High Yield Risk Management	2,383,453	0.0	-	-	-	-	-	-	-	-	-	-	-	-

As of March 31, 2016

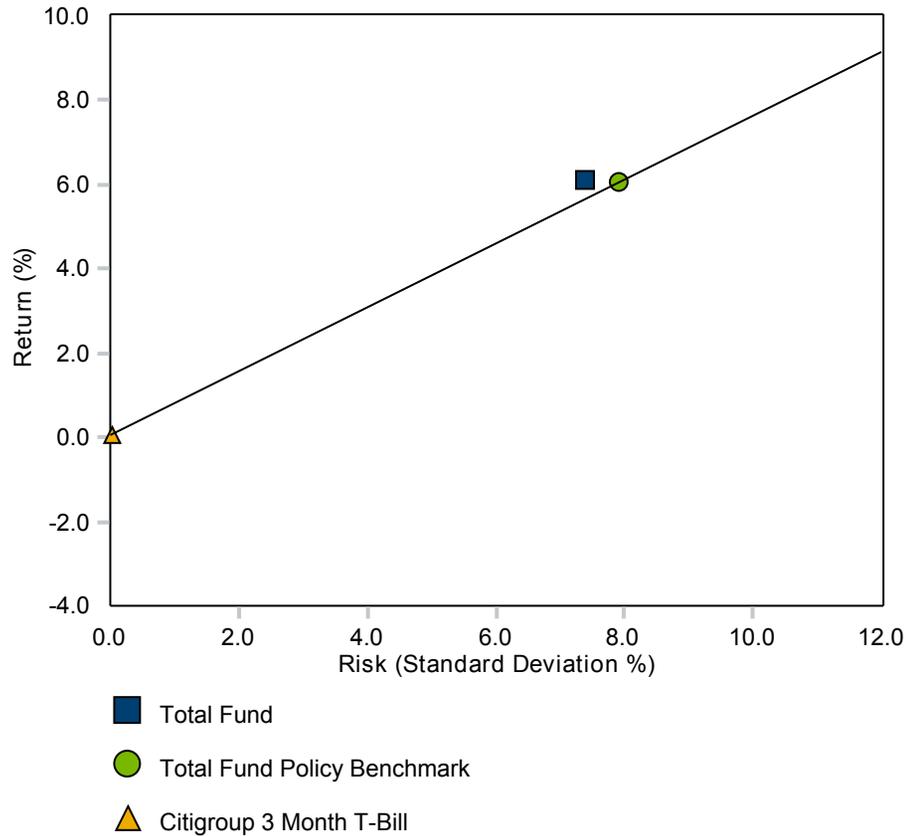
Asset Allocation & Performance

	Allocation		Performance(%)											
	Market Value (\$)	%	Fiscal 2015	Fiscal 2014	Fiscal 2013	Fiscal 2012	Fiscal 2011	Fiscal 2010	Fiscal 2009	Fiscal 2008	Fiscal 2007	Fiscal 2006	Fiscal 2005	Fiscal 2004
Total Real Assets	2,908,703,314	11.7	6.2	14.7	9.6	11.2	-	-	-	-	-	-	-	-
Real Estate	2,585,370,760	10.4	7.2	14.9	8.7	11.2	18.2	15.0	-22.0	-17.4	4.5	26.4	-	-
Global Public Real Estate	730,947,950	3.0	-5.6	19.6	6.5	12.6	15.0	15.4	-22.0	-17.4	4.5	26.4	-	-
Public Real Estate Performance Benchmark			-3.6	20.1	6.6	12.6	15.5	15.1	-23.1	-19.9	2.7	24.8	-	-
Internal Public Real Estate	730,947,950	3.0	-3.9	19.7	6.9	12.6	15.4	15.4	-22.0	-17.4	4.5	26.4	-	-
Internal Public Real Estate Performance Benchmark			-4.2	20.1	6.6	12.6	15.5	15.1	-23.1	-19.9	2.7	24.8	-	-
Domestic REIT	397,672,266	1.6	0.8	24.3	1.0	20.0	18.6	33.1	-33.0	-4.8	4.3	26.4	-	-
Domestic Real Estate Performance Benchmark			0.1	24.3	0.7	20.0	18.5	32.6	-33.8	-8.7	2.3	24.8	-	-
International REIT	333,275,684	1.3	-8.6	15.9	12.2	6.7	13.0	6.0	-14.0	-24.2	-	-	-	-
FTSE EPRA/NAREIT Global ex-U.S. Index			-8.1	16.6	12.0	6.8	13.2	5.7	-15.6	-24.8	-	-	-	-
Private Real Estate	1,854,422,810	7.5	14.1	12.5	10.1	10.7	13.0	-	-	-	-	-	-	-
Private Real Estate Performance Benchmark			13.4	4.0	4.1	-	-	-	-	-	-	-	-	-
Total Infrastructure	323,332,554	1.3	0.7	12.0	17.9	-	-	-	-	-	-	-	-	-
Private Infrastructure	323,332,554	1.3	0.3	9.0	17.9	-	-	-	-	-	-	-	-	-
Risk Reduction	5,329,698,873	21.5	2.5	2.9	-1.0	3.0	-	-	-	-	-	-	-	-
Total Rates	4,012,042,944	16.2	2.1	2.5	-	-	-	-	-	-	-	-	-	-
Barclays U.S. Treasury Float Adjusted: Intermediate			1.9	2.2	-	-	-	-	-	-	-	-	-	-
Absolute Return	1,253,283,750	5.1	4.8	5.8	8.0	-	-	-	-	-	-	-	-	-
91 Day T-Bill + 4% (1 month lag)			4.0	4.0	4.1	-	-	-	-	-	-	-	-	-
Total Cash	64,372,180	0.3												

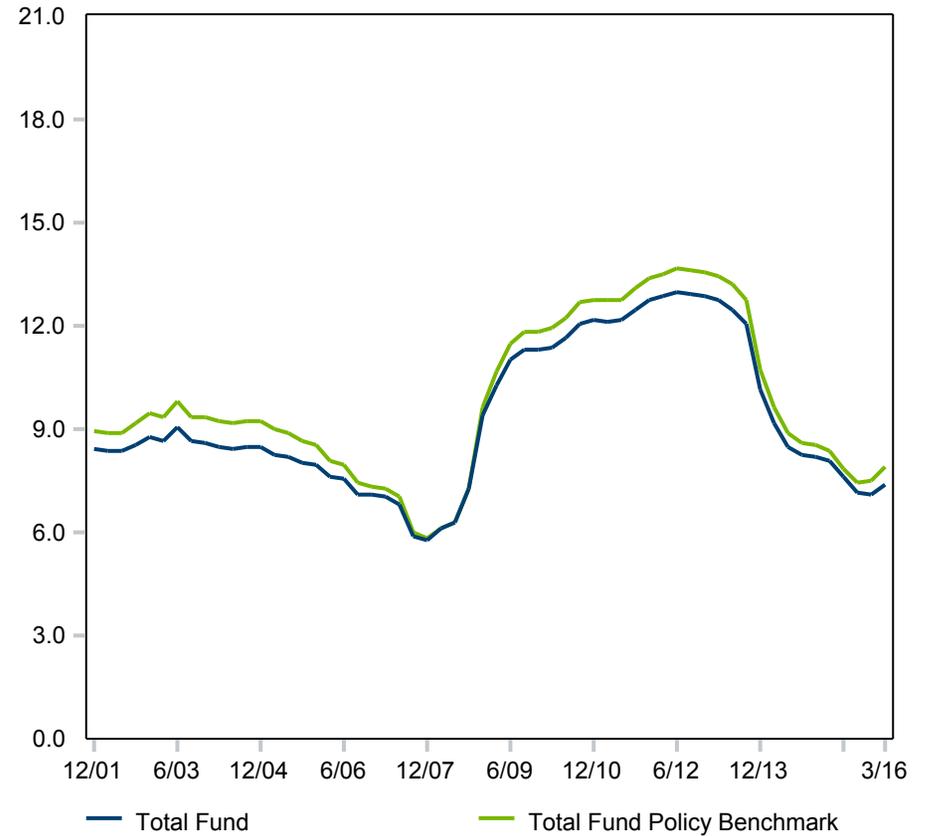
*Please see Appendix for benchmark descriptions

Total Fund Risk Profile

Annualized Return vs. Annualized Standard Deviation 5 Years



Rolling 5 Years Standard Deviation

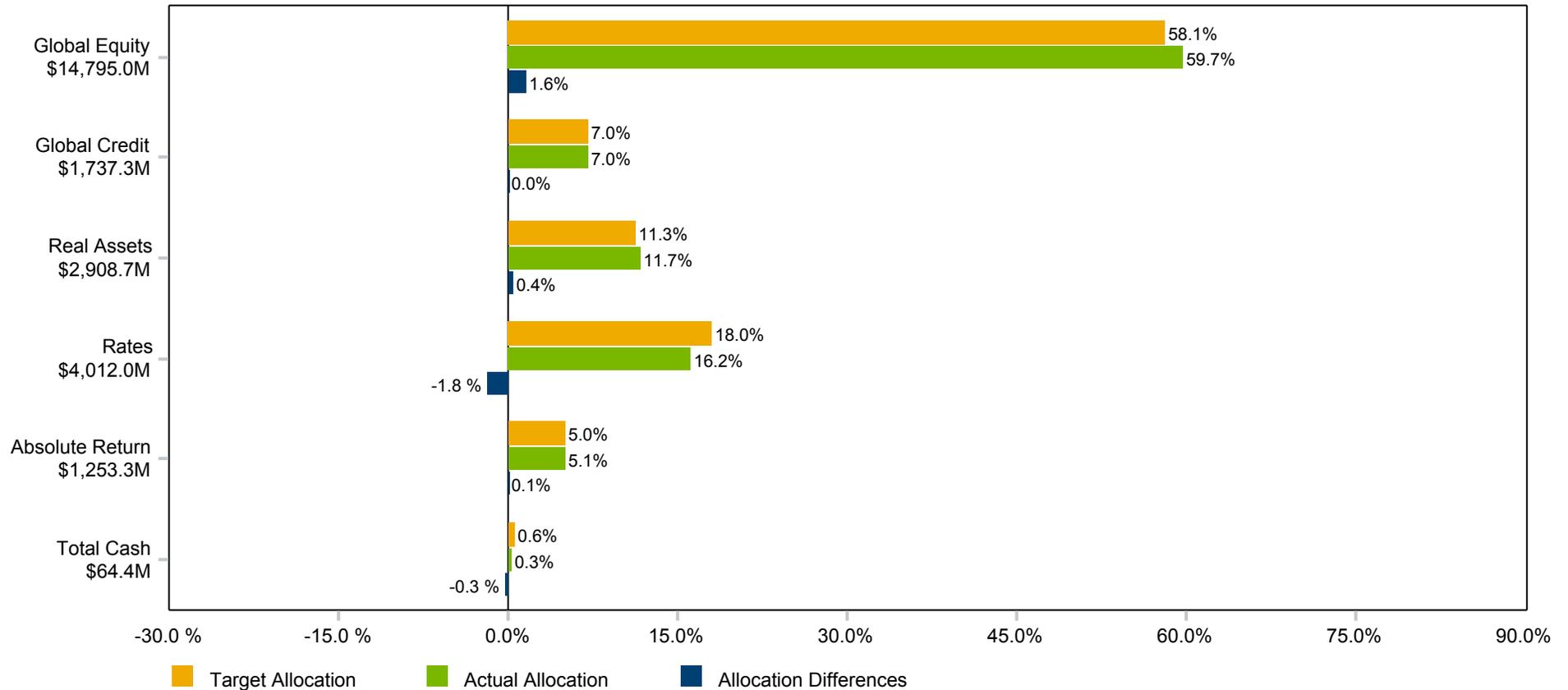


5 Years Historical Statistics

	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Total Fund	0.00	1.03	0.00	0.99	0.83	0.44	0.93	6.09	7.41	0.99
Total Fund Policy Benchmark	0.00	0.00	N/A	1.00	0.78	0.00	1.00	6.05	7.92	1.00
Citigroup 3 Month T-Bill	-6.14	7.92	-0.78	0.01	N/A	0.05	0.00	0.06	0.02	0.10

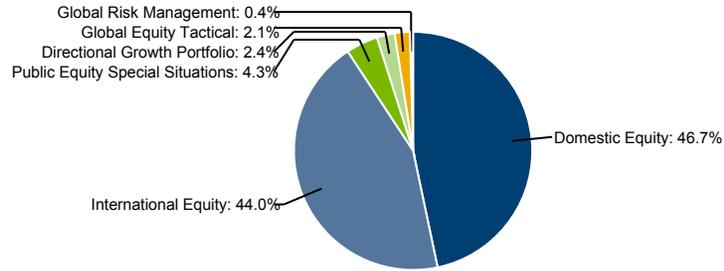
Asset Allocation Compliance

	Market Value (\$)	Current Allocation (%)	Target Allocation (%)	Minimum Allocation (%)	Maximum Allocation (%)
Total Fund	24,770,637,779	100.0	100.0	N/A	N/A
Global Equity	14,794,984,630	59.7	58.1	48.1	68.1
Global Credit	1,737,250,962	7.0	7.0	0.0	14.5
Real Assets	2,908,703,314	11.7	11.3	5.5	15.5
Rates	4,012,042,944	16.2	18.0	15.0	25.0
Absolute Return	1,253,283,750	5.1	5.0	0.0	10.0
Total Cash	64,372,180	0.3	0.6	0.0	1.3

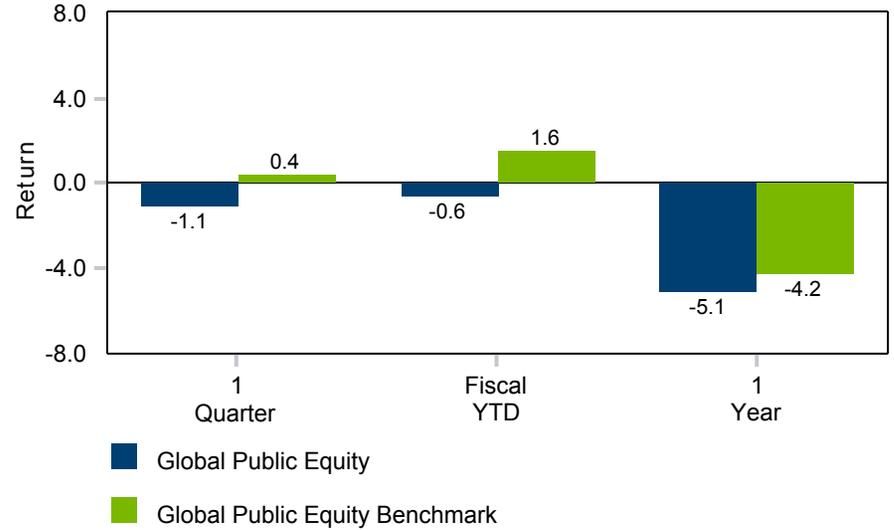


Global Public Equity Portfolio Overview

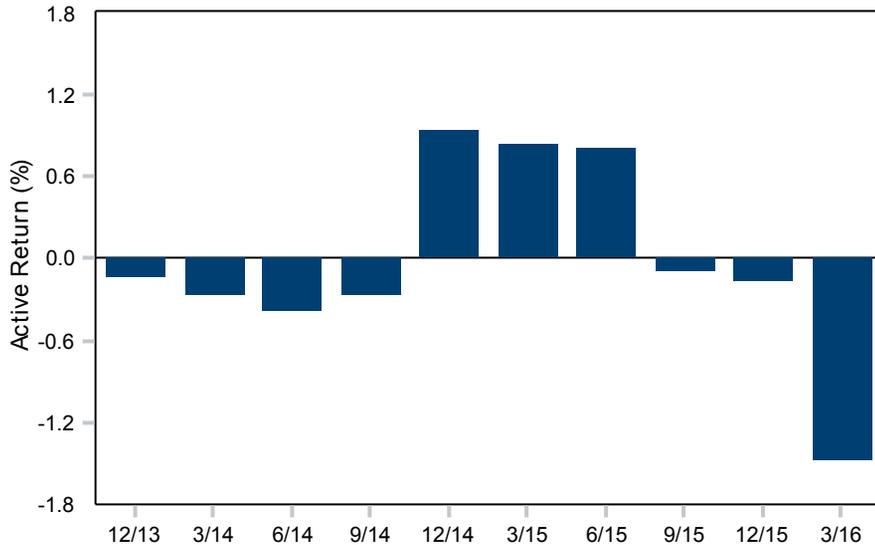
Current Allocation
March 31, 2016 : \$11,887M



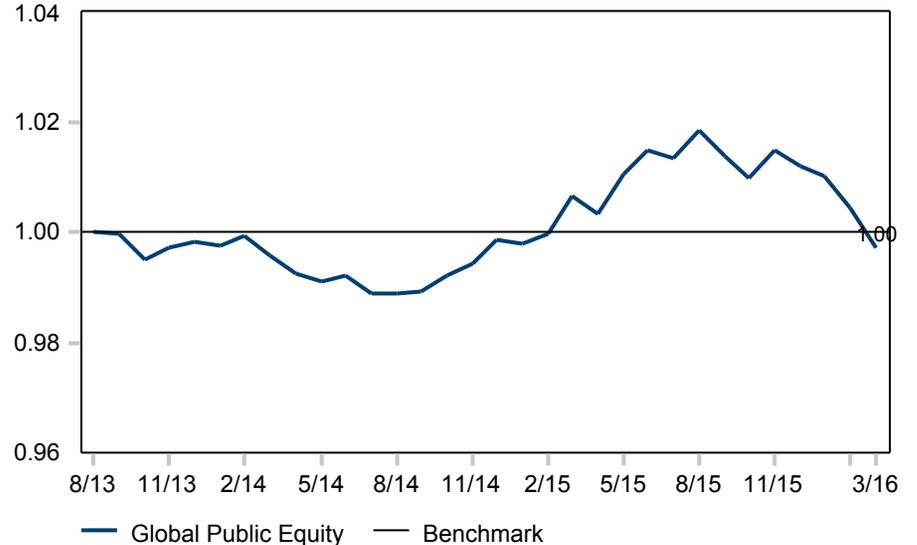
Return Summary



Quarterly Excess Performance

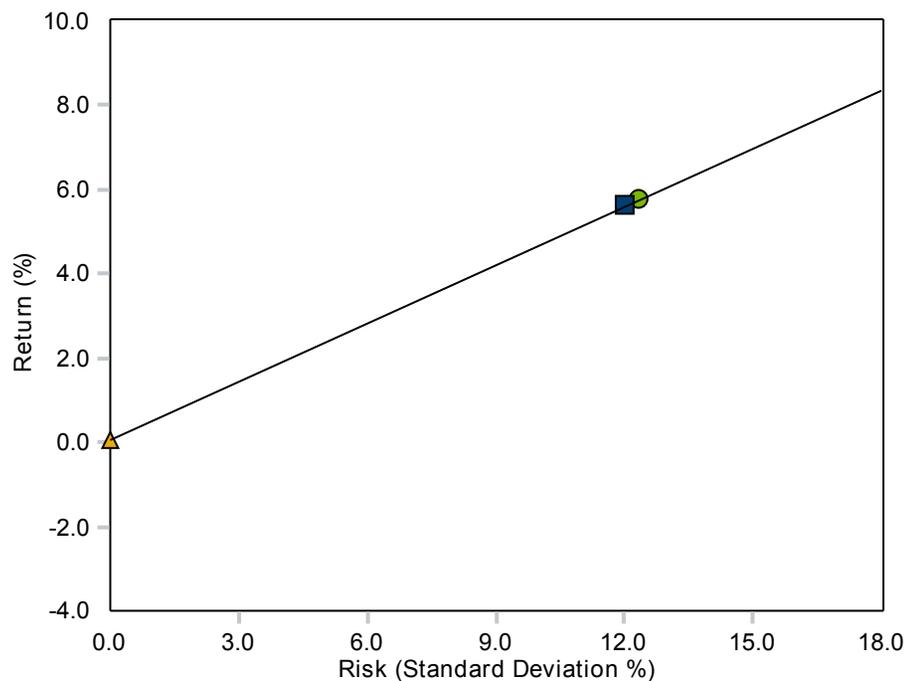


Ratio of Cumulative Wealth - Since Inception



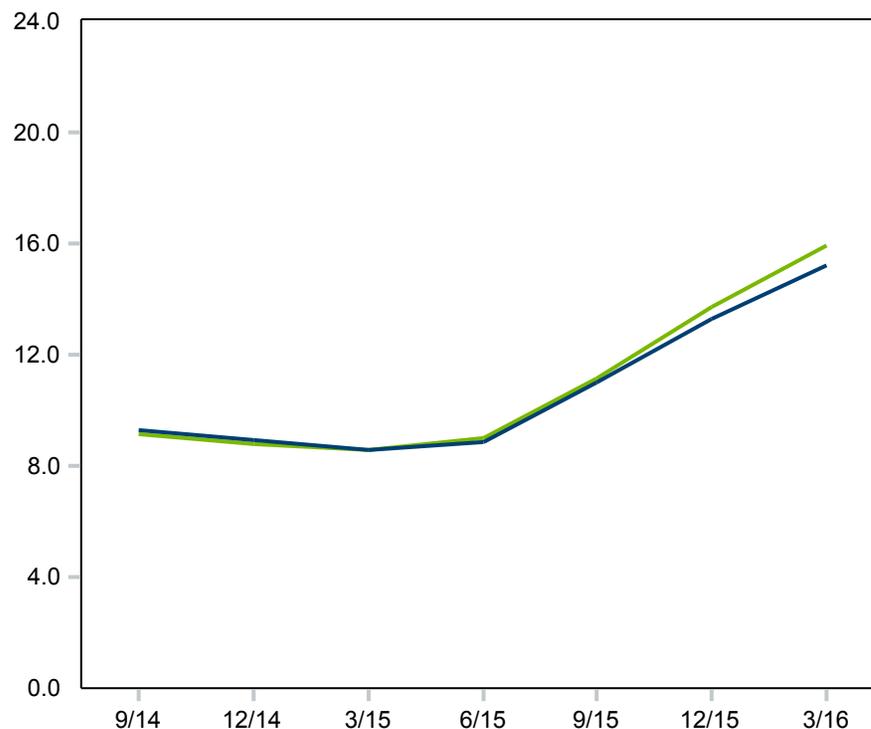
Global Public Equity Risk Profile

Annualized Return vs. Annualized Standard Deviation Since 9/1/2013



- Global Public Equity
- Global Public Equity Benchmark
- ▲ Citigroup 3 Month T-Bill

Rolling 1 Year Standard Deviation



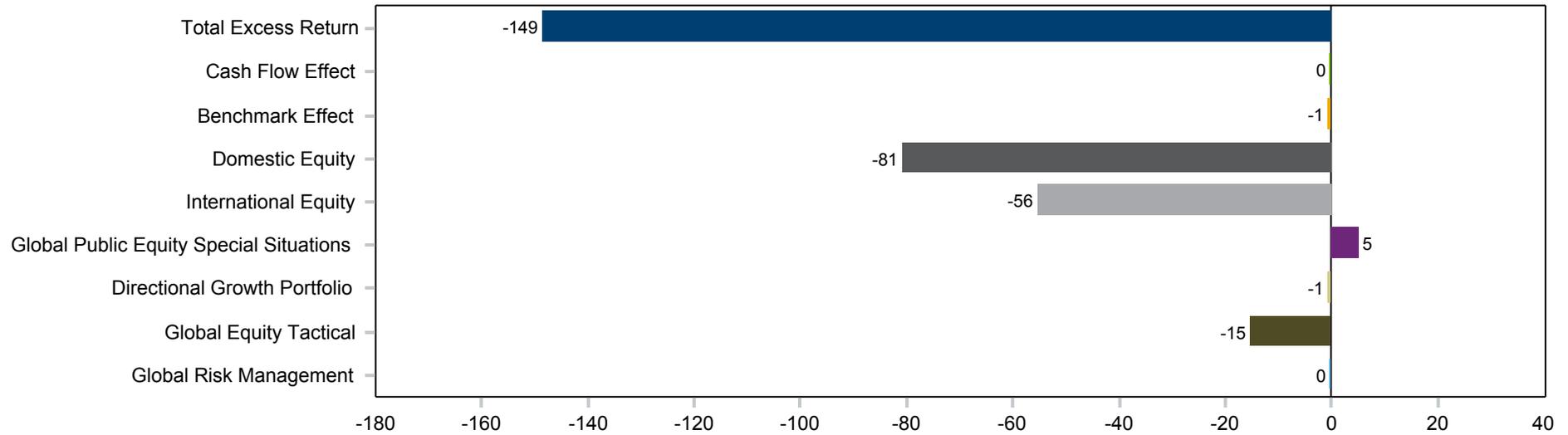
- Global Public Equity
- Global Public Equity Benchmark

Historical Statistics Since 9/1/2013

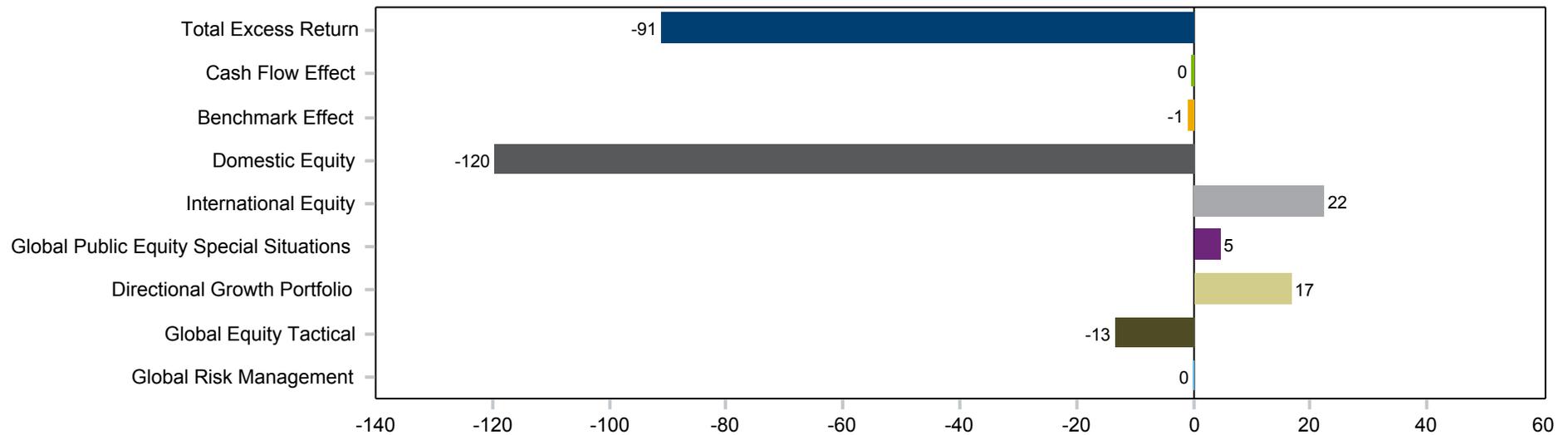
	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Global Public Equity	-0.15	1.30	-0.11	0.99	0.51	0.05	0.97	5.63	12.03	0.99
Global Public Equity Benchmark	0.00	0.00	N/A	1.00	0.51	0.00	1.00	5.75	12.36	1.00
Citigroup 3 Month T-Bill	-6.29	12.35	-0.51	0.01	N/A	0.04	0.00	0.04	0.02	0.09

Asset Class Attribution

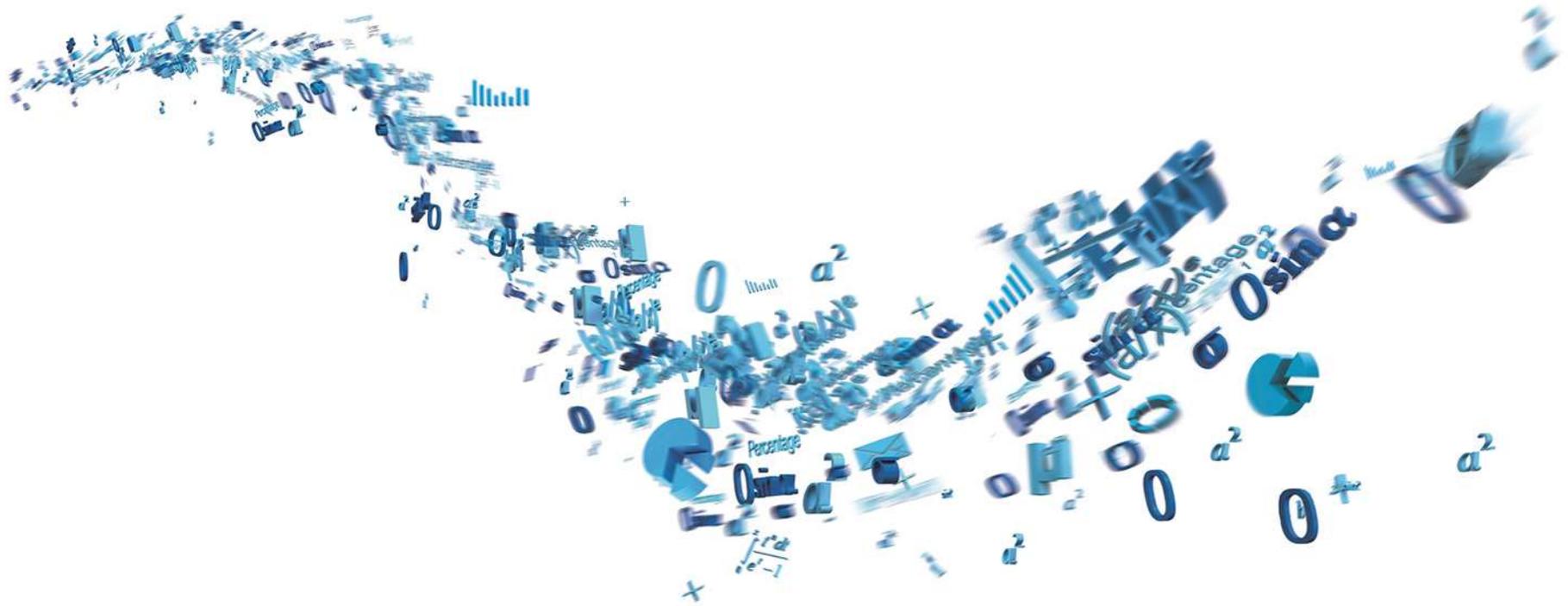
1 Quarter



1 Year



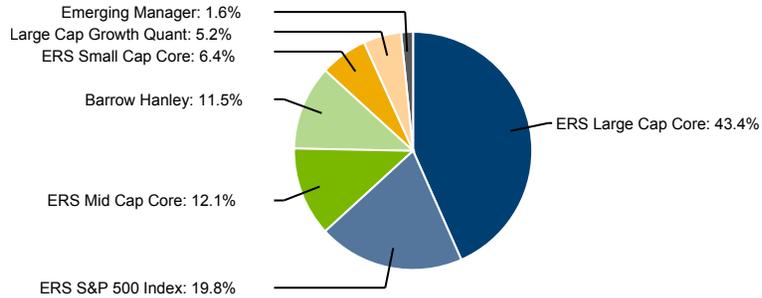
While the Special Situations, Directional Growth, and Global Equity Tactical component's underlying managers may have domestic or international equity benchmarks, the components are not included in the attribution for domestic and international equity.



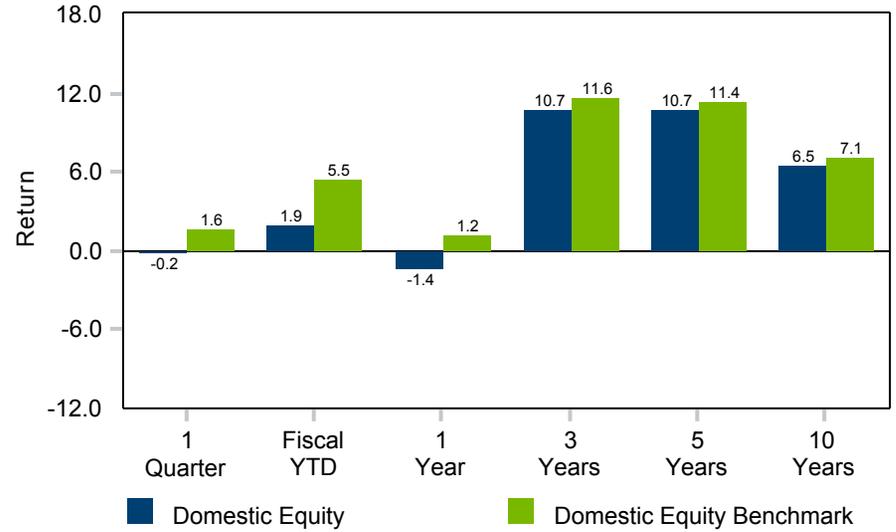
Domestic Equity

Domestic Equity Portfolio Overview

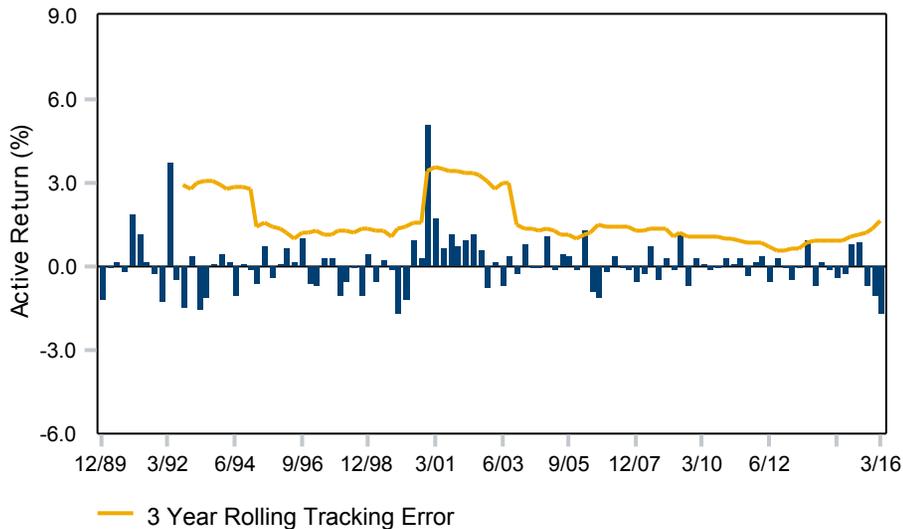
Current Allocation
March 31, 2016 : \$5,550M



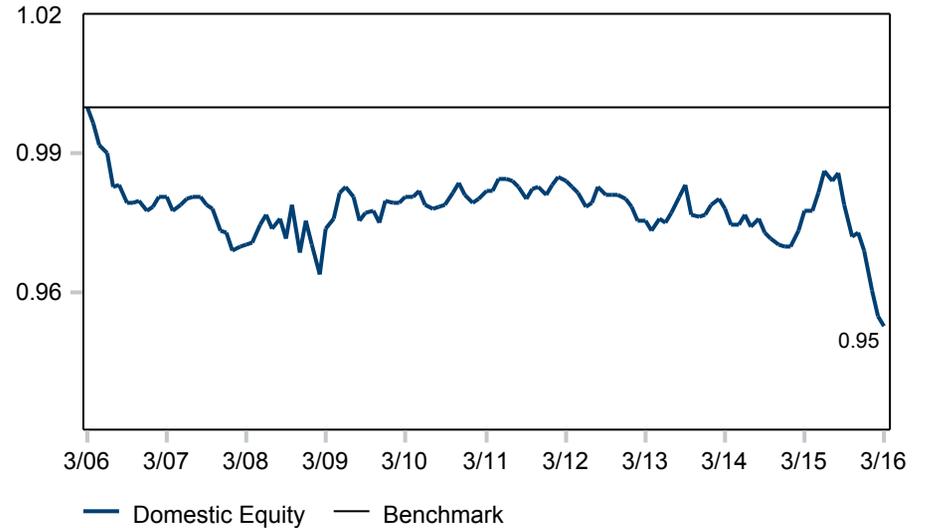
Return Summary



Quarterly Excess Performance

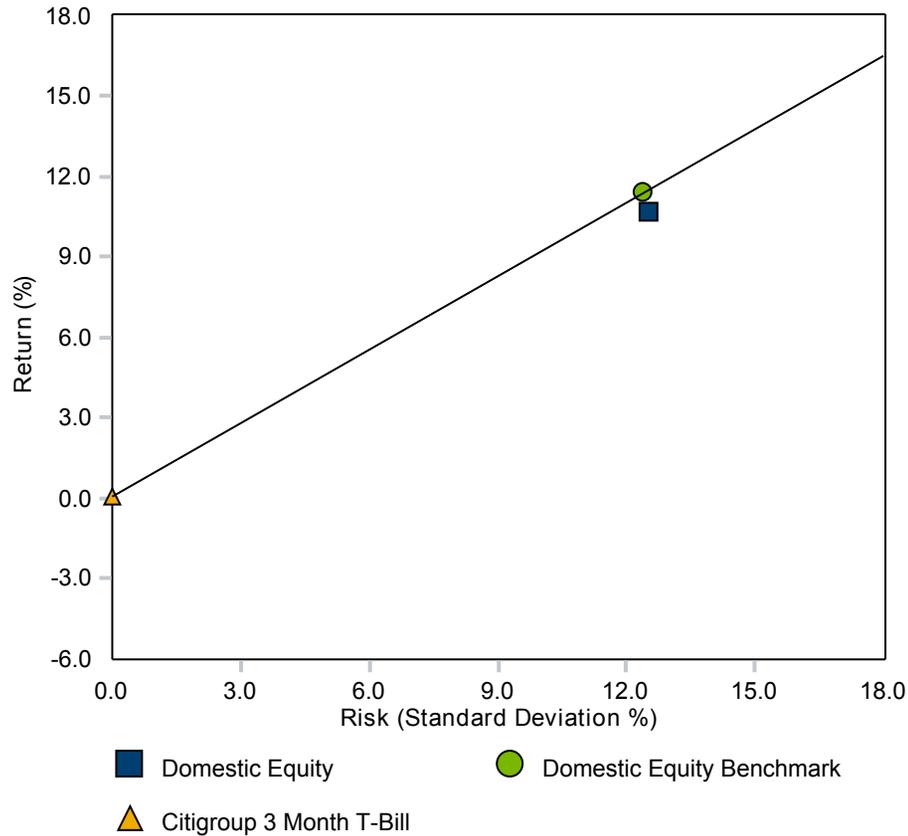


Ratio of Cumulative Wealth - 10 Years

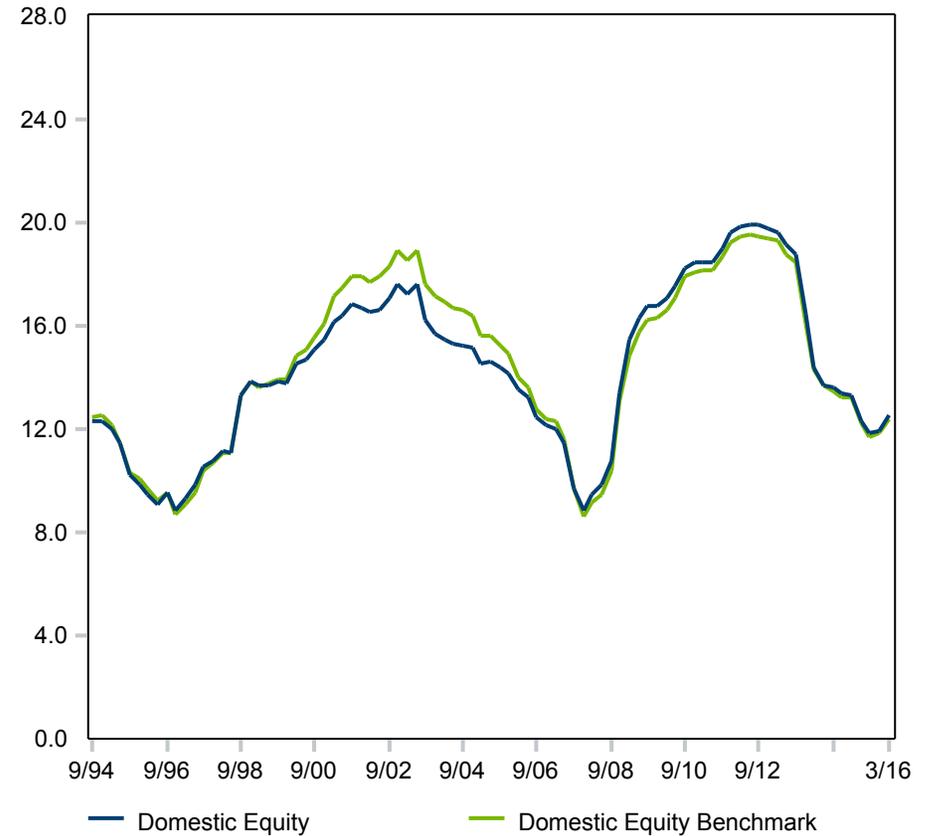


Domestic Equity Risk Profile

Annualized Return vs. Annualized Standard Deviation
5 Years



Rolling 5 Years Standard Deviation

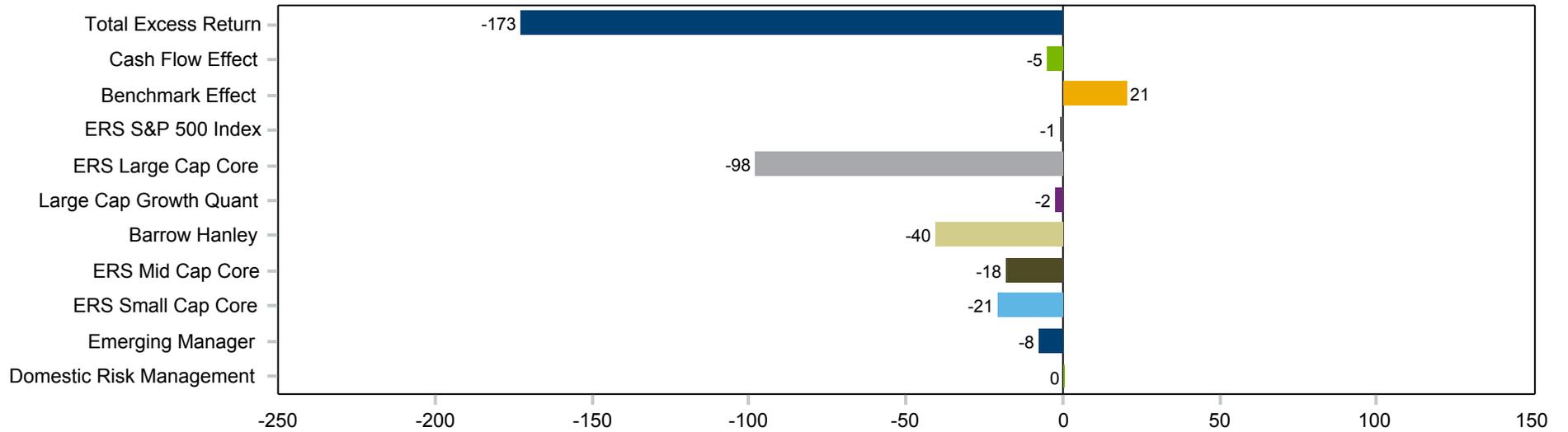


5 Years Historical Statistics

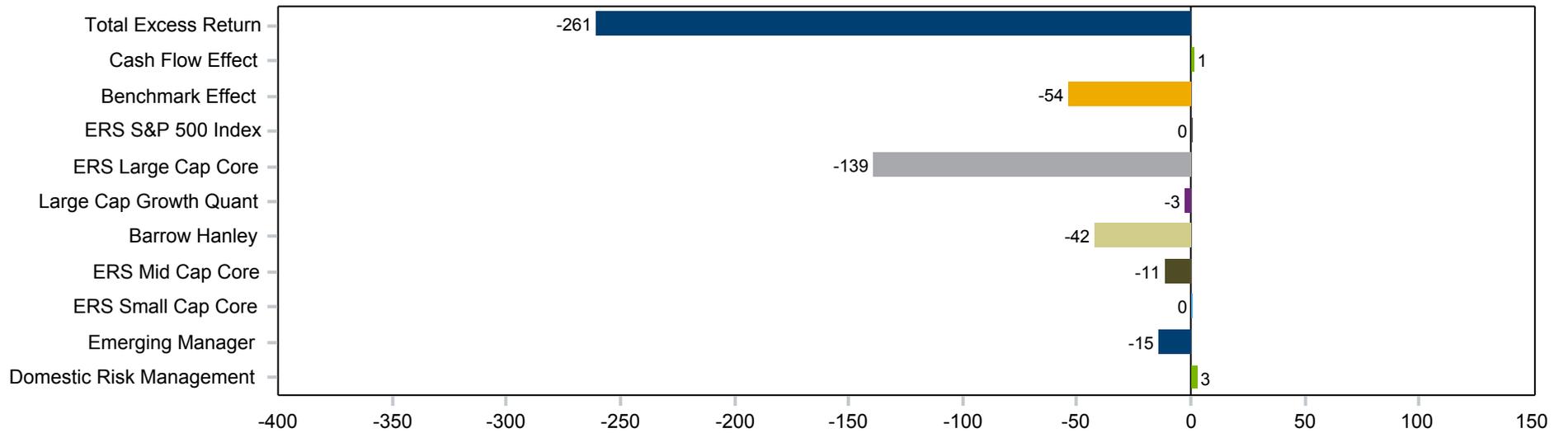
	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Domestic Equity	-0.60	1.02	-0.58	0.99	0.87	-0.69	1.01	10.70	12.55	1.00
Domestic Equity Benchmark	0.00	0.00	N/A	1.00	0.93	0.00	1.00	11.37	12.40	1.00
Citigroup 3 Month T-Bill	-11.51	12.40	-0.93	0.00	N/A	0.06	0.00	0.06	0.02	0.03

Asset Class Attribution

1 Quarter

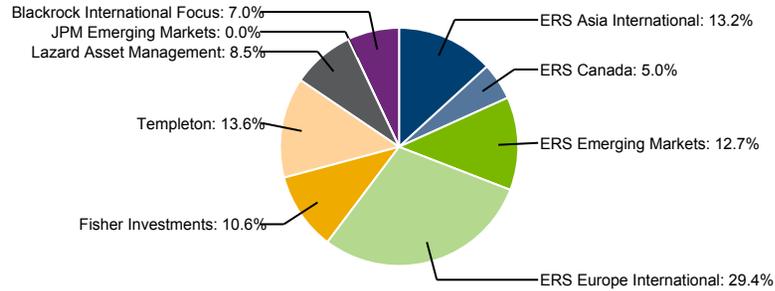


1 Year

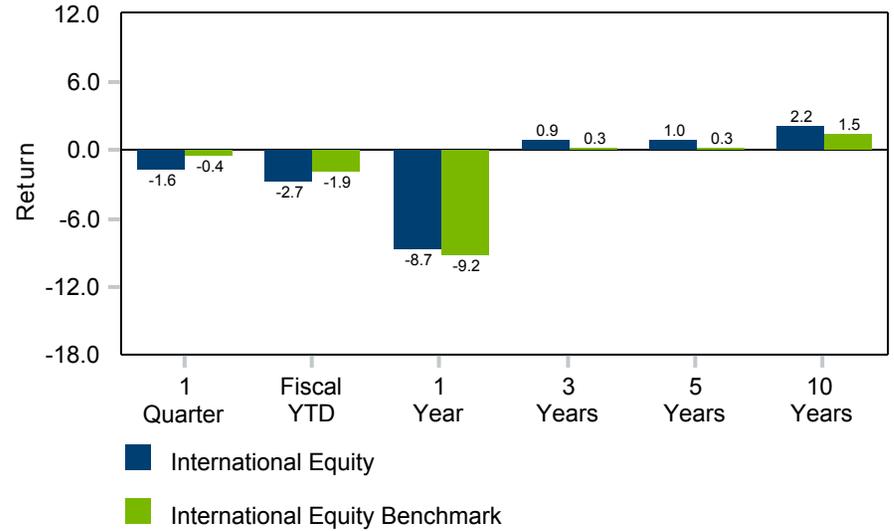


International Equity Portfolio Overview

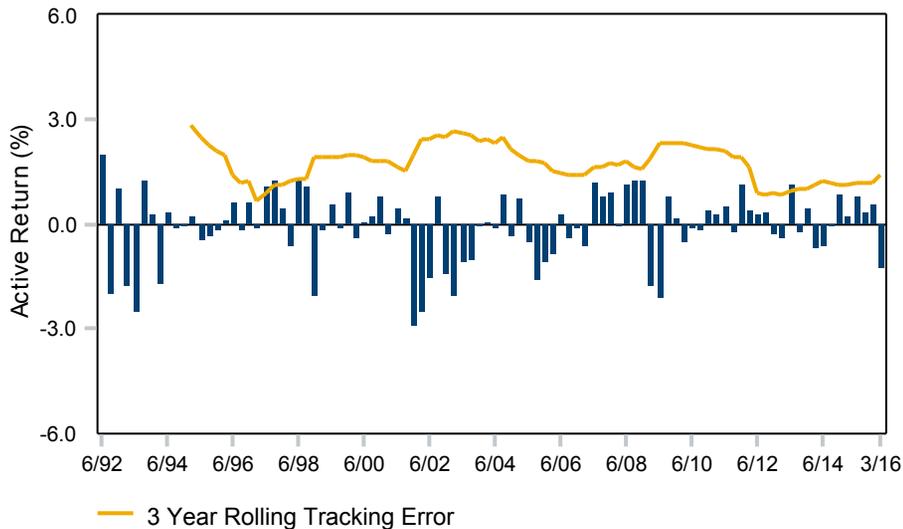
Current Allocation
March 31, 2016 : \$5,235M



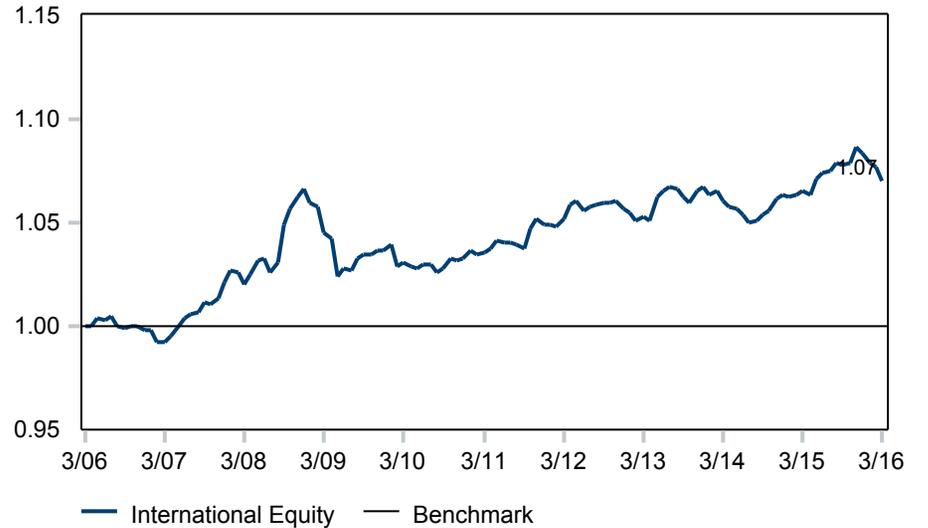
Return Summary



Quarterly Excess Performance

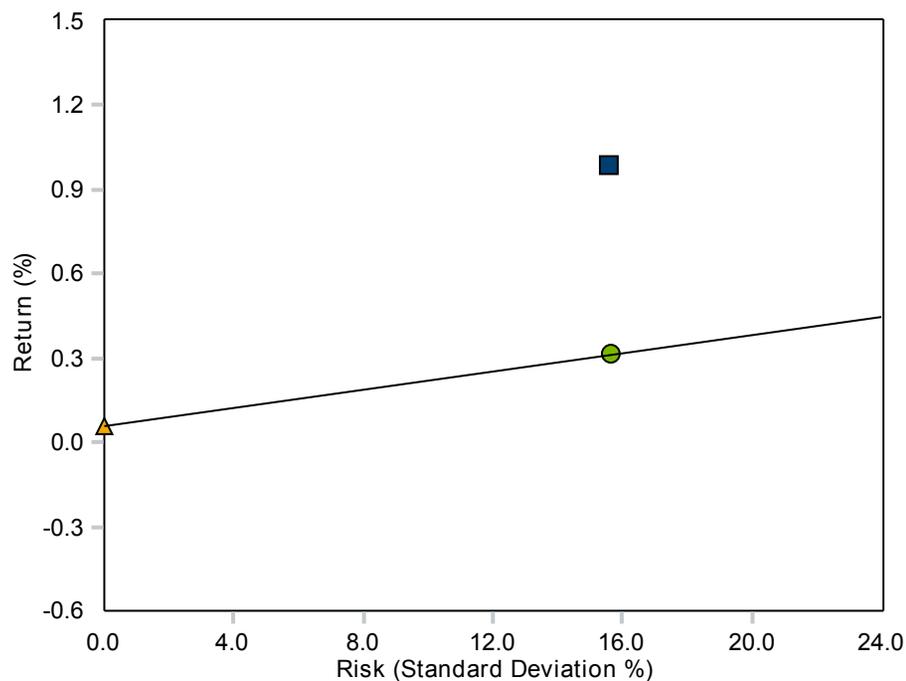


Ratio of Cumulative Wealth - 10 Years



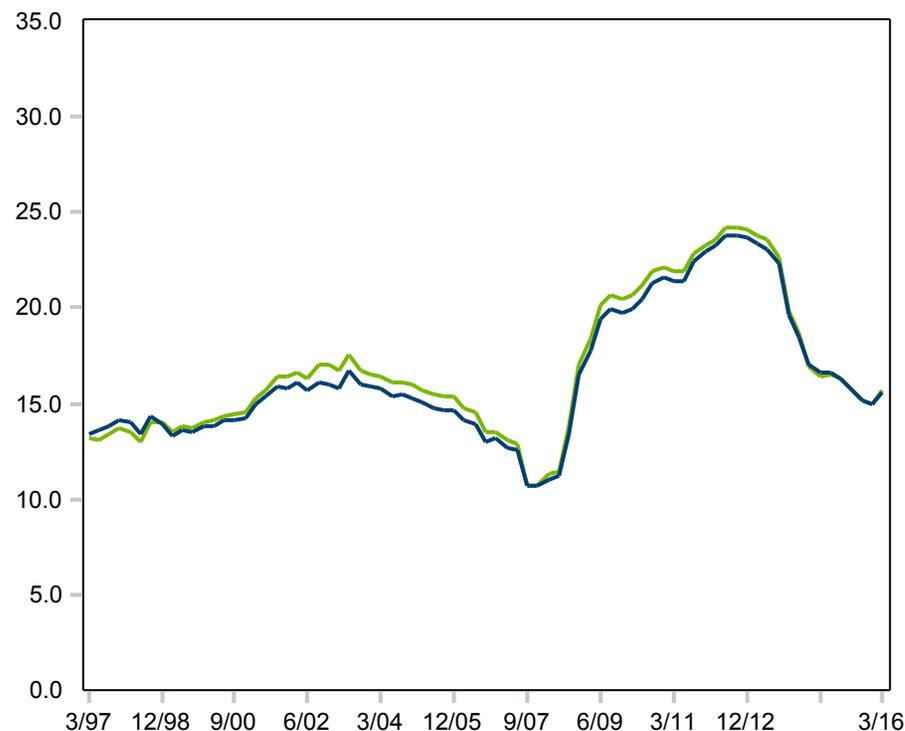
International Equity Risk Profile

Annualized Return vs. Annualized Standard Deviation 5 Years



- International Equity
- International Equity Benchmark
- ▲ Citigroup 3 Month T-Bill

Rolling 5 Years Standard Deviation



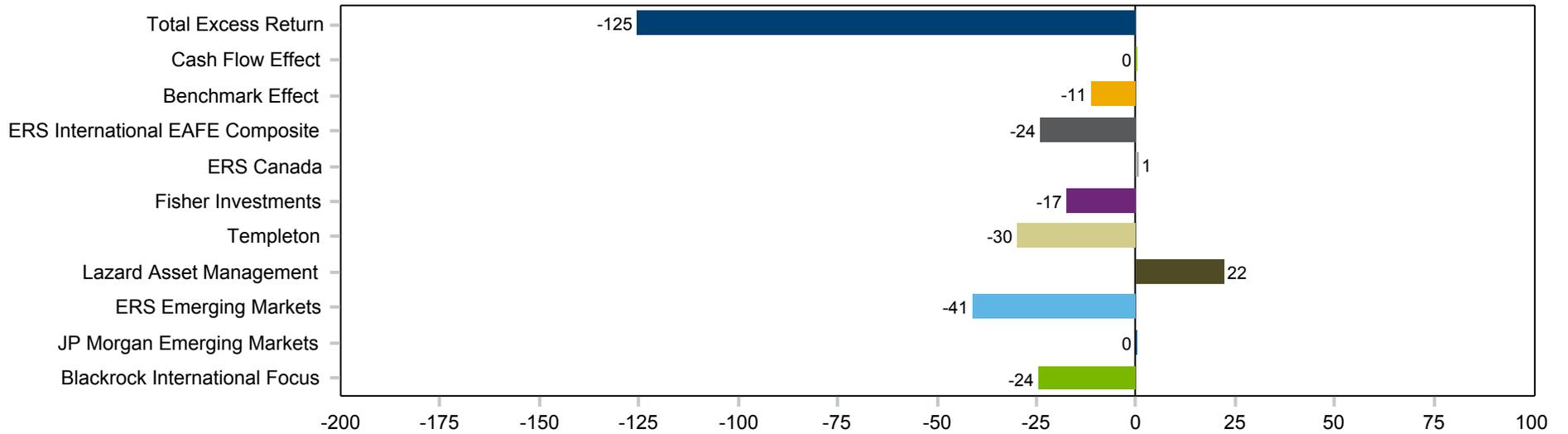
- International Equity
- International Equity Benchmark

5 Years Historical Statistics

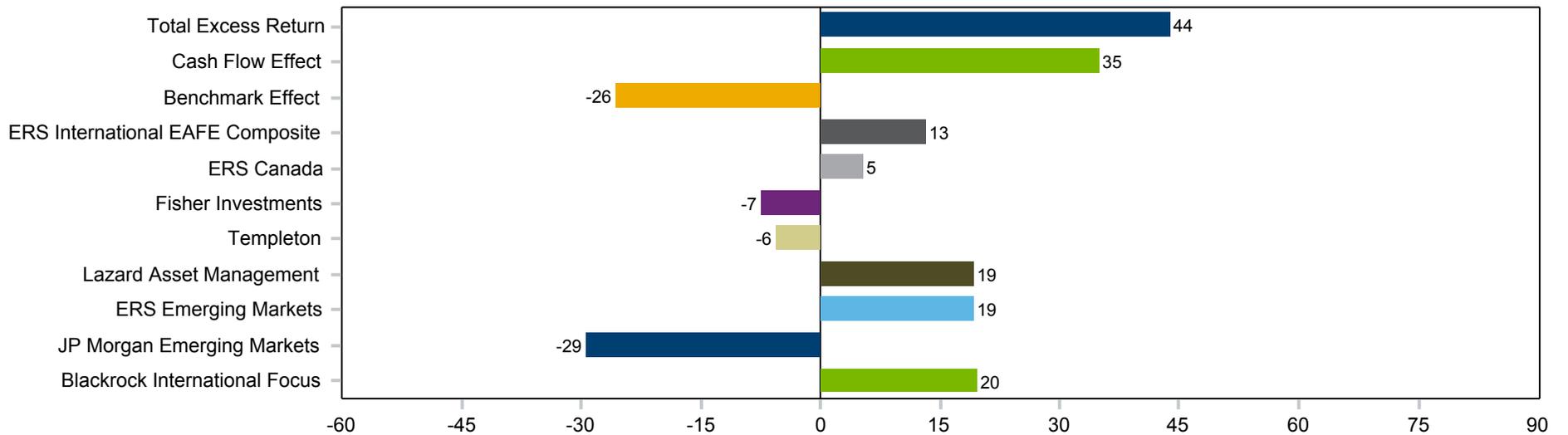
	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
International Equity	0.66	1.24	0.53	0.99	0.14	0.67	0.99	0.98	15.62	1.00
International Equity Benchmark	0.00	0.00	N/A	1.00	0.09	0.00	1.00	0.31	15.68	1.00
Citigroup 3 Month T-Bill	-1.47	15.68	-0.09	0.01	N/A	0.06	0.00	0.06	0.02	0.12

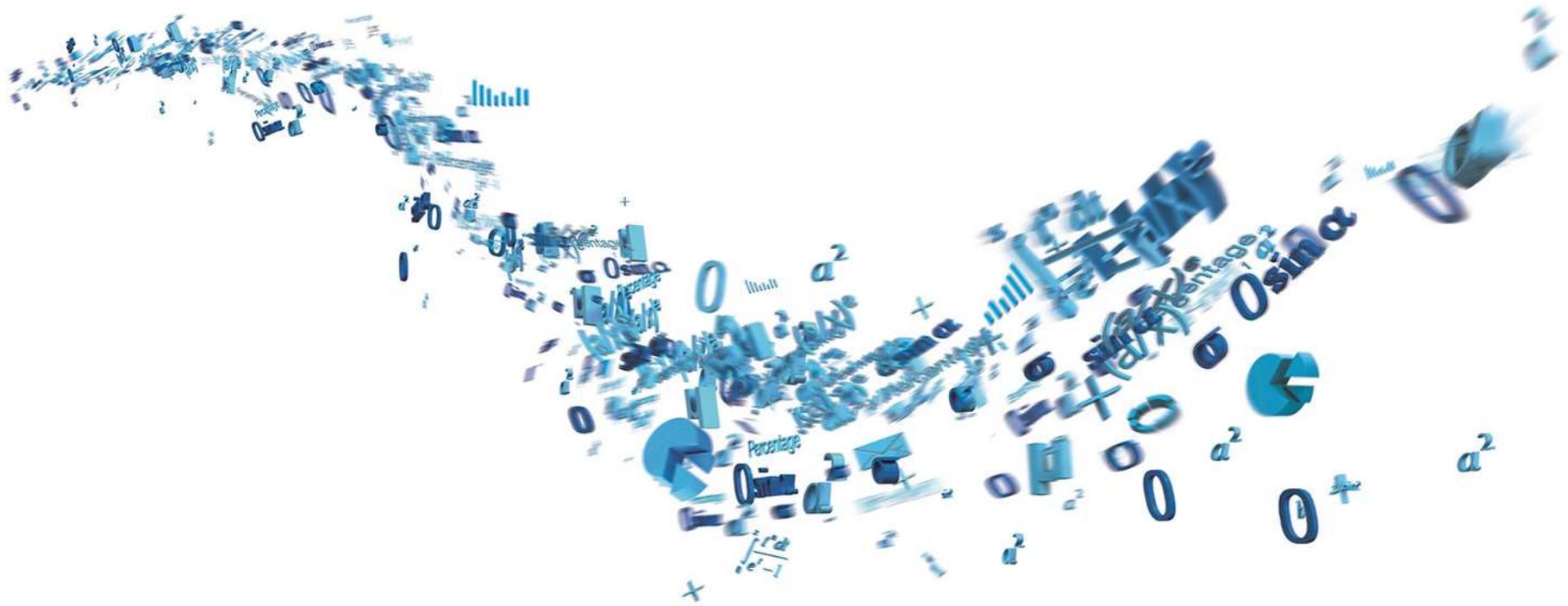
Asset Class Attribution

1 Quarter



1 Year





Private Equity

Overview

	Internal Rate of Return(%)			
	1 Year	3 Years	5 Years	Since Inception
Private Equity	6.7	11.9	11.6	10.9

Private Equity Program Summary by Fiscal Year as of 3/31/2016

ERS FY	# of Deals	Capital Committed	Capital Called	Distributions	Market Value
1999	1	\$100,000,000	\$88,405,114	\$129,578,992	\$0
2007	1	\$60,585,106	\$57,113,042	\$113,638,553	\$4,209,077
2008	3	\$197,620,000	\$227,519,359	\$221,541,281	\$145,659,531
2009	12	\$913,503,800	\$977,914,749	\$694,249,947	\$647,606,289
2010	7	\$463,590,000	\$466,584,657	\$263,884,062	\$314,149,249
2011	9	\$649,900,000	\$557,878,823	\$231,889,668	\$422,024,389
2012	7	\$501,849,443	\$355,309,759	\$105,427,016	\$372,121,516
2013	7	\$483,631,348	\$290,451,206	\$28,791,140	\$284,584,583
2014	13	\$1,189,526,857	\$489,578,611	\$37,905,240	\$475,164,884
2015	11	\$1,024,485,000	\$195,350,279	\$29,695,831	\$186,359,894
2016	4	\$296,672,087	\$41,285,716	\$0	\$41,129,163
Total	75	\$5,881,363,641	\$3,747,391,315	\$1,856,601,732	\$2,893,008,573

*Internal Rate of Return figures include market value adjustments made after 3/31/2016.

*Total portfolio market value includes FX contracts and STIF balance.

Overview

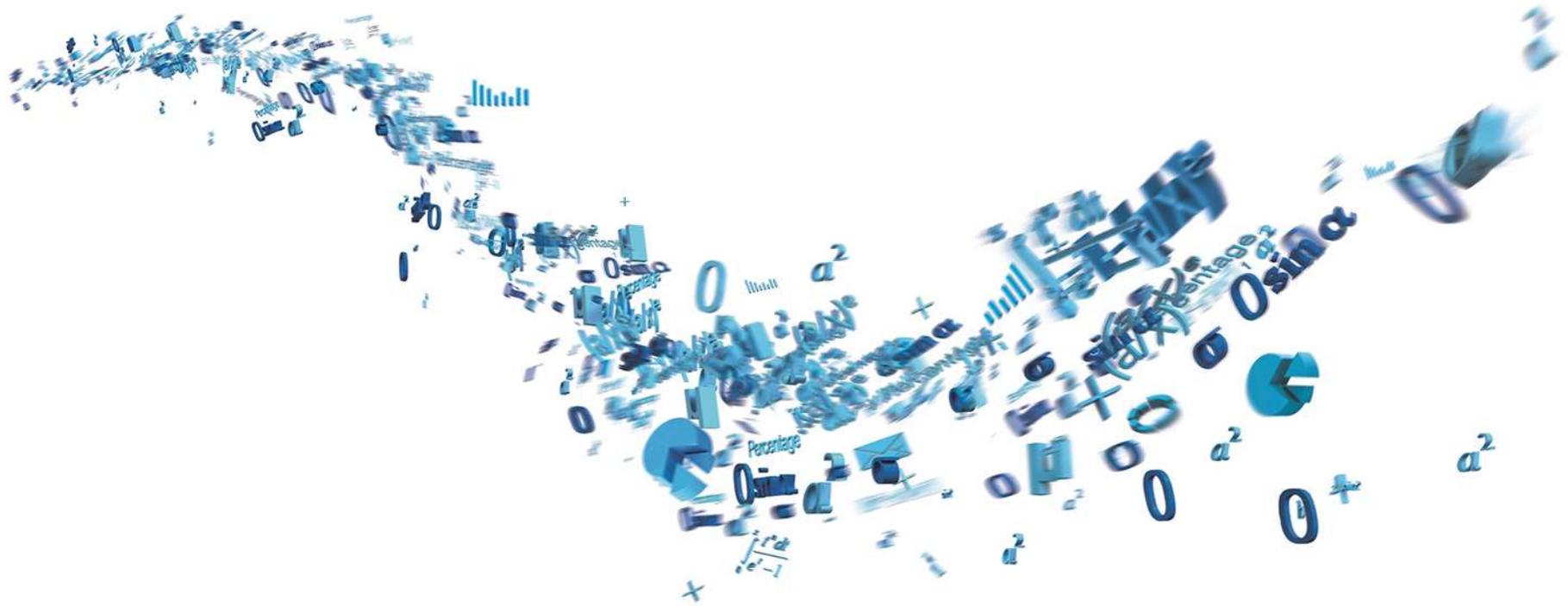
Private Equity Program Summary By Fund as of 3/31/2016

Deal #	Fund Name	ERS FY	Commitment Date	Capital Committed	Capital Called	Distributions	Market Value
1	Texas Growth Fund II	1999	December-98	\$100,000,000			
2	Southwest Opps Partners LP	2007	May-07	\$60,585,106			
3	New Mountain Partners III, L.P.	2008	November-07	\$60,000,000			
4	Carlyle Partners V, L.P.	2008	March-08	\$100,000,000			
5	Advent International GPE VI-C, L.P.	2008	March-08	\$37,620,000			
6	Brazos Equity Fund III, L.P.	2009	September-08	\$37,500,000			
7	Wind Point Partners VII, L.P.	2009	October-08	\$65,000,000			
8	Charterhouse Capital Partners IX, L.P.	2009	December-08	\$60,420,000			
9	CVC European Equity Partners V (B) LP	2009	December-08	\$89,683,800			
10	Hellman & Friedman Capital Partners VII, L.P.	2009	January-09	\$100,000,000			
11	Navis Asia Fund VI, L.P.	2009	February-09	\$60,000,000			
12	TA Subordinated Debt Fund III, L.P.	2009	April-09	\$50,000,000			
13	TA XI, L.P.	2009	April-09	\$100,000,000			
14	Riverside Capital Appreciation Fund V, L.P.	2009	April-09	\$100,000,000			
15	Triton Fund III, LP	2009	July-09	\$68,400,000			
16	Lexington Capital Partners VII, L.P.	2009	August-09	\$100,000,000			
17	Littlejohn Fund IV, L.P.	2009	August-09	\$82,500,000			
18	Quantum Energy Partners V, L.P.	2010	September-09	\$75,000,000			
19	HG Capital 6	2010	October-09	\$64,800,000			
20	LGT Crown Global Secondaries II PLC	2010	February-10	\$75,000,000			
21	Mason Wells Buyout Fund III, L.P.	2010	February-10	\$65,000,000			
22	Advent Latin America Fund V-H ,L.P.	2010	March-10	\$50,000,000			
23	Riverside Europe Fund IV, L.P.	2010	March-10	\$83,790,000			
24	Southern Cross Latin America PE Fund IV, L.P.	2010	July-10	\$50,000,000			
25	Baring Asia Private Equity Fund V, L.P.	2011	November-10	\$50,000,000			
26	ERS Private Equity Emerging Manager Fund I, L.P.	2011	December-10	\$50,000,000			
27	Euroknights VI No. 1 LP	2011	January-11	\$39,900,000			
28	Gores Capital Partners III L.P.	2011	January-11	\$100,000,000			
29	Private Equity International Fund I, LP	2011	March-11	\$165,000,000			
30	KSL Capital Partners III L.P.	2011	July-11	\$95,000,000			
31	Summer Street Capital III, LP	2011	July-11	\$50,000,000			
32	Longitude Venture Partners II LP	2011	August-11	\$50,000,000			
33	RLH Investors III, LP	2011	August-11	\$50,000,000			
34	LGT Crown Global Secondaries III PLC	2012	October-11	\$100,000,000			
35	HitecVision VI, L.P.	2012	November-11	\$70,000,000			
36	Frontier Fund III LP	2012	December-11	\$50,000,000			
37	Advent International GPE VII-C LP	2012	June-12	\$100,000,000			

Overview

Private Equity Program Summary By Fund as of 3/31/2016

Deal #	Fund Name	ERS FY	Commitment Date	Capital Committed	Capital Called	Distributions	Market Value
38	Castlelake II, LP	2012	July-12	\$75,000,000			
39	Court Square Capital Partners III, L.P.	2012	August-12	\$75,000,000			
40	Private Equity Co-Investments 2012	2012	Various	\$31,849,443			
41	Southern Cross Latin America Fund IV, L.P. (Secondary)	2013	September-12	\$25,000,000			
42	Riverside Capital Appreciation Fund VI, L.P.	2013	December-12	\$100,000,000			
43	HGCapital 7 A L.P.	2013	March-13	\$86,400,000			
44	Blue Wolf Capital Fund III, LP	2013	April-13	\$50,000,000			
45	Triton Fund IV LP	2013	April-13	\$79,800,000			
46	CVC Capital Partners VI (B) L.P.	2013	July-13	\$80,940,000			
47	Private Equity Co-Investments 2013	2013	Various	\$61,491,348			
48	Industry Ventures Secondary VII	2014	October-13	\$40,000,000			
49	Industry Ventures Special Opportunities II	2014	October-13	\$47,500,000			
50	KSL Credit Opportunities Fund I	2014	December-13	\$50,000,000			
51	Navis Asia Fund VII LP	2014	December-13	\$125,000,000			
52	Triton Debt Opportunities Fund I US LP	2014	January-14	\$42,180,000			
53	Castlelake III LP	2014	February-14	\$100,000,000			
54	HitecVision VII LP	2014	April-14	\$70,000,000			
55	Cotton Creek Capital Partners II LP	2014	May-14	\$31,500,000			
56	Energy & Minerals Group Fund III LP	2014	June-14	\$80,471,000			
57	Carlyle Global Financial Services Partners II LP	2014	June-14	\$100,000,000			
58	ERS Private Equity International II, L.P.	2014	June-14	\$300,000,000			
59	Quantum Energy Partners VI LP	2014	June-14	\$100,000,000			
60	Private Equity Co-Investments 2014	2014	Various	\$102,875,857			
61	Hellman & Friedman Capital Partners VIII, L.P.	2015	September-14	\$110,000,000			
62	Baring Asia Private Equity Fund VI, L.P.	2015	October-14	\$75,000,000			
63	Landmark Equity Partners XV LP	2015	October-14	\$175,000,000			
64	Landmark TX ERS Co-Investment Fund I, L.P.	2015	October-14	\$125,000,000			
65	ERS Private Equity Emerging Manager Fund II LP	2015	December-14	\$50,000,000			
66	KSL Capital Partners IV, LP	2015	January-15	\$125,000,000			
67	Frontier Fund IV, L.P.	2015	February-15	\$60,000,000			
68	Carlyle Energy Mezzanine Opportunities Fund II, LP	2015	March-15	\$85,000,000			
69	TA XII- A, L.P.	2015	June-15	\$125,000,000			
70	Private Equity Co-Investments 2015	2015	Various	\$69,485,000			
71	TA Subordinated Debt Fund IV, L.P.	2015	July-15	\$25,000,000			
72	Castlelake IV, L.P.	2016	September-15	\$100,000,000			
73	Private Equity Co-Investments 2016	2016	Various	\$26,672,087			
74	Southern Cross Latin America Private Equity Fund V, LP	2016	October-15	\$60,000,000			
75	Advent International GPE VIII-B-1, L.P.	2016	February-16	\$110,000,000			
Total				\$5,881,363,641	\$3,747,391,315	\$1,856,601,732	\$2,893,008,573

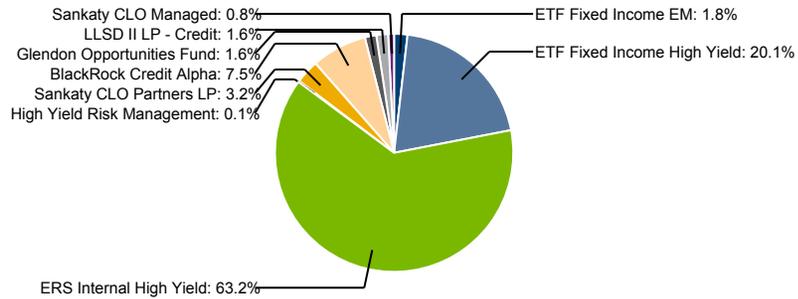


Global Credit

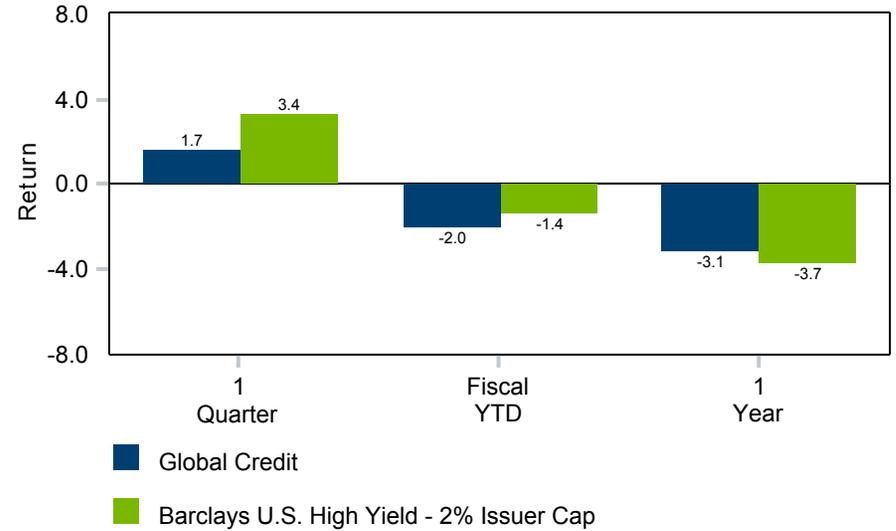
Global Credit Portfolio Overview

Current Allocation

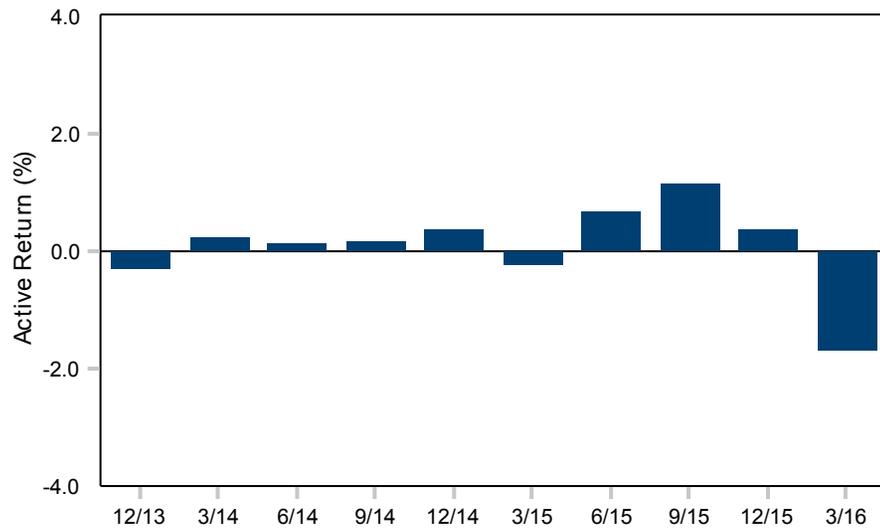
March 31, 2016 : \$1,737M



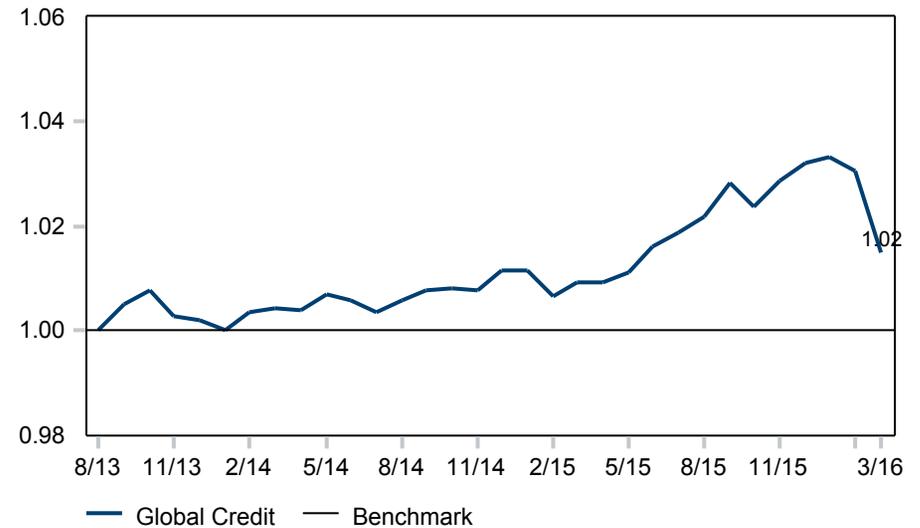
Return Summary



Quarterly Excess Performance

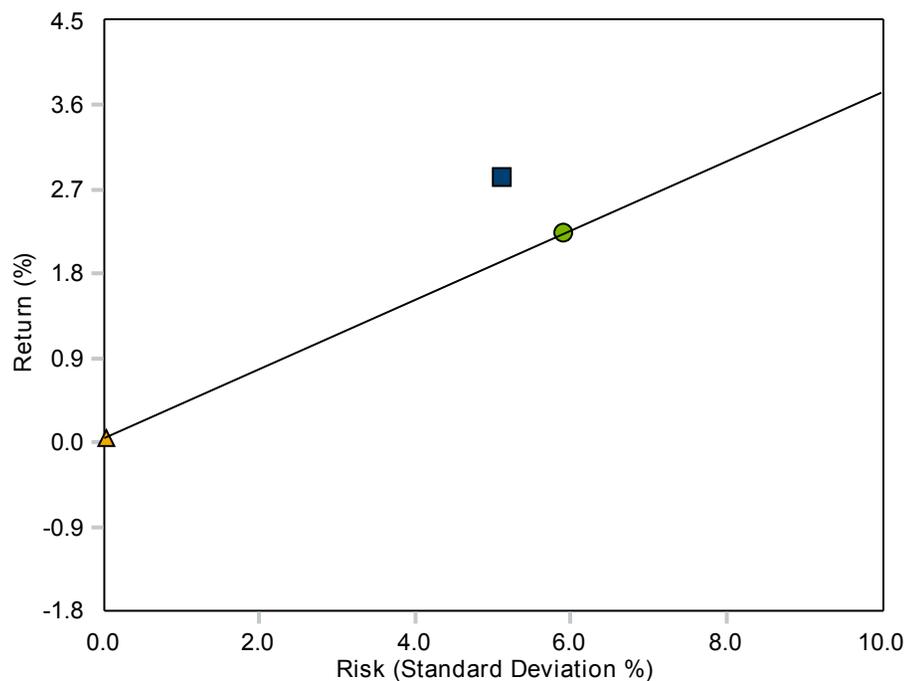


Ratio of Cumulative Wealth - Since Inception



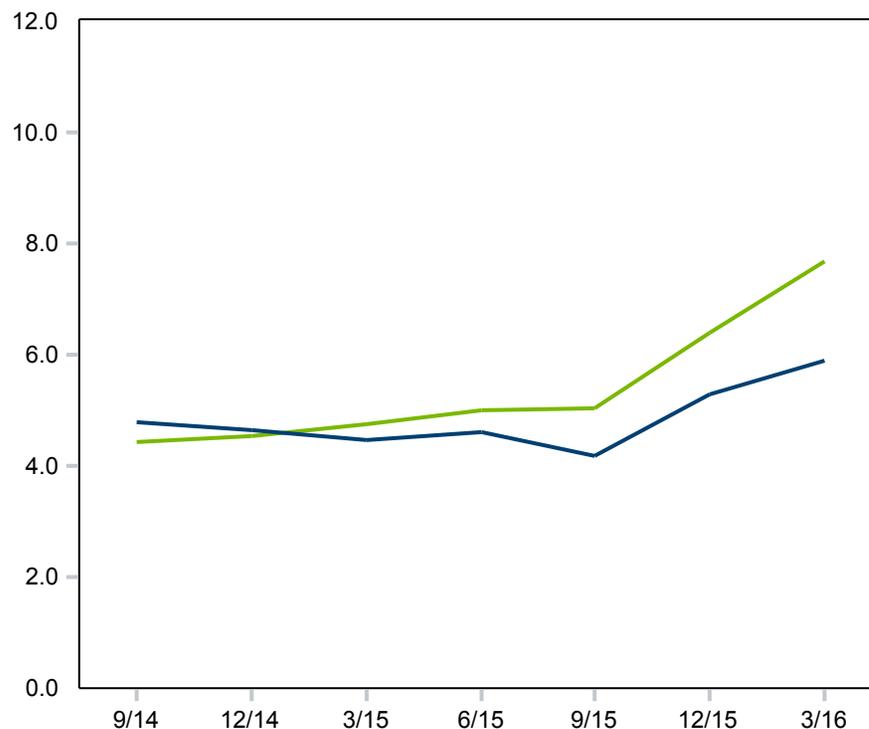
Global Credit Risk Profile

Annualized Return vs. Annualized Standard Deviation Since 9/1/2013



- Global Credit
- Barclays U.S. High Yield - 2% Issuer Cap
- ▲ Citigroup 3 Month T-Bill

Rolling 1 Year Standard Deviation



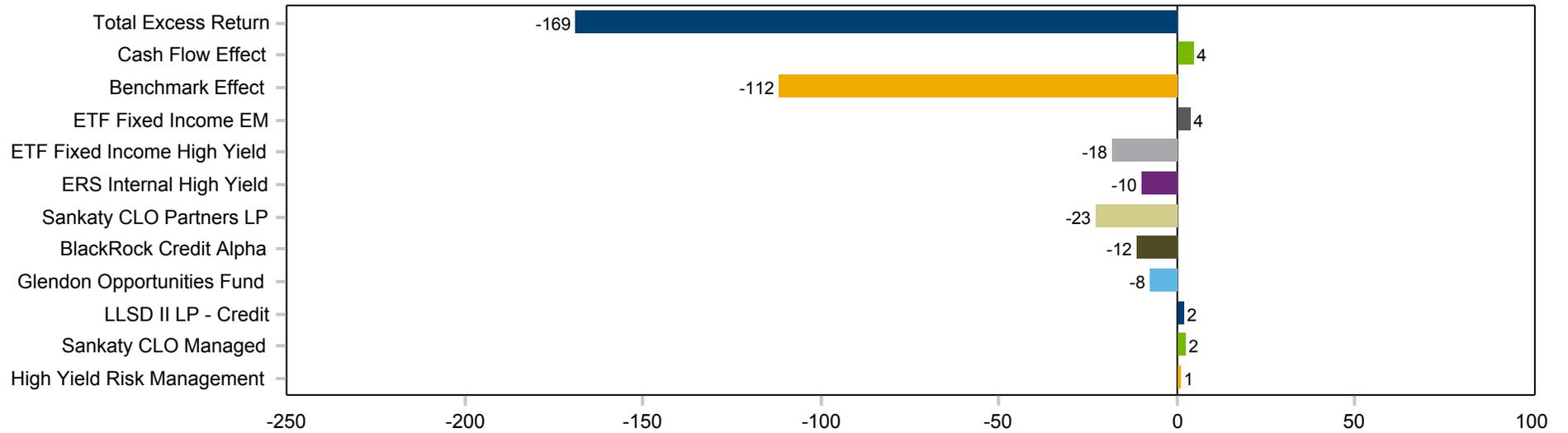
- Global Credit
- Barclays U.S. High Yield - 2% Issuer Cap

Historical Statistics Since 9/1/2013

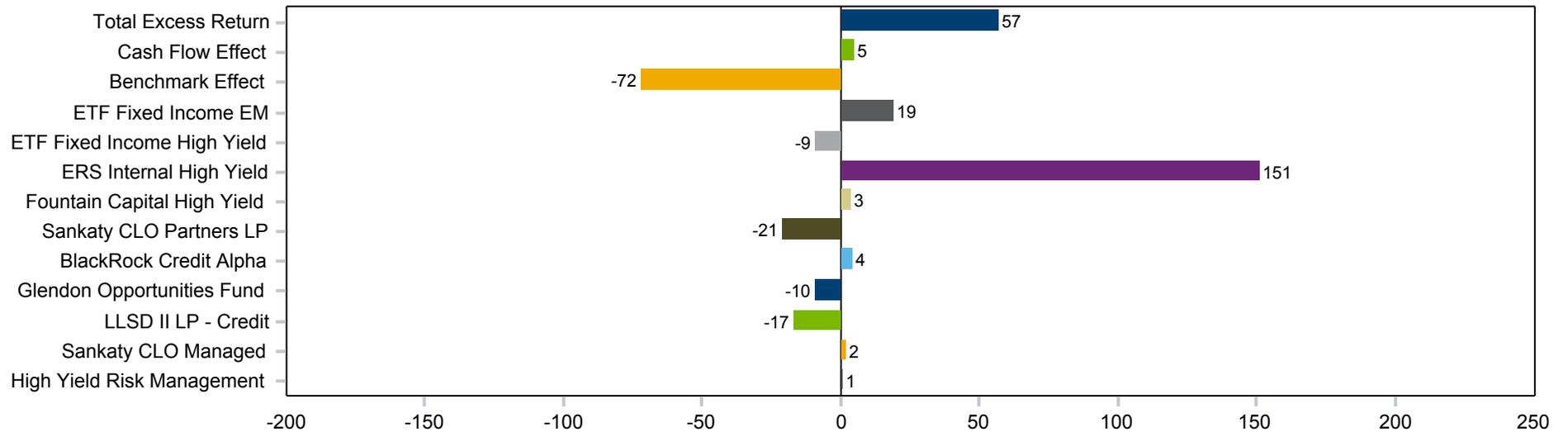
	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Global Credit	0.54	1.45	0.37	0.95	0.56	0.91	0.85	2.83	5.14	0.98
Barclays U.S. High Yield - 2% Issuer Cap	0.00	0.00	N/A	1.00	0.39	0.00	1.00	2.23	5.92	1.00
Citigroup 3 Month T-Bill	-2.33	5.91	-0.39	0.05	N/A	0.04	0.00	0.04	0.02	0.22

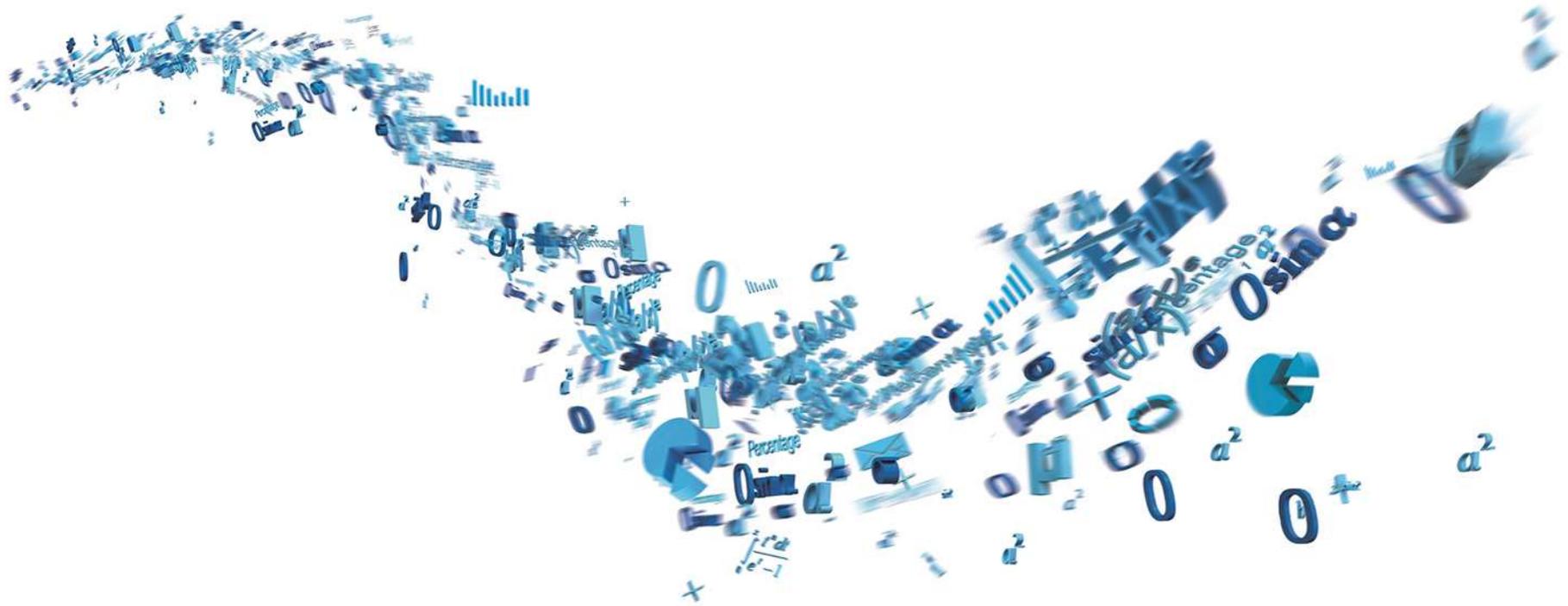
Asset Class Attribution

1 Quarter



1 Year

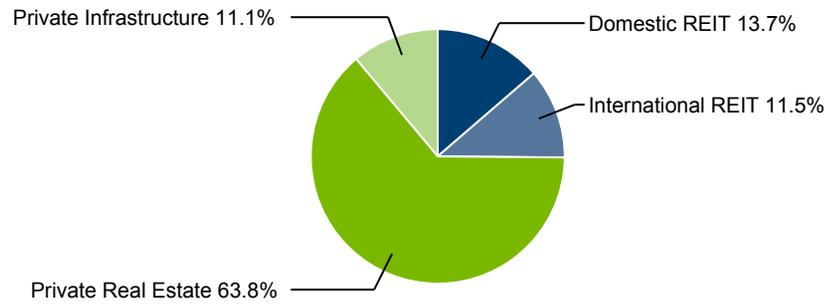




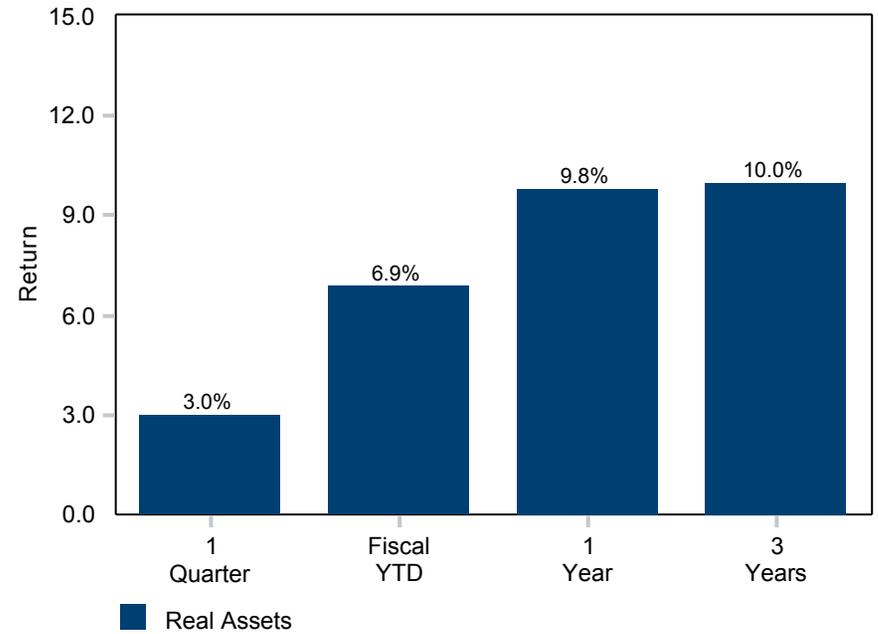
Real Assets

Real Assets Portfolio Overview

Current Allocation
March 31, 2016 : \$2,909M



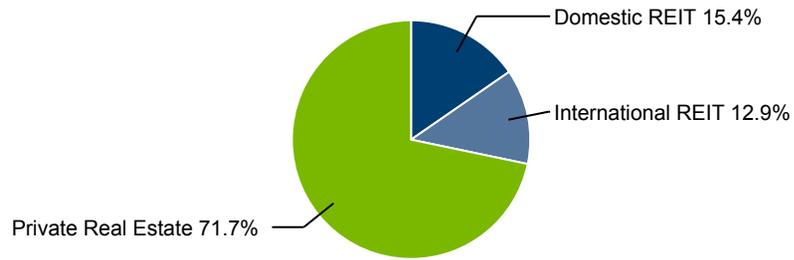
Return Summary



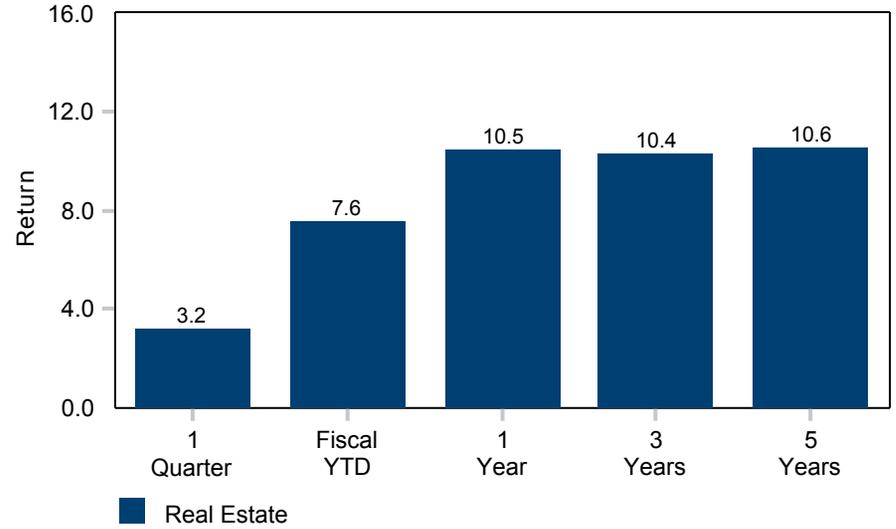
*Actual performance since 8/31/13, longer performance history was created synthetically

Real Estate Portfolio Overview

Current Allocation
March 31, 2016 : \$2,585M

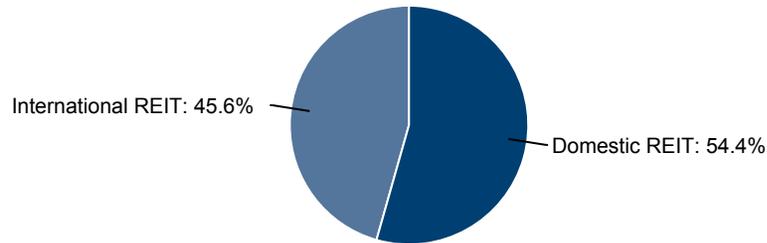


Return Summary

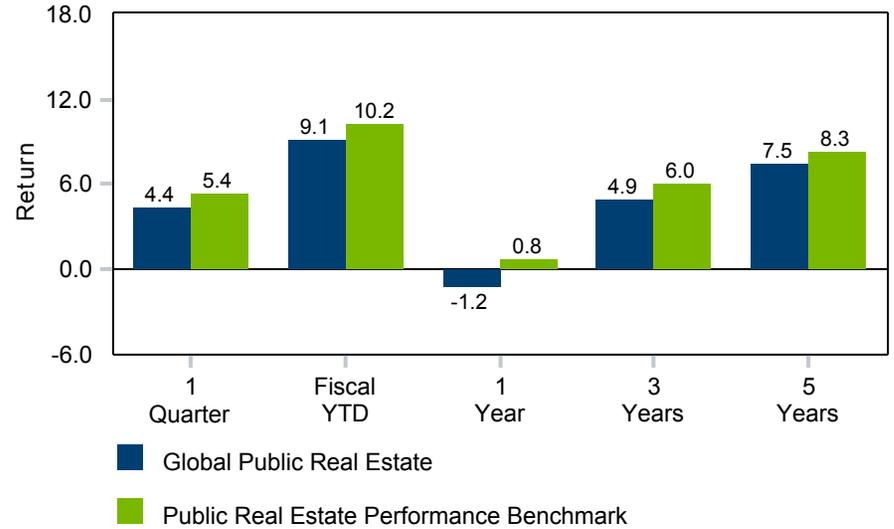


Global Public Real Estate Portfolio Overview

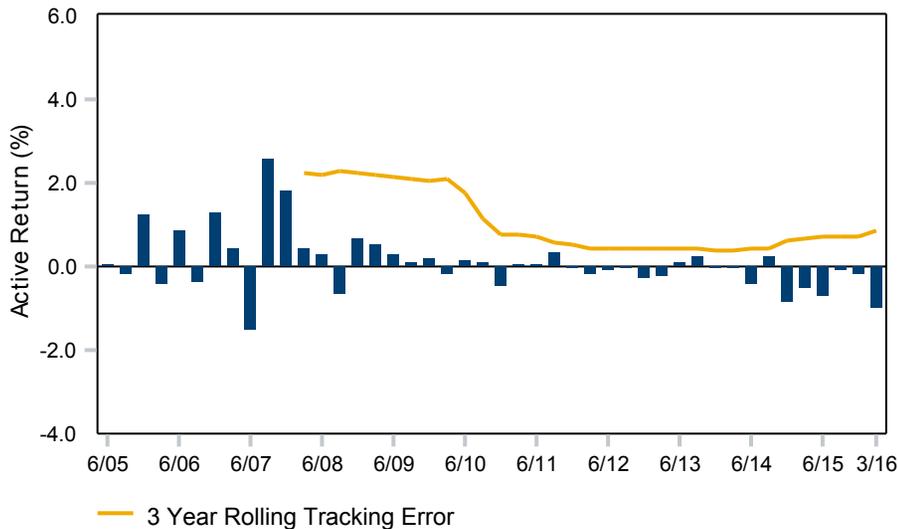
Current Allocation
March 31, 2016 : \$731M



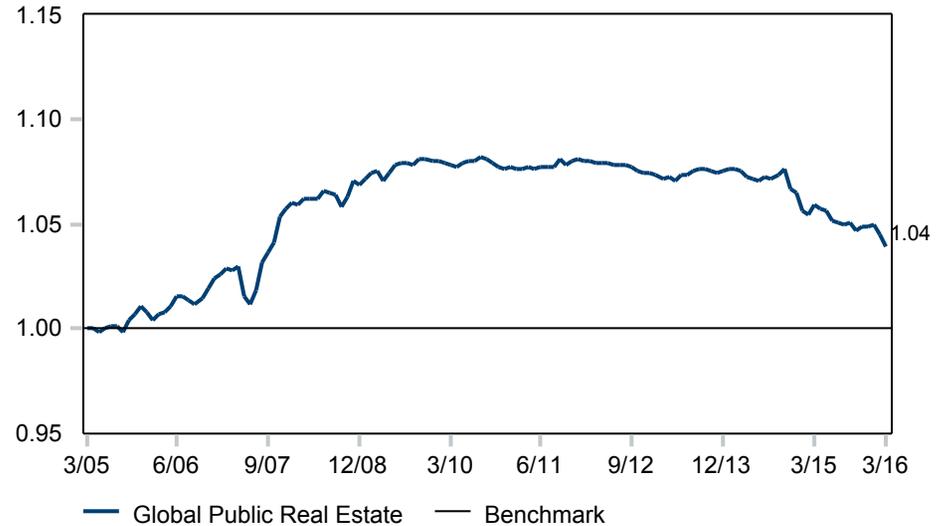
Return Summary



Quarterly Excess Performance

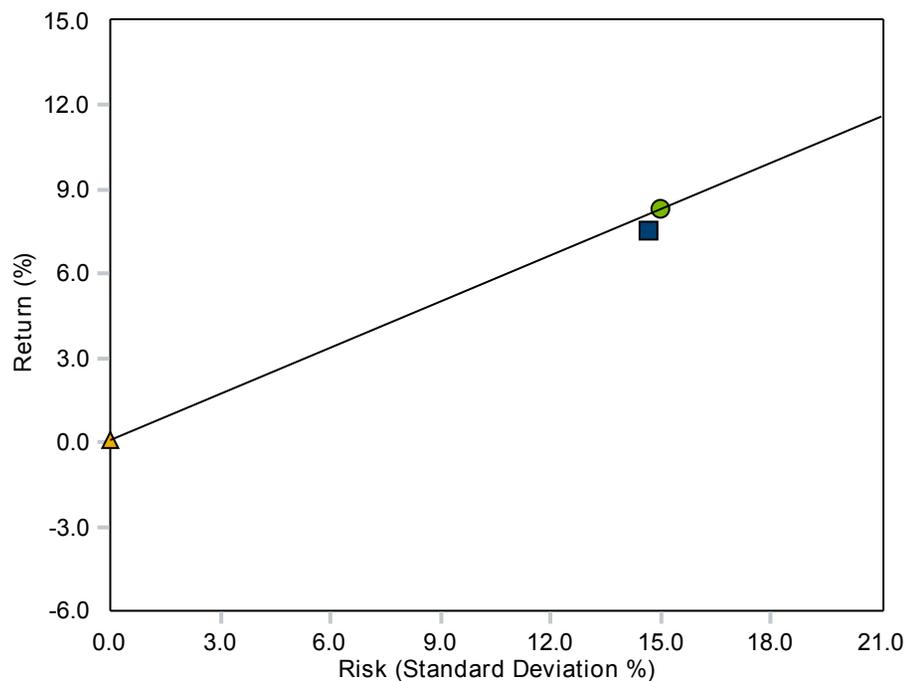


Ratio of Cumulative Wealth - Since Inception



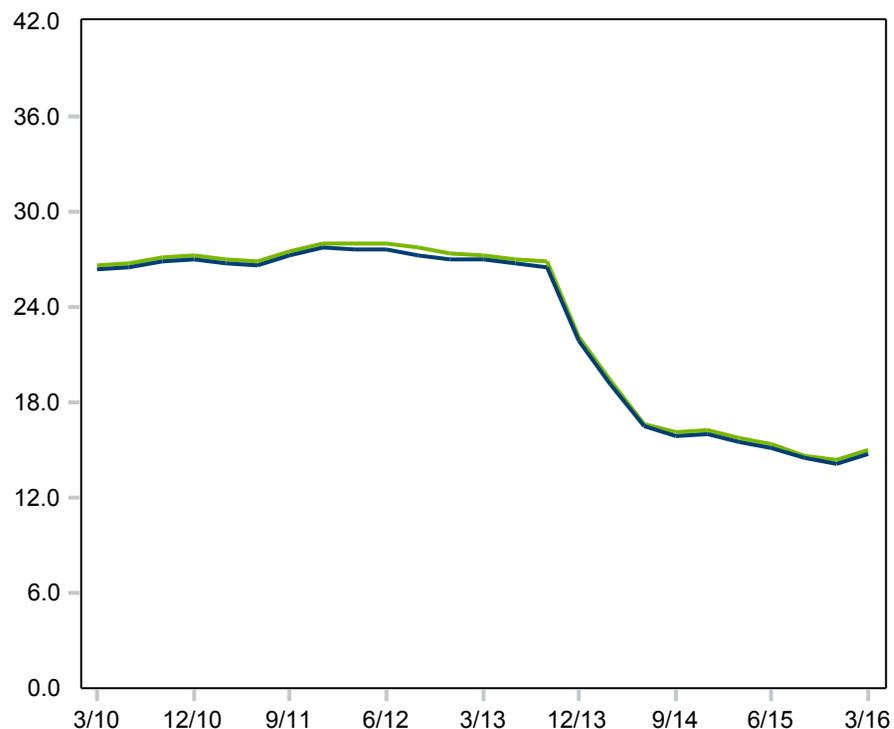
Global Public Real Estate Risk Profile

Annualized Return vs. Annualized Standard Deviation 5 Years



- Global Public Real Estate
- Public Real Estate Performance Benchmark
- ▲ Citigroup 3 Month T-Bill

Rolling 5 Years Standard Deviation



- Global Public Real Estate
- Public Real Estate Performance Benchmark

5 Years Historical Statistics

	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Global Public Real Estate	-0.76	0.81	-0.93	1.00	0.56	-0.57	0.98	7.51	14.69	1.00
Public Real Estate Performance Benchmark	0.00	0.00	N/A	1.00	0.60	0.00	1.00	8.28	14.98	1.00
Citigroup 3 Month T-Bill	-9.03	14.98	-0.60	0.03	N/A	0.05	0.00	0.06	0.02	0.17

Overview

	Internal Rate of Return(%)			
	1 Year	3 Years	5 Years	Since Inception
Private Real Estate	11.1	12.9	12.7	12.7

Private Real Estate Program Summary by Fiscal Year as of 3/31/2016

ERS FY	# of Deals	Capital Committed	Capital Called	Distributions	Market Value
2010	2	\$136,300,000	\$135,188,800	\$48,055,570	\$146,442,227
2011	7	\$599,900,000	\$618,651,054	\$335,902,340	\$559,892,857
2012	7	\$496,900,000	\$506,634,400	\$235,772,335	\$444,775,557
2013	5	\$416,060,000	\$321,666,149	\$174,776,279	\$232,212,058
2014	10	\$494,080,000	\$357,088,255	\$79,849,366	\$293,728,518
2015	8	\$466,495,248	\$117,982,710	\$14,559,006	\$106,031,301
2016	6	\$191,000,000	\$56,247,693	\$5,900,638	\$49,723,990
Total	45	\$2,800,735,248	\$2,113,459,061	\$894,815,533	\$1,832,806,507

Overview

Private Real Estate Program Summary By Fund as of 3/31/2016

Deal #	Fund Name	ERS FY	Commitment Date	Capital Committed	Capital Called	Distributions	Market Value
1	LaSalle Property Fund	2010	January-10	\$100,000,000			
2	Cornerstone Core Mortgage Fund	2010	May-10	\$36,300,000			
3	TIAA CREF Asset Management Core Property Fund	2011	September-10	\$125,000,000			
4	Madison International Real Estate Liquidity Fund IV	2011	October-10	\$60,000,000			
5	Invesco Core Real Estate	2011	January-11	\$100,000,000			
6	Texas ERS Private Real Estate Emerging Manager I, LP	2011	December-10	\$50,000,000			
7	Waterton Residential Property Venture XI	2011	February-11	\$100,000,000			
8	M&G Real Estate Debt Fund LP*	2011	June-11	\$39,900,000			
9	Prudential US Real Estate Debt Fund	2011	July-11	\$125,000,000			
10	Private Real Estate Emerging Manager I-Abacus	2012	January-12	\$20,000,000			
11	Aberdeen European Opportunities Property Fund of Funds, LLC*	2012	February-12	\$96,900,000			
12	Private Real Estate Emerging Manager I-Exeter	2012	May-12	\$20,000,000			
13	Prologis Targeted U.S. Logistics	2012	April-12	\$125,000,000			
14	Rockpoint Real Estate Fund IV, LP	2012/13	March-12 & March-13	\$137,500,000			
15	Latitude Management, Real Estate Capital III	2012/13	August-12 & August-13	\$100,000,000			
16	Northwood Real Estate Partners, LP	2012	August-12	\$50,000,000			
17	KTR Industrial Fund III	2013	November-12 & August-13	\$120,000,000			
18	Madison International Real Estate Liquidity Fund V	2013	December-12	\$80,000,000			
19	Brookfield Strategic Real Estate Partners B LP	2013	August-13	\$60,000,000			
20	M&G Real Estate Debt Fund II LP*	2013	May-13	\$64,800,000			
21	Prologis European Properties Fund II*	2013/14	August-13 & September-13	\$52,440,000			
22	Lone Star Real Estate Fund III	2014	September-13	\$70,000,000			
23	Torchlight Debt Opportunity Fund IV LLC	2014	October-13	\$35,000,000			
24	Orion European Real Estate Fund IV*	2014	November-13	\$68,400,000			
25	Pennybacker Fund III	2014	December-13	\$15,000,000			
26	Invesco Real Estate Asia Fund	2014/15/16	Jan-14, Feb-15, & Sept-15	\$50,000,000			
27	Campus-Clarion Student Housing Partners, LP	2014	February-14	\$65,000,000			
28	Hammes Partners II, L.P.	2014	February-14	\$50,000,000			
29	Wheellock Street Capital Fund II, LP	2014	April-14	\$47,000,000			
30	True North Real Estate Fund III LP	2014/15	May-14 & August-15	\$100,000,000			
31	DRA Growth & Income Fund VIII, LLC	2014	June-14	\$50,000,000			
32	Abacus Multi-Family Partners III LP	2015	December-14	\$50,000,000			
33	Rockpoint Real Estate Fund V LP	2015	January-15	\$100,000,000			
34	Waterton Residential Property Venture XII	2015	January-15	\$75,000,000			
35	U.S. Self Storage Value Fund I, LLC**	2015/16	February-15 & March-16	\$21,695,173			
36	BPE Asia Real Estate	2015	March-15	\$75,000,000			
37	Brookfield Strategic Real Estate Partners II LP	2015	March-15	\$75,000,000			
38	SRE Opportunity Fund II, L.P.	2015	April-15	\$15,000,000			
39	AMFP II Bartz Co-Investment	2015	July-15	\$5,800,075			
40	Horizon MH Communities Fund I, LP	2015	August-15	\$35,000,000			
41	Alliance Co-Investment, LP	2016	November-15	\$15,000,000			
42	Madison NYC Core Retail Partners, LP	2016	December-15	\$20,000,000			
43	Aviva Inv Re Cap Global Co-Investment***	2016	January-16	-			
44	ERS Private Real Estate Emerging Manager II, L.P.	2016	January-16	\$50,000,000			
45	Xander Investment Management Pte Ltd.	2016	February-16	\$50,000,000			
Total				\$2,800,735,248	\$2,113,459,061	\$894,815,533	\$1,832,806,507

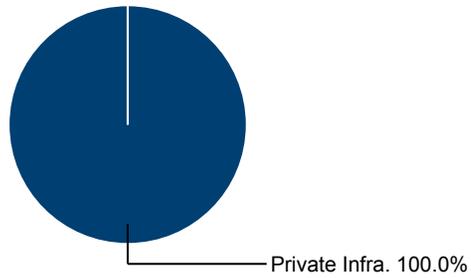
*Amounts in USD as of report date.

**U.S. Self Storage Value Fund I is a separate account, whereby ERS has the choice of whether or not to invest in each deal, causing the commitment amount to increase as deals are approved. Max commitment is \$50,000,000.

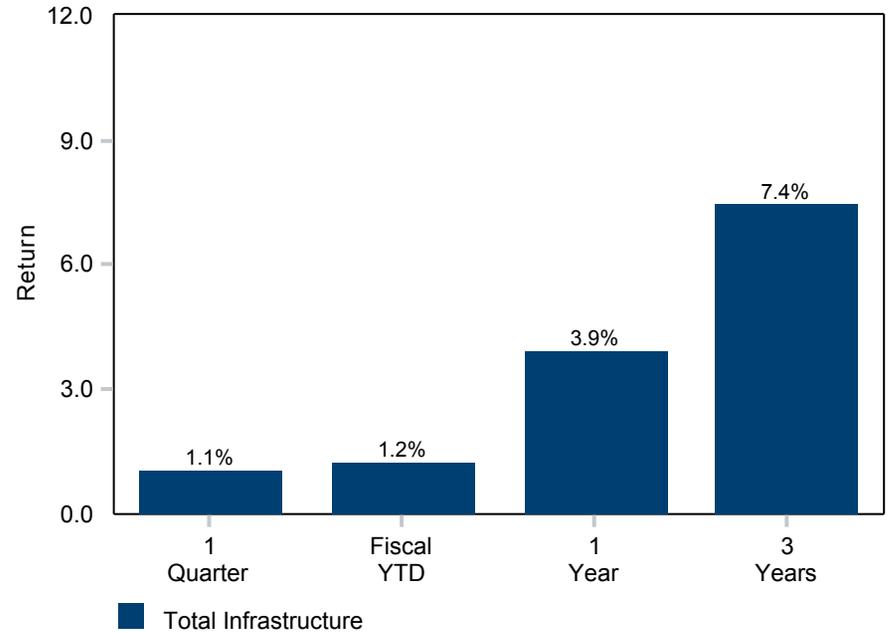
***Aviva Inv Re Cap Global is a co-investment mandate, whereby ERS has the choice of whether or not to invest in each deal, causing the commitment amount to increase as deals are approved. Max commitment is \$60,000,000.

Infrastructure Portfolio Overview

Current Allocation
March 31, 2016 : \$323M



Return Summary¹



¹ Includes returns from Public Infrastructure through 6/30/15.

Overview

	Internal Rate of Return(%)		
	1 Year	3 Years	Since Inception
Private Infrastructure	-23.4	-8.2	-4.8

Private Infrastructure Program Summary by Fiscal Year as of 3/31/2016

ERS FY	# of Deals	Capital Committed	Capital Called	Distributions	Market Value
2012	1	\$70,000,000	\$70,000,000	\$0	\$91,065,000
2013	2	\$205,000,000	\$132,841,819	\$2,445,614	\$159,236,659
2015	2	\$105,000,000	\$42,324,301	\$8,675,346	\$30,112,426
2016	2	\$148,000,000	\$50,477,329	\$7,359,622	\$42,918,469
Total	7	\$528,000,000	\$295,643,449	\$18,480,582	\$323,332,554

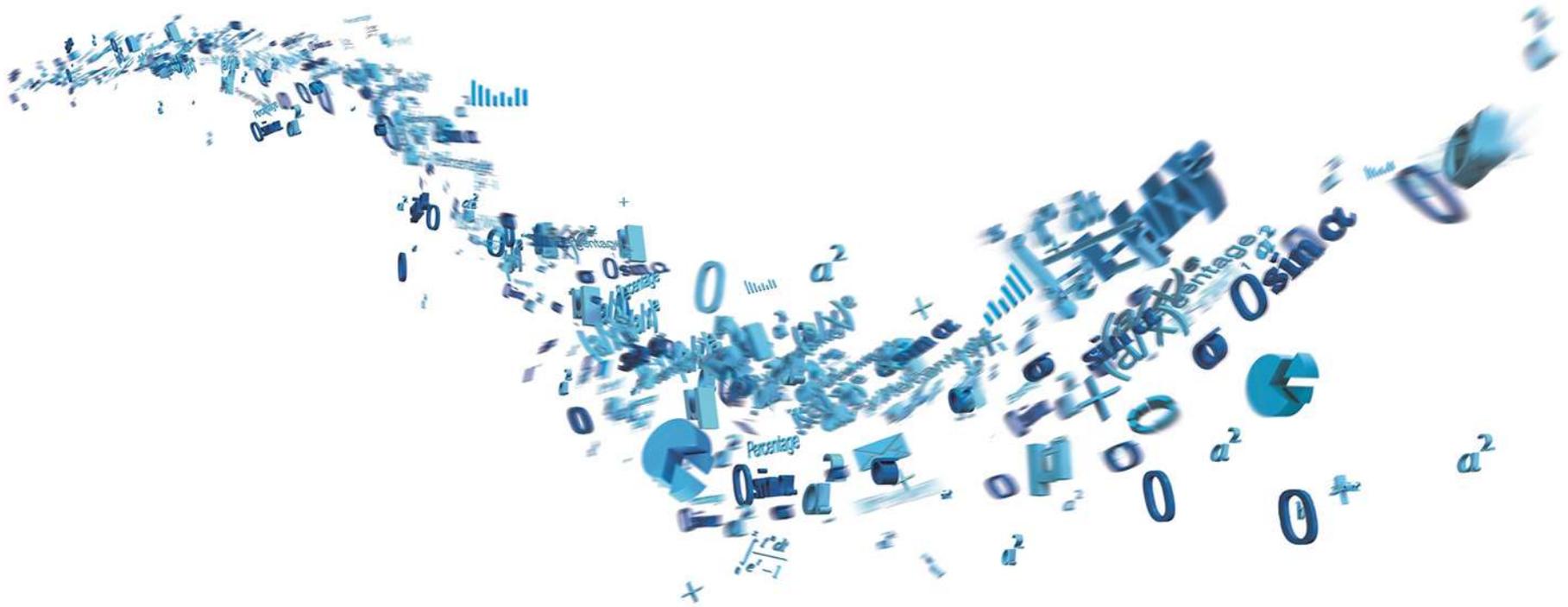
Private Infrastructure Program Summary By Fund as of 3/31/2016

Deal #	Fund Name	ERS FY	Commitment Date	Capital Committed	Capital Called	Distributions	Market Value
1	Infrastructure Co-Investments 2012	2012	June-12	\$70,000,000			
2	Infrastructure Co-Investments 2013	2013	September-12	\$130,000,000			
3	Actis Energy 3 R L.P.	2013	August-13	\$75,000,000			
4	ISQ Global Infrastructure Fund	2015	January-15	\$75,000,000			
5	Infrastructure Co-Investments 2015	2015	March-15	\$30,000,000			
6	Infrastructure Co-Investments 2016	2016	September-15	\$80,000,000			
7	Stonepeak Infrastructure Fund II, LP	2016	November-15	\$68,000,000			
Total				\$528,000,000	\$295,643,449	\$18,480,582	\$323,332,554

*The Market Values above do not include adjustments between March 31, 2016 and the preparation date of this report.

*The IRRs above include all adjustments effective March 31, 2016 that were received from the general partners by the time this report was prepared.

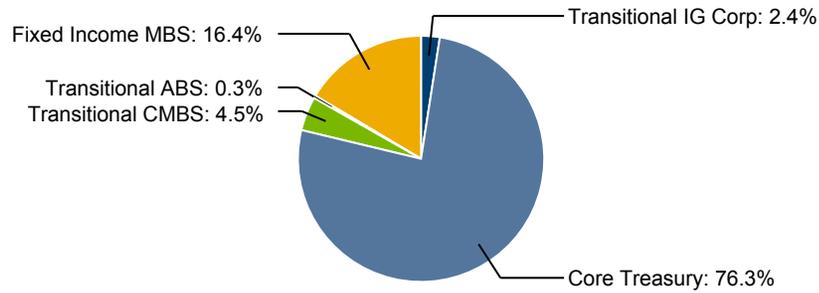
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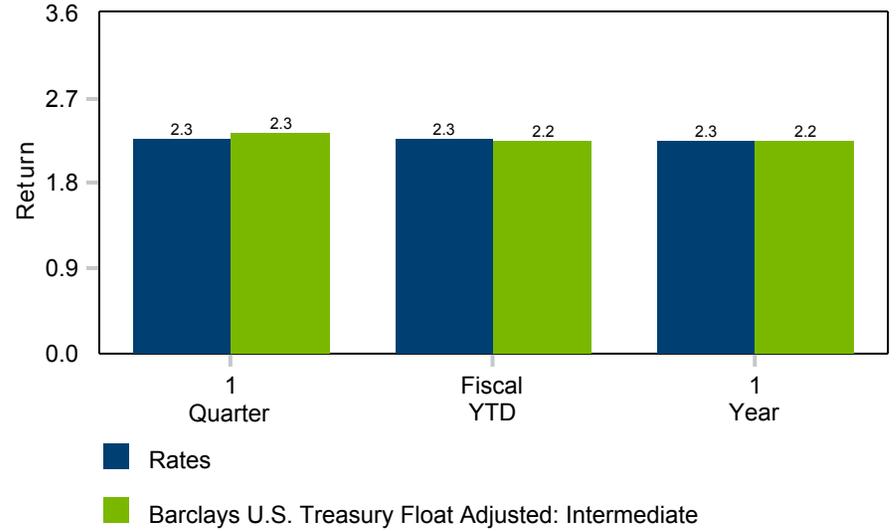
Rates

Total Rates Portfolio Overview

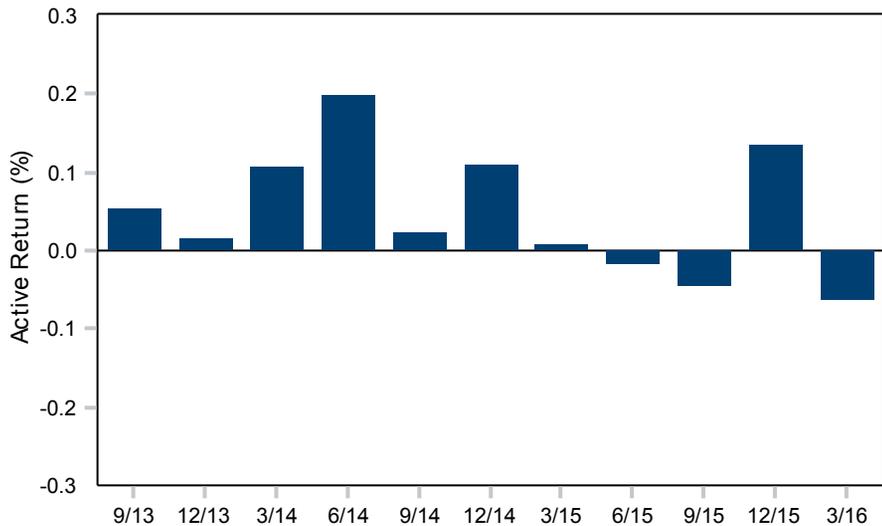
Current Allocation
March 31, 2016 : \$4,012M



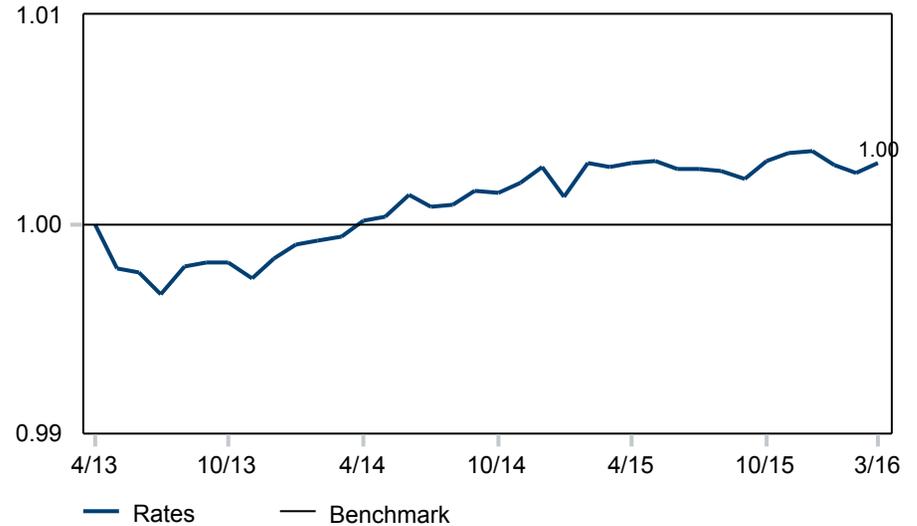
Return Summary



Quarterly Excess Performance

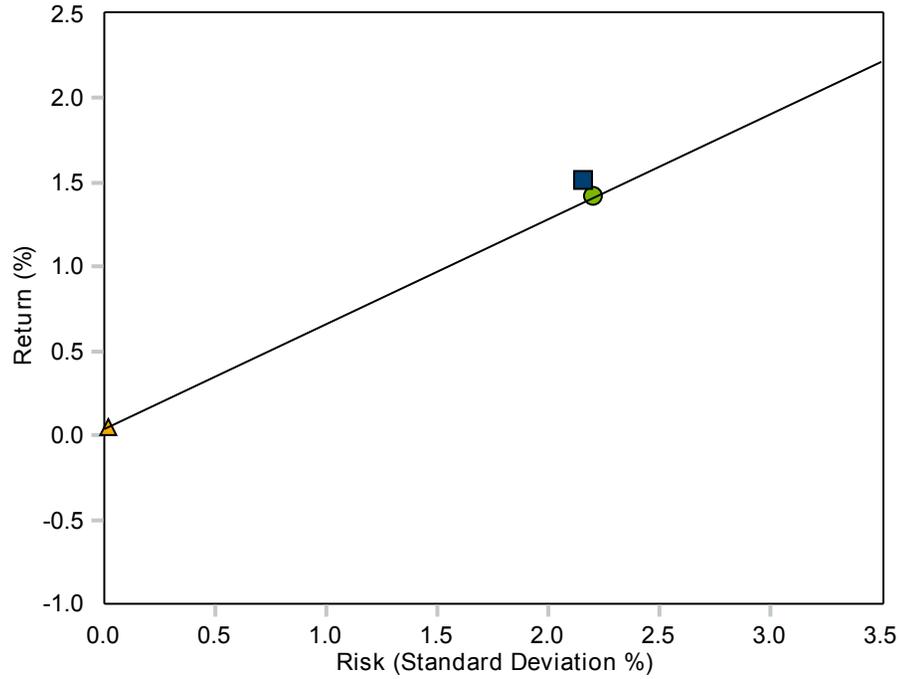


Ratio of Cumulative Wealth - Since Inception



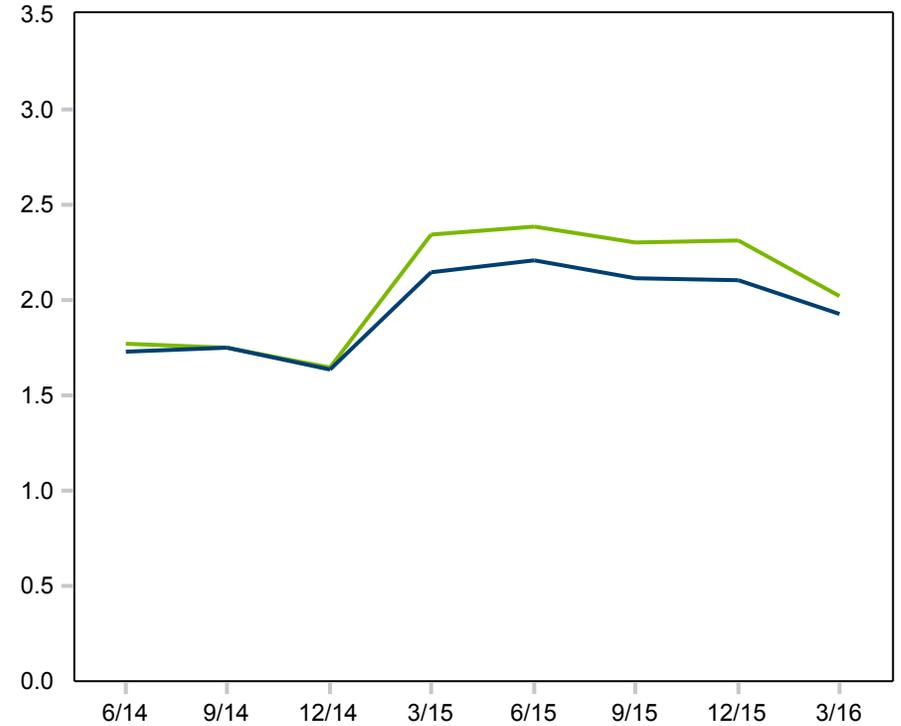
Rates Risk Profile

Annualized Return vs. Annualized Standard Deviation Since 5/1/2013



- Rates
- Barclays U.S. Treasury Float Adjusted: Intermediate
- ▲ Citigroup 3 Month T-Bill

Rolling 1 Year Standard Deviation

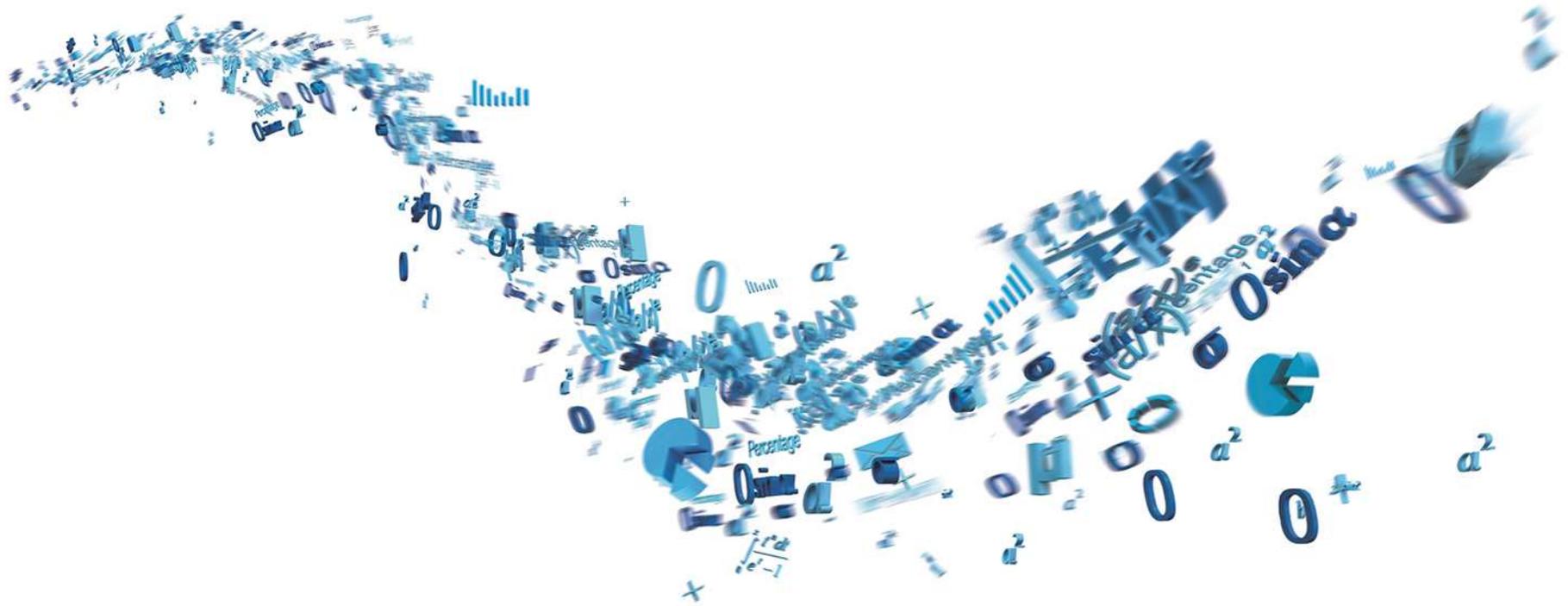


- Rates
- Barclays U.S. Treasury Float Adjusted: Intermediate

Historical Statistics Since 5/1/2013

	Active Return	Tracking Error	Information Ratio	R-Squared	Sharpe Ratio	Alpha	Beta	Return	Standard Deviation	Actual Correlation
Rates	0.10	0.26	0.38	0.99	0.69	0.14	0.97	1.51	2.16	0.99
Barclays U.S. Treasury Float Adjusted: Intermediate	0.00	0.00	N/A	1.00	0.63	0.00	1.00	1.41	2.21	1.00
Citigroup 3 Month T-Bill	-1.38	2.21	-0.63	0.01	N/A	0.04	0.00	0.04	0.02	0.12

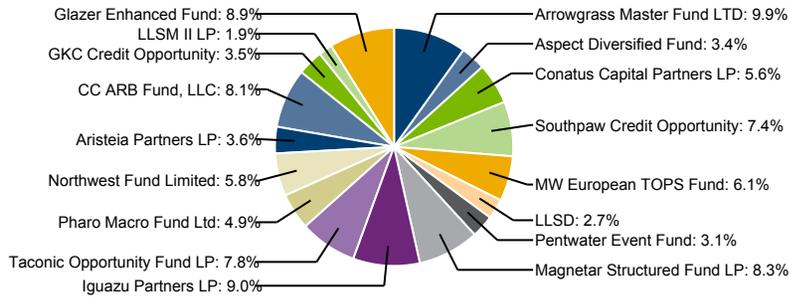
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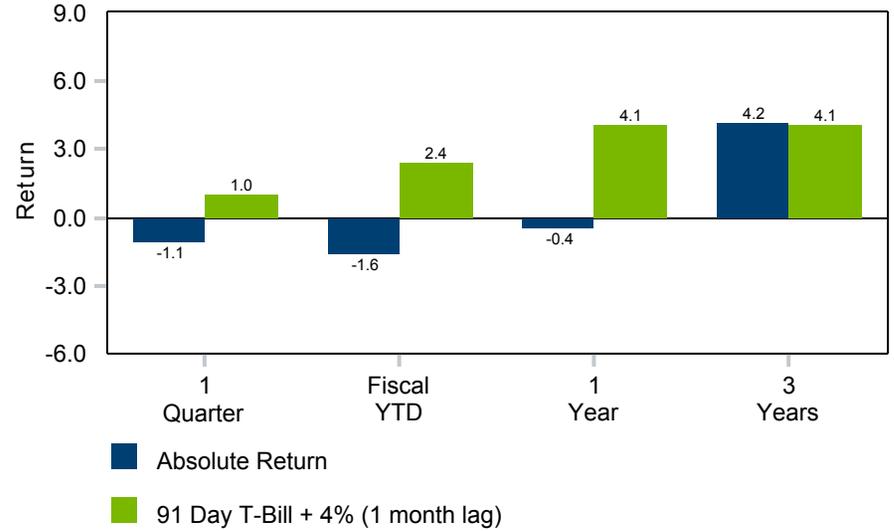
Absolute Return

Absolute Return Portfolio Overview

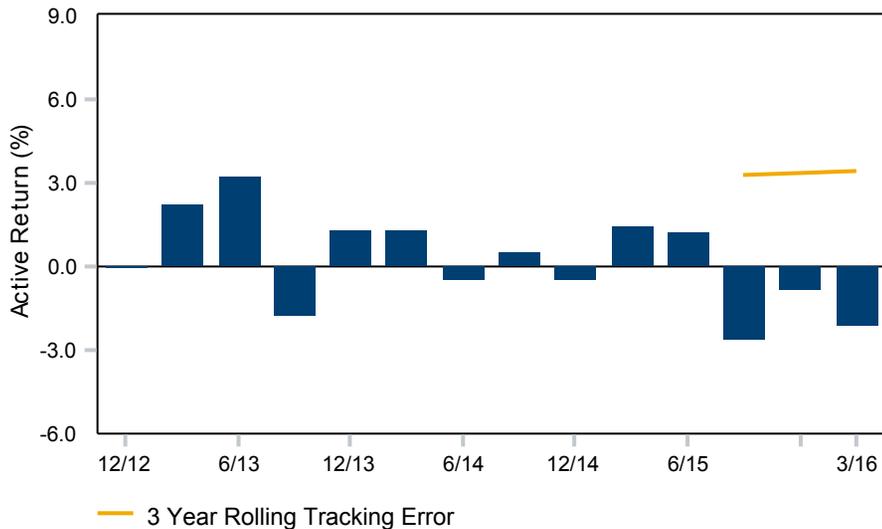
Current Allocation
March 31, 2016 : \$1,253M



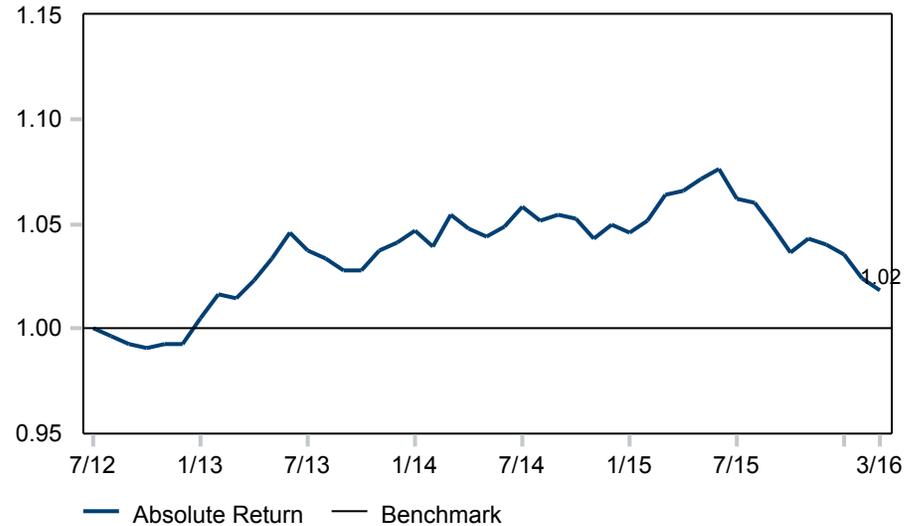
Return Summary



Quarterly Excess Performance



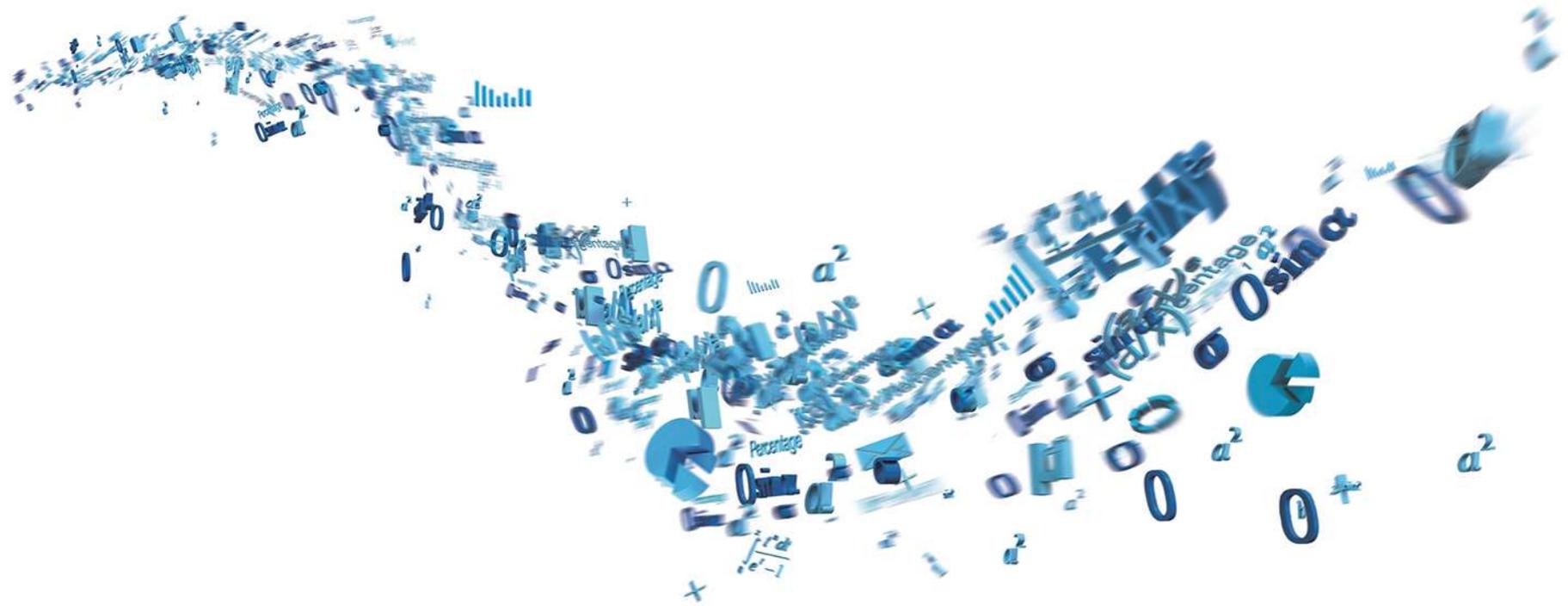
Ratio of Cumulative Wealth - Since Inception



Asset Allocation & Performance

	Allocation		Performance(%)		
	Market Value (\$)	%	1 Quarter	Fiscal YTD	1 Year
Absolute Return	1,253,283,750	100.0	-1.1	-1.6	-0.4
91 Day T-Bill + 4% (1 month lag)			1.0	2.4	4.1
Arrowgrass Master Fund LTD	123,872,905	9.9	1.6	2.2	4.4
Southpaw Credit Opportunity	93,319,099	7.4	-0.4	-1.9	-3.2
Aspect Diversified Fund	42,333,086	3.4	3.9	11.0	9.5
Conatus Capital Partners LP	69,790,011	5.6	-6.5	-7.4	-1.9
MW European TOPS Fund	76,734,506	6.1	1.2	2.6	8.2
Pentwater Event Fund	38,588,824	3.1	-4.0	-12.0	-15.0
LLSD	34,075,686	2.7	0.2	-1.1	9.0
Magnetar Structured Fund LP	104,517,320	8.3	-2.7	-6.6	-2.8
Iguazu Partners LP	113,172,059	9.0	-0.1	1.1	2.9
Taconic Opportunity Fund LP	97,754,269	7.8	-1.1	-3.6	-3.0
Pharo Macro Fund Ltd	61,916,288	4.9	-2.2	-0.6	-2.6
Northwest Fund Limited	72,800,398	5.8	-4.6	-3.2	-5.9
Aristeia Partners LP	45,119,780	3.6	-3.6	-6.1	-8.7
CC ARB Fund, LLC	101,312,787	8.1	-2.0	-1.8	0.5
GKC Credit Opportunity	43,323,759	3.5	1.7	4.2	5.5
LLSM II LP	23,448,528	1.9	-2.6	-7.8	-18.6
Glazer Enhanced Fund	111,204,446	8.9	-	-	-

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Appendix

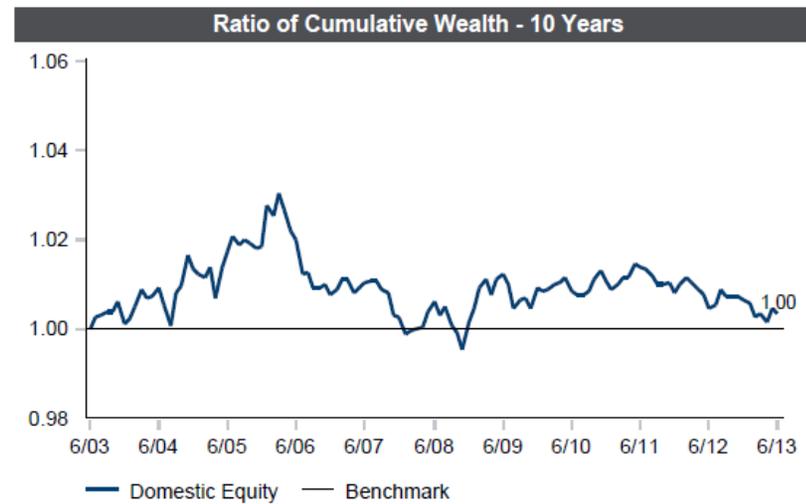
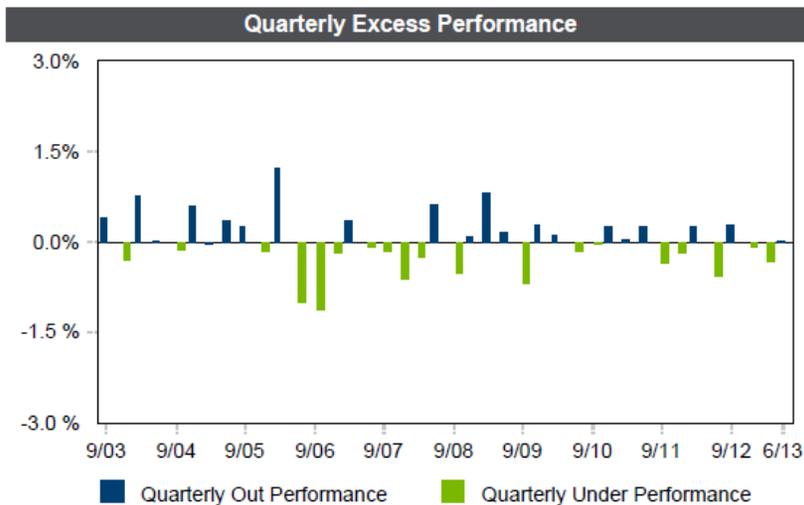
Total Fund Benchmark 3/31/2016

Total Fund Policy Benchmark		
Asset Class	Policy Index	Weight
Global Public Equity	MSCI All Country World IMI Index	48.1%
Global Private Equity	MSCI All Country World IMI Index Plus 300 BPS	10.0%
Global Credit	Barclays U.S. High Yield 2% Issuer Cap Index	7.0%
Public Real Estate	FTSE EPRA/NAREIT Developed Net (portion lagged)	3.0%
Private Real Estate	NCREIF ODCE Net Index (1 month lag)	7.0%
Private Infrastructure	Actual Return	1.3%
Rates	Barclays Intermediate Treasury Index	18.0%
Absolute Return	90 Day T-bill + 4% (1 month lag)	5.0%
Cash	Merrill Lynch 3 Month Treasury Bill	0.6%
Total		100.0%

Appendix

EXPLANATION OF EXHIBITS

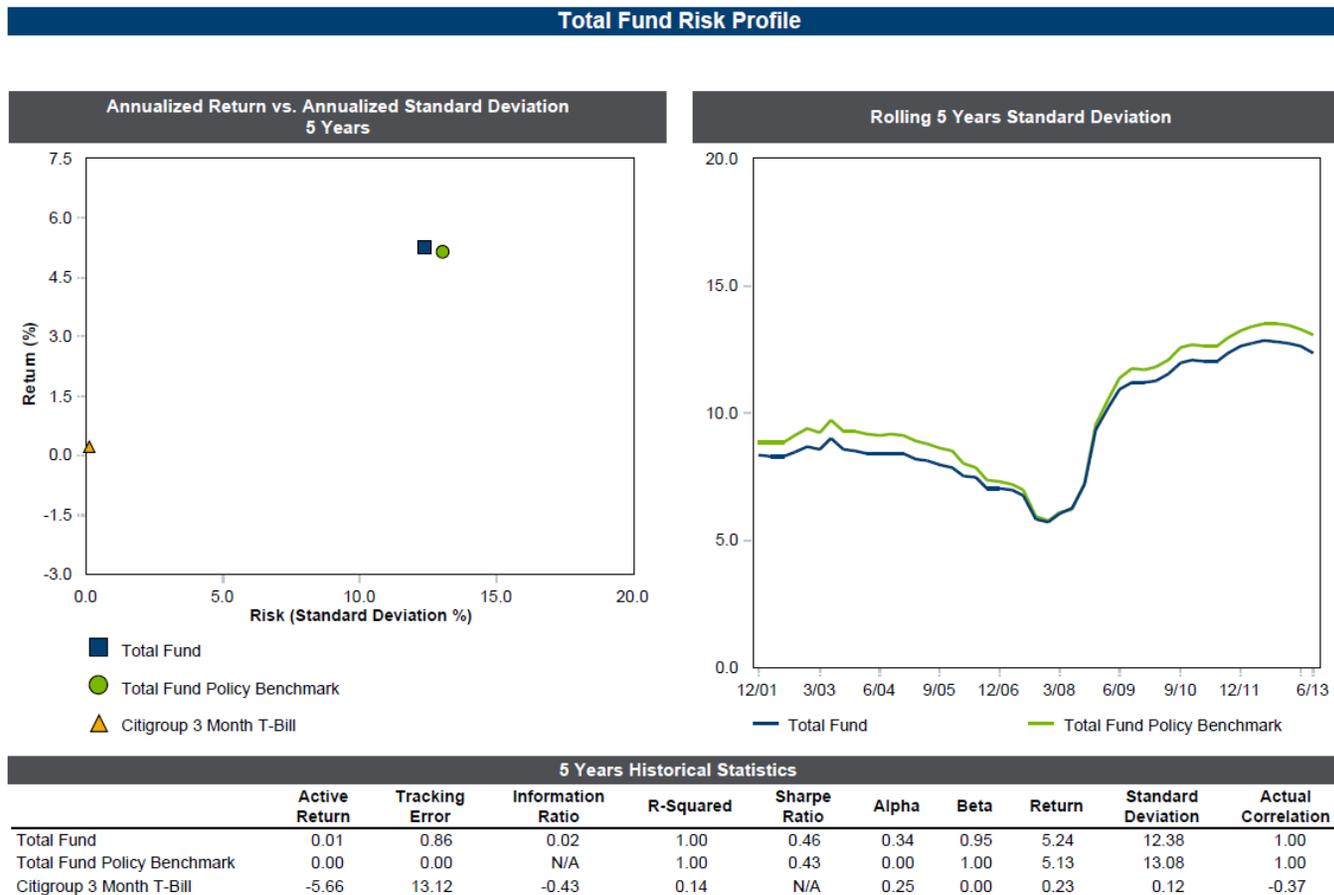
Quarterly and Cumulative Excess Performance - The vertical axis, excess return, is a measure of fund performance less the return of the primary benchmark. The horizontal axis represents the time series. The quarterly bars represents the underlying funds relative performance for the quarter. The ratio of cumulative wealth represents the fund's cumulative relative performance versus its primary benchmark. An upward-sloping line indicates superior fund performance versus its benchmark. Conversely, a downward-sloping line indicates underperformance by the fund. A flat line is indicative of benchmark-like performance.



Appendix

Risk-Return Graph - The horizontal axis, annualized standard deviation, is a statistical measure of risk, or the volatility of returns. The vertical axis is the annualized rate of return. As investors generally prefer less risk to more risk and always prefer greater returns, the upper left corner of the graph is the most attractive place to be.

Rolling 5 Years Standard Deviation - The vertical axes measures standard deviation for the 5 year period prior to the corresponding time series date on the horizontal axis for both a fund and its respective benchmark.



Statistics Definition

Statistics	Definition
Active Return	- Arithmetic difference between the managers return and the benchmark return over a specified time period.
Actual Correlation	- It is a measure of the correlation (linear dependence) between two variables X and Y, giving a value between +1 and -1 inclusive. It is widely used in the statistics as a measure of the strength of linear dependence between two variables. Also called coefficient of correlation.
Alpha	- A measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. It is a measure of the portfolio's historical performance not explained by movements of the market, or a portfolio's non-systematic return.
Beta	- A measure of the sensitivity of a portfolio to the movements in the market. It is a measure of a portfolio's non-diversifiable or systematic risk.
Information Ratio	- Measured by dividing the active rate of return by the tracking error. The higher the Information Ratio, the more value-added contribution by the manager.
R-Squared	- The percentage of a portfolio's performance explained by the behavior of the appropriate benchmark. High R-Square means a higher correlation of the portfolio's performance to the appropriate benchmark.
Return	- Compounded rate of return for the period.
Sharpe Ratio	- Represents the excess rate of return over the risk free return divided by the standard deviation of the excess return. The result is the absolute rate of return per unit of risk. The higher the value, the better the product's historical risk-adjusted performance.
Standard Deviation	- A statistical measure of the range of a portfolio's performance, the variability of a return around its average return over a specified time period.
Tracking Error	- A measure of the standard deviation of a portfolio's performance relative to the performance of an appropriate market benchmark.

Appendix

Total Fund	Total Fund Policy Benchmark is currently comprised of the MSCI All Country World IMI, MSCI AC World IMI Index Plus 300 basis points, Barclays US High Yield 2% Issuer Cap, FTSE EPRA/NAREIT Blend, NCREIF ODCE NET (1 month in arrears), Barclays Intermediate Treasury, BofA Merrill Lynch 3 Month Treasury Bill + 4% (lagged 1 month), BofA Merrill Lynch 3 Month Treasury Bill, and actual returns for Private Infrastructure.
Universe	Universe - The rankings are based on a universe of 68 total public pension plans with greater than \$1.0 billion in assets compiled by BNY Mellon Performance & Risk Analytics.
Global Equity	MSCI All Country World Index - A capitalization-weighted index of stocks representing 46 stock markets in Europe, Australia, the Far East, the Middle East, Latin America and North America.
Global Public Equity	Global Public Equity Benchmark – The benchmark consists of the S&P 1500 and MSCI ACWI ex U.S. using actual portfolio weights until 8/31/14, the MSCI All Country World Index until 8/31/15 and the MSCI All Country World IMI Index thereafter.
Domestic Equity	Domestic Equity Benchmark - The benchmark consists of the S&P 500 until 8/31/08 and the S&P 1500 Index thereafter. The S&P 1500 Index is a combination of the S&P 500, S&P MidCap 400, and S&P SmallCap 600 indices, and represents 85% of the total U.S. stock market.
ERS S&P 500 Index Fund & ERS Large Cap Core	S&P 500 Stock Index - A capitalization-weighted index representing stocks chosen by Standard & Poor's, Inc. for their size, liquidity, stability and industry group representation. The companies in the S&P 500 Index are generally among the largest in their industries.
Large Cap Growth Quant	S&P 500/Citigroup Growth Index - An index of approximately 286 stocks in the S&P 500 Index covering all pure growth stocks and the growth distribution of those having both growth and value characteristics
Barrow Hanley Mewhinney & Strauss	S&P 500 Value Index - A capitalization-weighted index representing publicly traded U.S. value stocks. Value is determined by the stocks' book value to price ratio, sales to price ratio and dividend yield.
ERS Mid Cap Core	S&P Mid Cap 400 Index - A market-capitalization-weighted index of stocks in all major industries in the mid-range of the U.S. stock market.
ERS Small Cap Core	S&P 600 Index - Focuses on the small-cap segment of the market, including companies from a variety of different sectors/industries. In order for a stock to be added to the S&P 600 Index, it must be a U.S. company, have adequate liquidity and reasonable per-share price, and have a market cap of \$300 million to \$1 billion.
Emerging Manager Composite	S&P 1500 Index is a combination of the S&P 500, S&P MidCap 400, and S&P SmallCap 600 indices, and represents 85% of the total U.S. stock market.
International Equity	International Equity Benchmark - The Benchmark consists of the MSCI EAFE Net January 1999 through August 2008 and the MSCI ACWI ex US Net thereafter. MSCI All Country World ex-U.S. Index - A capitalization-weighted index consisting of 22 developed and 23 emerging countries, but excluding the U.S. Covers approximately 85% of global equity opportunity set outside of the U.S.
ERS International EAFE Composite	MSCI EAFE Index - An equity index which captures large and mid cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 900 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Appendix

ERS Canada	MSCI Canada - A market capitalization-weighted index that captures broad Canadian equity market coverage including over 680 constituents across large, mid, small and micro capitalizations. The index covers approximately 85% of the free float-adjusted market capitalization in Canada.
Fisher Investments	Fisher Performance Benchmark - The benchmark consists of the MSCI EAFE Net from July 2006 through September 2008 and MSCI ACWI ex US Net thereafter. MSCI All Country World ex-U.S. Index - A capitalization-weighted index consisting of 22 developed and 23 emerging countries, but excluding the U.S. Covers approximately 85% of global equity opportunity set outside of the U.S.
Templeton	Templeton Performance Benchmark - The benchmark consists of the MSCI EAFE Net from April 2003 through September 2008 and MSCI ACWI ex US Net thereafter. MSCI All Country World ex-U.S. Index - A capitalization-weighted index consisting of 22 developed and 23 emerging countries, but excluding the U.S. Covers approximately 85% of global equity opportunity set outside of the U.S.
Lazard Asset Management	MSCI EAFE Index - An equity index which captures large and mid cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 900 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Blackrock International Focus	MSCI All Country World ex-U.S. Index - A capitalization-weighted index consisting of 22 developed and 23 emerging countries, but excluding the U.S. Covers approximately 85% of global equity opportunity set outside of the U.S.
ERS Emerging Markets	MSCI Emerging Markets Index - A capitalization-weighted index of stocks representing 23 Emerging Markets. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Total Global Credit	Barclays U.S. High Yield - 2% Issuer Cap - An index comprising US corporate, fixed-rate, noninvestment-grade debt with at least one year to maturity and at least \$150 million in par outstanding. Index weights for each issuer are capped at 2%.
ETF Fixed Income Emerging Markets	ETF Fixed Income EM Performance Benchmark - The benchmark consisted of the Barclays Emerging Market from July 2012 through August 2013 and the Barclays U.S. Corporate High Yield 2% Issuer Capped thereafter.
ETF Fixed Income High Yield	Barclays U.S. High Yield 2% Issuer Cap - The Benchmark consists of the Barclays U.S. High Yield from July 2012 through August 2013, and the Barclays U.S. High Yield 2% Issuer Capped thereafter.
Private Credit	Barclays U.S. High Yield 2% Issuer Cap (1 month lag) - An index comprising US corporate, fixed-rate, noninvestment-grade debt with at least one year to maturity and at least \$150 million in par outstanding. Index weights for each issuer are capped at 2%.

Appendix

Real Estate	<p>The benchmark consists of the FTSE EPRA/NAREIT Global Index through August 31st, 2010 and a combination of the Global Real Estate Performance Benchmark and the return of the Private Real Estate subsequent to August 31, 2010.</p>
Global Public Real Estate	<p>Public Real Estate Performance Benchmark- consists of the MSCI REIT from March 2005 - March 2007, a floating weight benchmark comprised of the EPRA/NAREIT US and EPRA/NAREIT US Global ex US from April 2007 through December 2007, the EPRA NAREIT Global Index from January 2008 through August 2013, the FTSE EPRA/NAREIT Developed Net from September 2013 through August 2014, and a MV weighted blend of the Total Internal Public RE Benchmark and the Wells St. Partner custom benchmark from September 2014 thereafter</p>
Private Real Estate	<p>Private RE Performance Benchmark - consists of the 91 Day T-Bill + 4% RE benchmark from 9/1/2012 through 8/31/14 and the NCREIF NFI-ODCE Net 1 month lagged beginning 9/1/14.</p>
Internal Public Real Estate	<p>Public Real Estate Performance Benchmark- The benchmark consists of the MSCI REIT from March 2005 - March 2007, a floating weight benchmark comprised of the EPRA/NAREIT US and EPRA/NAREIT US Global ex US from April 2007 through December 2007, the EPRA NAREIT Global Index from January 2008 through August 2013, and the FTSE EPRA/NAREIT Developed Net thereafter</p>
Domestic REIT	<p>Domestic REIT Performance Benchmark- The benchmark consists of the MSCI REIT from May 2000 - March 2007 and the FTSE EPRA/NAREIT thereafter. FTSE NAREIT Index - Includes all tax-qualified equity real estate investment trusts (REITs) meeting certain size and liquidity criteria that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List. Equity REITs include those firms that own, manage and lease investment-grade commercial real estate. Specifically, a company is classified as an Equity REIT if 75% or more of its gross invested book assets is invested in real property.</p>
International REIT	<p>FTSE EPRA NAREIT Global ex-U.S. Index - Designed to represent general trends in eligible real estate equities worldwide. Relevant real estate activities are defined as the ownership, disposure and development of income-producing real estate.</p>
Total Rates	<p>Barclays Intermediate Treasury Index- Consists of fixed-rate debt securities with maturities from one up to (but not including) 10 years from the U.S. Government Bond indices.</p>
Absolute Return	<p>91 Day T-Bill +4% (1 month lag)- The benchmark consists of the 91 Day T-Bill + 4% through 8/31/14 and the 91 Day T-Bill + 4% 1 month lagged beginning 9/1/14.</p>

AHIC Thought Leadership Highlights

White Papers

All Investors: The Small Cap Alpha Myth Revisited	Link
Healthcare Industry: Redefining Retirement in the Health Care Industry (Part Five of Five Part Series)	Link
All Investors ex-DC: Real Estate Beta: Understanding the Power of Core	Link
All Investors ex-DC: Risk Parity – Looking at Risk Through a Different Lens	Link
All Investors ex-DC: Investing in Private Equity Fund of Funds versus the Public Markets	Link
Endowments and Foundations: Raising Your Corpus From the Dead	Link
DB & DC: Hot Topics in Retirement and Financial Well-Being	Link
DB & DC: Real Deal Study	Link
Private DB: Bipartisan Budget Act of 2015	Link
Private DB: Pension Funding Strategy	Link
DC: Customize DC Investments for Participant Success	Link
DC: How 403(b) Plans are Wasting Nearly \$10 Billion Annually, and What Can Be Done to Fix It	Link

Current Topics of Interest

Private DB: Bipartisan Budget Act of 2015	Link
Private DB: Annuity lift-outs for small benefit retirees	
DC: Fiduciary Focus - Fees	Link
DC: Mythbusters: The Case for Retirement Income in DC Plans	Link

Aon Hewitt Retirement and Investment Blog

<https://retirementandinvestmentblog.aon.com/>

Events

Replay recent webinars, including the most recent session on “Pension Annuity Settlements: Why Are There So Many People Involved?”	Link
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Disclaimers and Notes

Disclaimers:

- Please review this report and notify Aon Hewitt Investment Consulting (AHIC) with any issues or questions you may have with respect to investment performance or any other matter set forth herein.
- The client portfolio market value data presented in this report have been obtained from the custodian. AHIC has compared this information to the investment managers' reported returns and believes the information to be accurate. AHIC has not conducted additional audits and cannot warrant its accuracy or completeness.
- The mutual fund information found in this report is provided by Lipper Inc. and AHIC cannot warrant its accuracy or timeliness.
- Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group.

Notes:

- The rates of return contained in this report are shown on an after-fees basis unless otherwise noted. They are geometric and time weighted. Returns for periods longer than one year are annualized.
- Universe percentiles are based upon an ordering system in which 1 is the best ranking and 100 is the worst ranking.
- Due to rounding throughout the report, percentage totals displayed may not sum up to 100.0%. Additionally, individual fund totals in dollar terms may not sum up to the plan totals.

PUBLIC AGENDA ITEM - #6

Review and Discussion of the Fiscal Year 2015 Global Investment Performance Standards Compliance Performance Report

May 17, 2016

ERS has undergone a Global Investment Performance Standards (GIPS) verification of their performance reporting for the year ended August 31, 2015. Endorsed by more than 30 country sponsors globally, the GIPS standards provide guidance on the calculation and presentation of performance to ensure a level playing field for evaluating investment results. The GIPS standards allow investors and others to compare investment performance on a consistent basis because claiming compliance means adhering to a set of comprehensive standards that include data calculation methodology, composite construction, disclosures, and presentation and reporting, among others.

History of the GIPS standards:

This need for a practitioner-driven set of ethical principles and a standardized, industry-wide approach to calculating and reporting investment results led the Association for Investment Management and Research (AIMR[®], now known as the CFA Institute) to sponsor, develop, and publish a minimum global standard by which firms could calculate and present their investment results. The foundation for the GIPS standards was first established in 1987, with the creation of the AIMR Performance Presentation Standards (AIMR-PPS[®]), voluntary performance guidelines for the North American investment management industry.

To develop one globally accepted set of standards, the GIPS committee began work in 1995. AIMR published the GIPS standards for public comment in February 1998, after circulating several drafts among industry participants to obtain their acceptance of the concepts of the Standards. After an extensive period of public comment, the AIMR Board of Governors formally endorsed the GIPS standards in February 1999.

On February 4, 2005, the CFA Institute Board of Governors approved the revised GIPS standards, which created a single global standard of investment performance reporting. The GIPS standards replaced the various country-specific performance standards and are widely accepted among the international industry of investment managers.

Since their introduction in 1999, the GIPS standards have gathered momentum with investment management firms worldwide adopting these voluntary, ethical standards for calculating and presenting historical investment performance.

While initially adopted primarily by investment management firms, asset owners, including pension funds, have recently begun to seek compliance with the GIPS standards as a way to demonstrate five important things to legislative bodies, oversight boards, and the general public: (1) a voluntary commitment to follow global industry standards (with respect to performance calculation and presentation) based on the principles of fair representation and full disclosure; (2) adherence to best practice with respect to the valuation of investments; (3) the establishment of robust investment performance policies and procedures; (4) a commitment to methods of calculation and presentation of investment performance that are consistent, transparent, and comparable; and (5) a commitment to adopt the same set of performance standards often required of any external investment managers that the asset owner retains.

STAFF RECOMMENDATION:

The agenda item is presented for information and discussion purposes only. No action is required.

ATTACHMENT – 1

Exhibit A – August 31, 2015 Verification Report by ACA Compliance Group

**Employees Retirement System of Texas
Verification Report**

August 31, 2015





Verification Report

Employees Retirement System of Texas
200 E. 18th Street
Austin, TX 78701

We have verified whether Employees Retirement System of Texas (the Firm) (1) complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS[®]) on a firm-wide basis for the periods from September 1, 2009 through August 31, 2015, and (2) designed its policies and procedures to calculate and present performance in compliance with the GIPS standards as of August 31, 2015. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures. Our responsibility is to express an opinion based on our verification. We conducted this verification in accordance with the required verification procedures of the GIPS standards. We also conducted such other procedures as we considered necessary in the circumstances.

In our opinion, the Firm has, in all material respects:

- Complied with all the composite construction requirements of the GIPS standards on a firm-wide basis for the periods from September 1, 2009 through August 31, 2015; and
- Designed its policies and procedures to calculate and present performance in compliance with the GIPS standards as of August 31, 2015.

This report does not relate to or provide assurance on any composite compliant presentation of the Firm and does not ensure the accuracy of any specific composite compliant presentation.

ACA Performance Services, LLC

ACA Performance Services, LLC
April 4, 2016

Employees Retirement System of Texas
Total Fund Composite
September 1, 2009 through August 31, 2015

Fiscal Year	Net of External Costs Only ¹ (%)	Net of Fees ² (%)	Benchmark Return (%)	As of August 31		3-Year Annualized Standard Deviation	
				Externally Managed Assets (%)	Total Composite Assets (\$ millions)	Total Fund (Net) %	Benchmark %
2010	6.48	6.40	6.80	19	20,389.8		
2011	12.36	12.28	12.02	22	22,118.6		
2012	8.04	7.95	8.11	28	22,772.1		
2013	9.87	9.78	9.52	33	23,858.8	8.37	8.66
2014	14.58	14.48	15.00	37	26,131.6	7.43	7.67
2015	0.44	0.34	(1.03)	38	25,177.9	5.32	5.51

The Employees Retirement System of Texas (“ERS”) claims compliance with the Global Investment Performance Standards (“GIPS”®) and has prepared and presented this report in compliance with the GIPS standards. ERS has been independently verified for the period September 1, 2009 through August 31, 2015. The verification report is available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Accompanying Notes

- 1) For purposes of complying with the GIPS standards, the firm is defined as the Employees Retirement System of Texas (“ERS”), which was established in 1947 by the Texas State Legislature and is the manager of the assets of the Employees Retirement System of Texas. The Total Fund was created and incepted in 1947.
- 2) The Total Fund Composite includes all the discretionary assets managed by ERS for the benefit of participants in the Employees Retirement System of Texas Plan, the Judicial Retirement System Plan II (JRS II) and the Law Enforcement and Correctional Officer Supplemental Plan (“LECOS”). The Total Fund blended benchmark is calculated monthly using a blend of the asset class benchmarks based on the Total Fund’s tactical weights for the respective asset classes. Each asset class utilizes a total return benchmark. The asset class weights listed below are as of August 31, 2015. Information for benchmark strategic weights and asset class weights for other periods is available upon request.

¹ Returns net of external costs are net of transaction costs and investment management fees only. These returns are also reported by ERS custodian as “net of fees”.

² Returns net of fees as defined by GIPS are net of transactions costs, investment management fees and internal Investment Division and other agency overhead costs.

Asset Class/Composite	Description	Benchmark	Benchmark Weights at August 31, 2015 (%)	Asset Class Weights at August 31, 2015 (%)
Global Public Equity	The global public equity asset class is a combination of a variety of strategies across different geographies and market capitalization ranges with aggregate portfolio holdings and characteristics similar to the broader market as represented by the established benchmark.	MSCI All Country World Net Index	47.67	48.52
Global Private Equity	Private equity investments involve the purchase of illiquid equity and debt securities of companies that, in most instances, are not publicly traded. Investments in private company securities are made primarily through blind pool limited liability vehicles such as limited partnerships.	Actual Return	10.26	11.03
Global Credit	The global credit asset class is a combination of high yield, bank loans and emerging market debt. The high yield fixed income portfolio includes a combination of bonds with a credit rating below investment grade. The bank loan portfolio includes loans made to businesses with credit ratings that are below investment grade, similar to high yield bonds. Loans are typically secured by the assets of the issuing company and rank first in priority of payment in event of default. As a result, default rates tend to be lower than those from high yield bonds and the recovery rates are higher. The emerging market debt portfolio includes U.S. dollar and local denominated bonds issued in or by emerging countries or entities within such countries. The portfolio also includes U.S. dollar denominated corporate bonds issued in emerging countries.	Barclays U.S. High Yield 2% Issuer Cap Index	5.50	6.05
Public Real Estate	The public real estate portfolio includes domestic and international public investments in real estate investment trusts.	Total Public RE Blended BM	3.00	2.95
Private Real Estate	The private real estate portfolio includes domestic and international	NCREIF ODCE Net Index 1 mo.	5.99	6.49

	private and debt investments. Vehicles established to own interests in real property and related assets primarily through limited liability entities such as limited partnerships or limited liability companies may be used.	Arrears		
Private Infrastructure	Infrastructure investments refer to the investment in large-scale public systems, services, and facilities that are necessary for economic activity. An infrastructure investment is typically focused on generating income (often with inflation linkage) with some capital appreciation. The low liquidity investments are often made in essential services, with high barriers to entry, and predictable cash flows.	Actual Return	0.87	0.99
Rates	The intermediate treasury portfolio consists of liquid United States Treasury Notes with maturities ranging between 1 to 10-years. There are approximately 200 such securities available with a combined market value of over \$500 billion.	Barclays Intermediate Treasury Index	19.50	17.53
Cash	The cash portfolio is managed to maintain liquidity and preserve principal with a maximum final maturity of 18 months and with a minimum credit quality rating of A.	Merrill Lynch 3 Month Treasury Bill	1.22	1.34
Hedge Funds	This strategy includes private commingled investment vehicles with transparency that (1) issue securities only to accredited investors or qualified purchasers through limited liability vehicles such as limited partnerships or limited liability companies; and (2) engage primarily in the trading of securities and other financial instruments. In this policy, hedge fund also includes any private investment fund of funds or other commingled vehicle that itself invests in hedge funds.	90 Day Tbill + 4% (1 month lag)	5.00	5.10

The public assets of ERS are managed in accordance with the active risk budget as noted in Addendum III of the Investment Policy. The Investment Policy is available upon request. The investment objective for the Total Fund is to earn, over at least a moving thirty year period, an annualized return that equals or exceeds the actuarial rate of return, approved by the Employees Retirement System Board ("Board") to value the liabilities of ERS. As of August 31, 2014, the actuarial rate of return is 8.0%. ERS hires external managers to actively manage selected portfolios. The percent of externally managed assets for the Total Fund was 38% as of August 31, 2015.

- 3) Net of fees returns are net of brokerage commissions, expenses related to trading and applicable foreign withholding taxes on dividends, interest and capital gains, actual investment management fees and internal Investment Division and other agency overhead costs. All returns and asset values are expressed in U.S. dollars.

Total Fund performance is calculated monthly using time-weighted rates of return reduced by internal division and agency overhead costs applied on an annual basis. Overhead costs netted against returns include information services, in-house and external legal counsel, finance, executive office, human resources and building operations.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

- 4) The Total Fund Composite included all individual portfolios that are combined into one aggregate portfolio. The performance of the combined portfolio reflects the overall mandate of the plan. Because the Total Fund Composite is one aggregate portfolio for all periods, no measure of internal dispersion of annual portfolio returns is presented.
- 5) The three-year annualized ex-post standard deviation measures the variability of the composite and the benchmark for the 36-month period. This measure is not required for periods ended prior to 31 August 2012.
- 6) Because the Total Fund Composite represents 100% of the assets managed by ERS, this presentation represents ERS' list of composite descriptions.

Supplemental Information:

The information in the table below is supplemental to the Total Fund compliant presentation presented on the previous pages. Performance information is for the period September 1, 2014 through August 31, 2015, except as noted, and is net of external management fees.

Fund/Asset Class	Net Return (%)	Benchmark Return (%)	Number of Portfolios	Assets (\$ millions)	% of Fund Assets	% Externally Managed
Total Fund	0.44	(1.03)	47	25,177.9	100.0	38.0
Global Public Equity	(3.48)	(6.29)	21	12,257.3	48.5	27.0
Global Private Equity	11.03		2	2,768.5	11.0	100.0
Global Credit	(1.37)	(2.93)	7	1,518.5	6.0	16.0
Public Real Estate	(5.58)	(3.57)	3	741.4	3.0	11.7
Private Real Estate	14.09	13.39	2	1,628.1	6.5	100.0
Private Infrastructure	0.32		1	247.9	1.0	100.0
Rates	2.06	1.90	6	4,399.7	17.5	0.0
Cash	1.21	0.03	4	337.5	1.3	0.0
Hedge Funds	4.85	4.02	1	1,279.1	5.1	100.0

PUBLIC AGENDA ITEM - #7

Review, Discussion and Consideration of the ERS *Investment Policy*

May 17, 2016

BACKGROUND:

The Employees Retirement System of Texas (ERS) *Investment Policy* is determined by the Board of Trustees (Board). In accordance with Section 2.3 of the ERS *Investment Policy*, staff will recommend changes as needed to the Investment Advisory Committee (IAC) and Board.

The following changes are proposed to acknowledge the growth of tradeable investments. The main changes include expanding personal trading parameters to include the trading of various funds. The proposed changes are explained below and reflected in the excerpt of the ERS *Investment Policy* that follows.

Proposed Revision #1

- Added Closed-end funds, which are regulated like mutual funds and have similar reasons for not including in personal trading
- Included in the exclusion to cover derivatives of closed-end funds and ETFs
- Included an express exclusion for direct investment plans where the timing is outside of the control of the covered person. It can be inferred that these would be properly excluded because of the definition of "Personal Trades" but upon our review of peer plans saw more than not expressly stated so included

Proposed Revision #2

- Included express language that certain gifts given to staff used in performing official ERS duties also have a monetary limitation of \$50 in value

Proposed Revision #1: Section 5.1 Code of Ethics and Personal Investment Activities; A. Personal Transactions

- A. Personal Transactions.** Section 5.1.A of this policy applies only to the Executive Director, Deputy Executive Director and ERS Investment-Related Staff (all of whom may be collectively referred to in this subsection as "Covered Person"). All ERS Investment-Related Staff shall obtain the approval of the Chief Investment Officer or a designee appointed by the Chief Investment Officer prior to making personal trades in securities in which ERS is invested or is considering investment. Similarly, the Chief Investment Officer, the Deputy Executive Director, and the Executive Director shall obtain approval from the Internal Auditor or a designee appointed by the Internal Auditor. Such trade approval is only **valid** for the trading day on which the approval is requested.

For purposes of **the pre-clearance requirement described above, the term** this section of the policy, "security" is defined as publicly traded stocks, bonds, and certain derivative instruments **but does not include (A) open-end mutual funds, closed-end funds or and exchange traded funds ("ETFs") that are based on broad-based securities indices or (B) derivatives linked to the performance of such closed-end funds or ETFs. Furthermore, the pre-clearance requirement described above does not apply to any acquisitions or dispositions of any security that are not deliberate or willful on the part of the Covered Person, including, without limitation: (A) the purchase or sale of any security that is effected in an account over which a Covered Person has no direct or**

indirect influence or control; (B) the acquisition of any security pursuant a dividend reinvestment program; or (C) the acquisition of any security through a stock dividend, stock split, reverse stock split, merger, consolidation, spin-off, or other similar corporate reorganization or distribution that is generally applicable to all holders of the relevant class of securities.

For purposes of the foregoing paragraph, a securities index will be considered "broad-based" if it satisfies the criteria adopted by both the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission; namely: (1) if it has more than nine component securities; (2) none of its component securities comprises more than 30% of its weighting; (3) no group of five of its component securities together comprise more than 60% of its weighting; and (4) the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume ("ADTV") of more than \$50 million (or in the case of an index with 15 or more component securities, \$30 million).

Proposed Revision #2: Section 5.1 Code of Ethics and Personal Investment Activities; B. Gifts, Benefits or Favors

B. Gifts, Benefits or Favors. Trustees, IAC members, the Executive Director, the Chief Operating Officer and ERS Investment-Related Staff shall not solicit, accept, or agree to accept any gifts, personal benefits, or personal favors. The terms "gifts," "personal benefits" and "personal favors" include, without limitation, anything reasonably regarded as pecuniary gain or pecuniary advantage, including gifts or other economic benefits to any other person in whose welfare the trustee, IAC member, Executive Director, Chief Operating Officer or ERS Investment-Related Staff has a direct and substantial interest.

This prohibition does not apply to the following, except there is absolutely no exception for any gifts, personal benefits, or personal favors from Placement Agents, as defined in Addendum VIII:

- i. gifts of books, pamphlets, articles or other such materials that contain information directly related to and used in performing the official ERS duties of the individual (provided that such items are less than \$50 in value);
- ii. gifts of nominal value (non-cash items of less than \$50.00 in value), modest items of food and refreshments on infrequent occasions so long as the donor is present, unsolicited advertising or promotional material and other items of nominal intrinsic value;
- iii. a fee prescribed by law to be received by an individual or any other personal benefit to which the individual is lawfully entitled or which is given as legitimate consideration in a capacity other than the individual's position with ERS; and
- iv. a gift or other personal benefit conferred on account of kinship or a personal, professional, or business relationship independent of the official status of the individual's position with ERS.

STAFF RECOMMENDATION:

Staff recommends the proposed revisions to the ERS *Investment Policy*, as presented in this agenda item, be adopted. Staff's proposed motion is included with this agenda item.

PUBLIC AGENDA ITEM - #8a*

Review, Discussion and Consideration of the Fixed Income Program:

8a. Market Update and Program Overview

May 17, 2016

EXECUTIVE SUMMARY

Staff continues the implementation of ERS' fixed income program, which is comprised of two separate and distinct mandates, Rates and Credit. This agenda item briefly explains those two program's unique purpose within the asset allocation framework and their performance to date. Fixed Income as an asset class is an extremely diverse group of assets, all of which have contractually fixed cash flows. It is perhaps simplest to think of the present value of these cash flows as a function of the underlying level of interest rates with which they are discounted, and the likelihood that the cash flows will occur on time and in the amount specified as the credit component of the assets. These two sets of factors are largely independent of each other from an investment prospective, thus ERS attempts to isolate each in the following portfolios:

- **The Rates Portfolio** – is comprised primarily of securities issued by the U.S. Treasury which are currently viewed as having no credit risk. It may also include securities issues from other government-backed agencies and some legacy transition assets.¹ This portfolio is the primary component of the risk reducing portion of the asset allocation as well as the principal source of liquidity for the Trust. Its current AUM is \$4 billion and is entirely internally managed. It is benchmarked against the Barclay's Intermediate Treasury Index (*LT08TRUU* on Bloomberg).
- **The Credit Portfolio** – is comprised primarily of below investment grade bonds whose value is derived from their perceived credit worthiness and liquidity. It may also include loans to similarly rated highly levered companies, emerging market debt, and structured products. This portfolio is part of the return seeking allocation and is benchmarked to the total return of the Barclay's U.S. Corporate High Yield 2% Issuer Capped Index (*LF89TRUU* on Bloomberg). Its current AUM is \$1.7 billion, or 7% of total assets, scheduled to grow to 10% of the Trust over the next 18 months. It holds 63% of its assets, equal to \$1.1 billion, in the internally managed high yield portfolio ("IHY"), another 22%, equal to \$380 million, in credit-based Exchange Traded Products ("ETPs"), and the remaining 15%, equal to \$250 million, is externally managed in four satellite allocations.

Overview:

ERS is a "mature" pension plan, which is a euphemism for it paying more in benefits each year than it takes in from contributions. This creates a continual need to sell assets in order to make the benefit payments regardless of Trust performance. This is significant because large losses in the financial

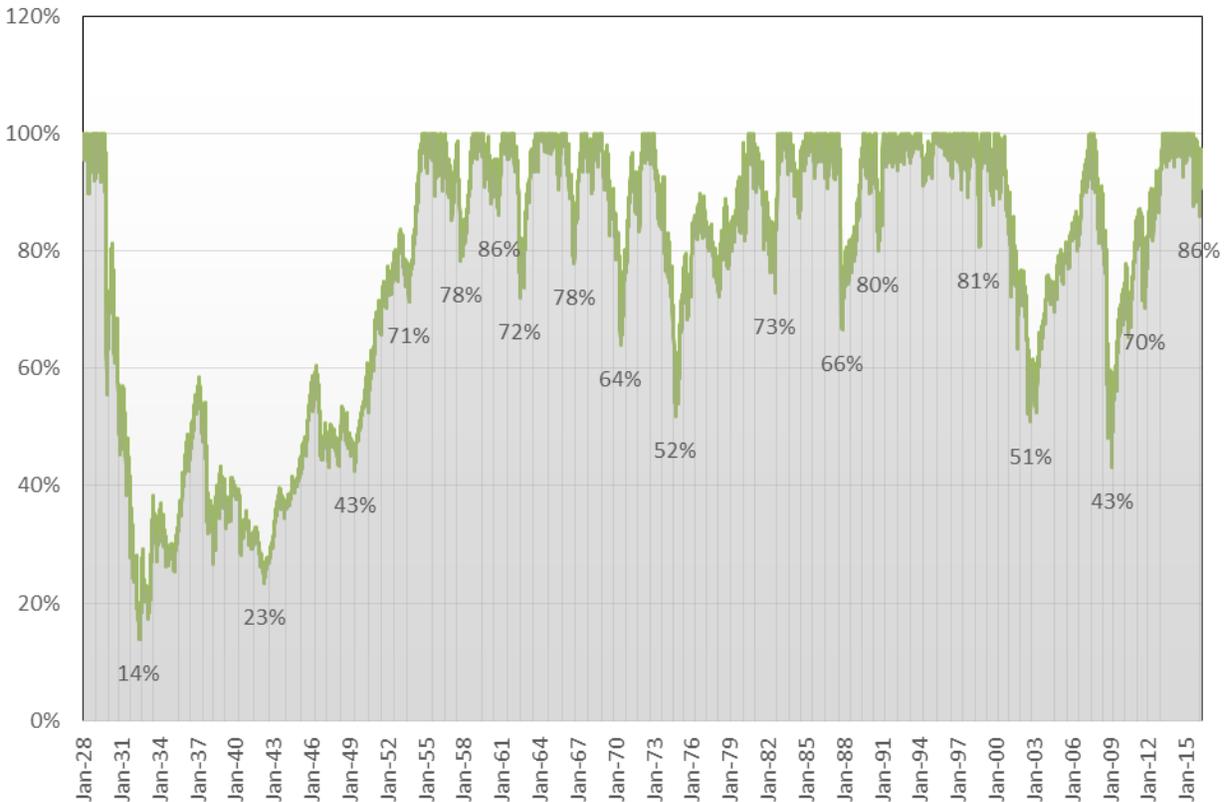
¹ Legacy assets owned by ERS include investment grade corporate bonds, CMBS, and ABS securities that are not suitable for Rates or Credit. These assets have shrunk from \$2.4 billion to approximately \$290 million. Liquidations reduced the risks of the remaining assets to the point that there is no longer a relevant benchmark with which to judge their performance. At staff's recommendation, the Board approved moving the remaining assets into the Rates portfolio for their continued orderly liquidation as of the beginning of fiscal year 2015.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

markets occur with greater frequency than implied by a normal distribution. Thus, there is a material likelihood without the Rates portfolio that ERS would be required to sell displaced assets to fund benefits. Historically such dislocations have proven to be buying opportunities.

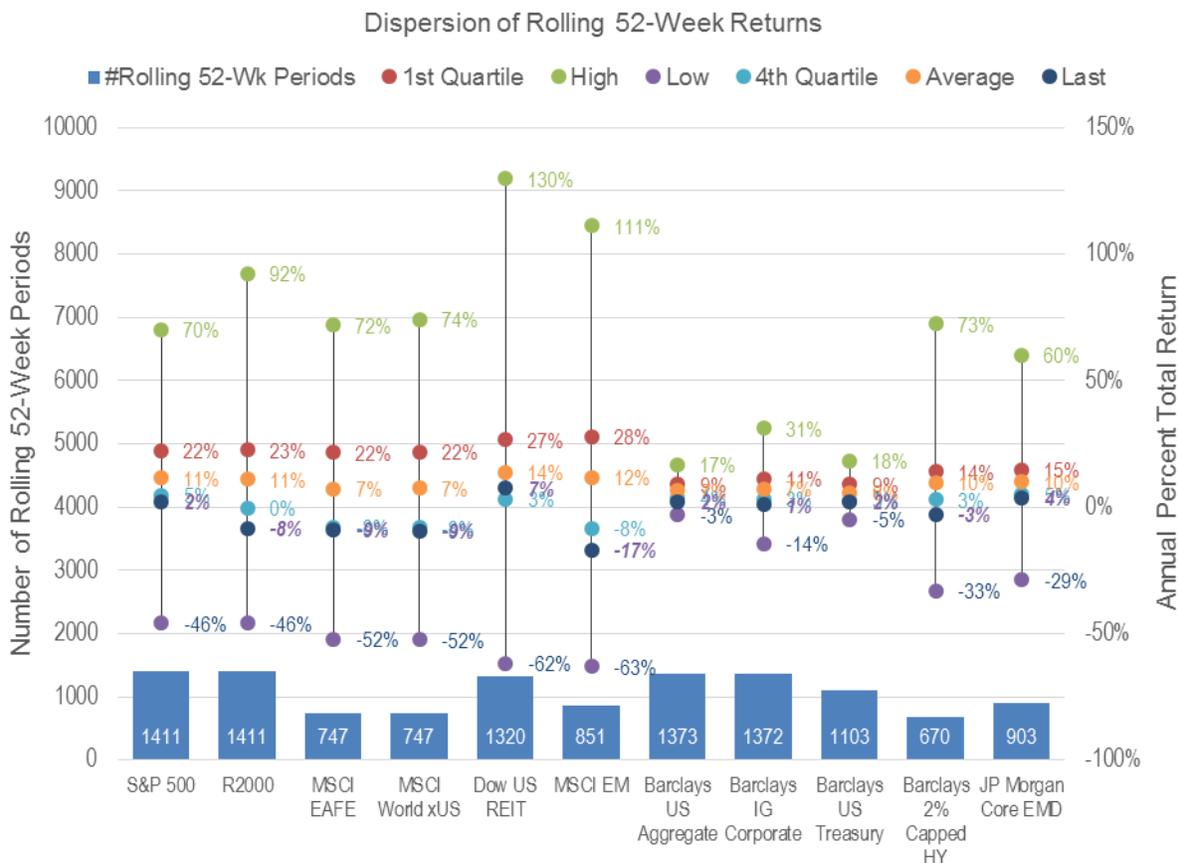
To illustrate the magnitude of these sell-offs, the following chart is the historical drawdowns of the S&P 500 price index or *SPX* on Bloomberg. Note that there have been 11 sell-offs of $\geq 20\%$ since 1954.

Historical S&P 500 Price Drawdowns



These drawdowns proved to be good opportunities to buy discounted assets and earn excess returns. A pension plan with positive net contributions could do so without needing to necessarily sell assets, but all other plans must have a source of funds to rebalance. The traditional role of the fixed income allocation is to stabilize the plan's asset values and provide liquidity because it is historically much less volatile than equities.

The following chart as of April 15, 2016 illustrates this concept by showing the rolling 52-week total return dispersions of several major asset categories in a floating bar format going back as far as their data is available. The highest, lowest, and average 52-week return for each is shown, as well as their quartile breaks and the most recent ending period. The number of rolling periods available for each is shown with the blue bars along the bottom.



For example, in 1411 rolling 52-week periods the S&P 500 price index’s highest observed return is 70%, its lowest is -46%, and its average is 11%. The most recent 52-week period returned 2%, which is in the bottom quartile of its historical distribution, containing everything below 5%.

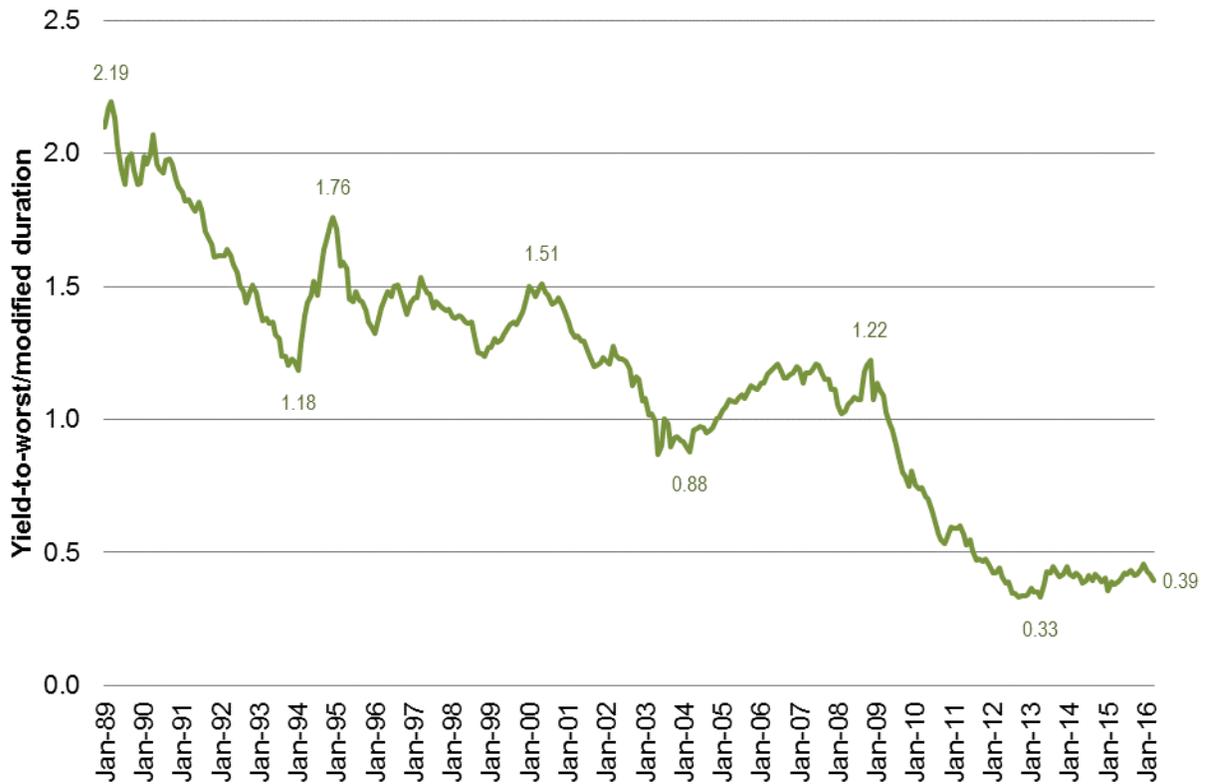
The relative length of the floating bar between each asset’s high and low quartile breaks and their respective maximum and minimum returns informs as to how “fat-tailed” the asset class has been, or how non-normally the historical returns are distributed. The greater the segments’ length, the more non-normal. Historically, U.S. public real estate, represented by the Dow Jones U.S. REIT index, is by far the most volatile asset class shown (longest floating bar) ranging from +130% to -62% (192%) and it also poses the fattest tails +103% from the 1st quartile break to its maximum and -59% from its 4th quartile break to its minimum. The next most volatile is emerging market equity represented by the MSCI EM index with a range of 174% and +83% and -55% tails. The Barclays U.S. Aggregate (“the Agg”) is the least volatile asset class shown with a range of 20% (+17% to -3%).

Higher volatility asset classes need to compensate investors with higher expected returns, and the historical risk efficiency of each can be proxied by dividing its average return by its respective range of outcomes. This analysis omits the importance of their respective correlations to other asset classes from a total fund perspective, but is helpful in understanding an allocation’s collection of risks and returns. In general the correlations of risk assets increase in periods of financial market stress, potentially negating

all the advantages of diversification. Thus, to ensure adequate liquidity for benefit payments and re-balancing, the asset allocation must include sufficient amounts of less risky assets such as the Agg. The problem with such low volatility assets is their returns are low. The Agg's average is 7%, as is also the Barclay's investment grade ("IG") corporate index, and 6% for the Barclays U.S. Treasury index. All three have exhibited relatively low historical volatility.

These fixed sectors comprise the majority of traditional pension plans' fixed income allocations. ERS abandoned an Agg-style program in late February 2013. There were several reasons for doing so, chief among them is the historical risk and return relationship of the Agg that produced the above floating bar does not represent its current relationship. This is better illustrated by the following chart which divides the yield of the Agg (its reward) by its modified duration (its risk assuming no credit losses). The ratio effectively shows the amount interest rates would have to increase in a year for the total return of the Agg to turn negative. As recently as 2009 an increase of at least 100 basis points, or "bps", was required for this to occur, but that amount has declined and it currently only takes 39 bps to do so. Given the current level of central bank stimulus, the overall level of government indebtedness and its unsustainable fiscal situation, staff believes rate increases of this magnitude or greater are likely enough to make the Agg unappealing from a risk and return perspective.

Barclays Aggregate Risk/Return Relationship Over Time



Another problem identified by staff with Agg-style mandates is illustrated by the following scatterplot of its monthly returns vs. those of the Barclays U.S. Treasury index. This chart reveals that while the Aggregate index contains nearly 10 thousand different issues, it is almost entirely explained by the return of U.S. Treasuries, which implies limited diversification advantage for taking on the credit and liquidity risk of investing in everything else included in the Agg.



The same is true when comparing the Barclays U.S. investment grade credit index vs. Treasuries shown below. Again, the majority (71%) of its historical monthly return is explained solely by the return of Treasuries, not credit. Because these corporates add little meaningful diversification and historical return advantage, there is not a compelling reason to invest in them. Further, they tend to perform their worst in the same market dislocations as other risk assets. For example, in September 2008 (the month Lehman Brothers collapsed) the SPX fell -908 bps and IG corporates -777 bps, while Treasuries increased 61 bps. For these reasons ERS chose to focus on Treasuries for the liquidity driven Rates portfolio.

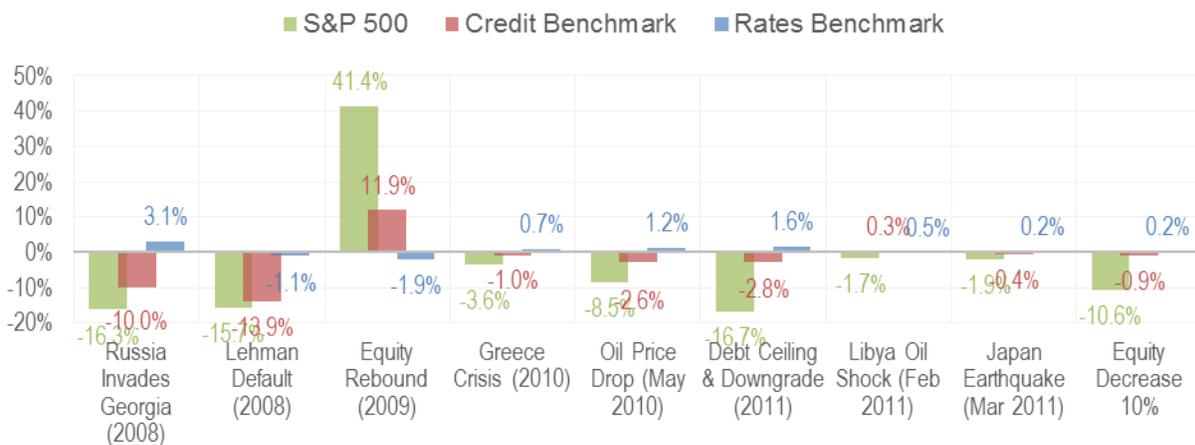


It is notable from the earlier return dispersion chart that the Barclays 2% capped high yield (“HY”) index has a narrower range (103%), slightly higher maximum (73%), and lower minimum (-33%) 52-week return than the SPX, with an average return of over 10% for 668 observed periods. As shown below, it also has effectively none of its historical return explained by the performance of Treasuries.



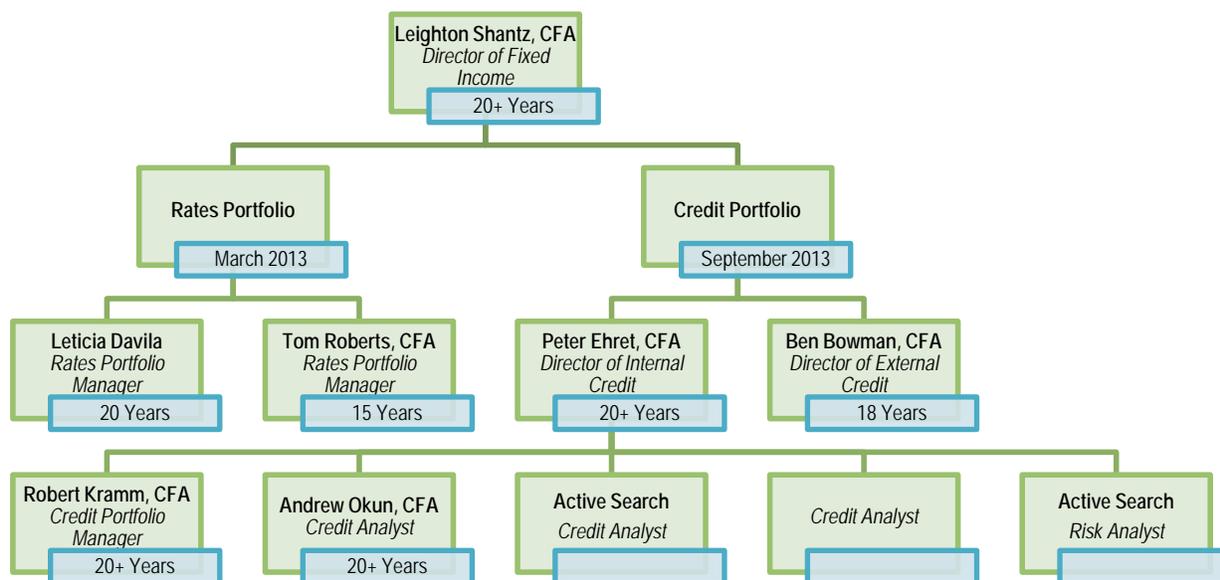
While credit driven fixed income has a higher correlation with other return seeking assets than with rate-driven ones, its monetization to the Trust is ultimately dependent upon interest payments and maturities rather than selling in the secondary market. For these reasons, ERS chose to create the Credit portfolio in the return seeking portion of the asset allocation.

The following chart is a Bloomberg PORT scenario analysis of how the current holdings in the Rates and Credit benchmarks would perform vs. the current holdings of the SPX in various historically observed scenarios. Staff does not believe history will repeat, but utilizes such analysis as a tool to predict if asset diversification is likely to be effective going forward. The take-away is that the Rates benchmark returned a positive number when the S&P was negative in all but one historical scenario (the Lehman Default measured from September 15 - October 15, 2008) and the Credit benchmark exhibits much lower risk despite a relatively high average historical return.



As noted above, ERS has been utilizing the Rates and Credit strategies for almost three years and staff considers it an improvement over the previous Aggregate style. ERS is more liquid even with a decline in the fixed income allocation and has more flexibility to invest in less liquid return seeking assets. It also makes tactical shifts in asset allocation more efficient and effective since it is easier to re-balance the liquid Rates portfolio than an Agg-styled one.

To implement both Rates and Credit mandates ERS has the experienced team shown below. No team member has less than 15 years of experience in institutional asset management and most of those years were earned outside of ERS. As of April, the team is actively searching for experienced high yield credit analysts as well as a more junior risk analyst. Fixed income asset management is extremely nuanced, and the difference between success and failure is often tiny. Avoiding losses is typically more critical to overall success than picking out-performers. For this reason it is critical that staff be comprised of experienced individuals and avoid the pitfalls often made by those early in their career. The following organization chart is the future anticipated composition of the Fixed Income team.



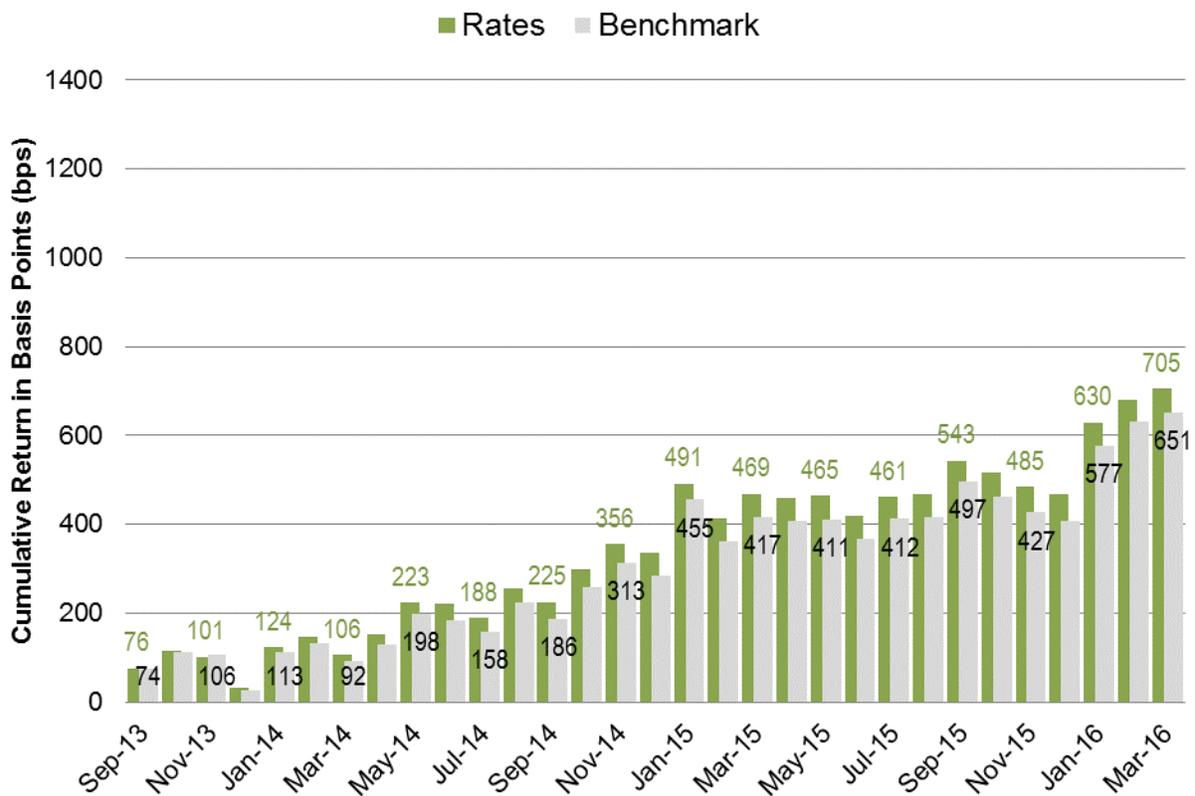
Performance:

Relative performance for both Rates and Credit has been positive for the past two years. Staff believes it will be able to continue to outperform its benchmarks over the long term. The following table lists both strategies' absolute and relative performance. Excess returns have declined for the fiscal year and year-to-date compared with prior years.

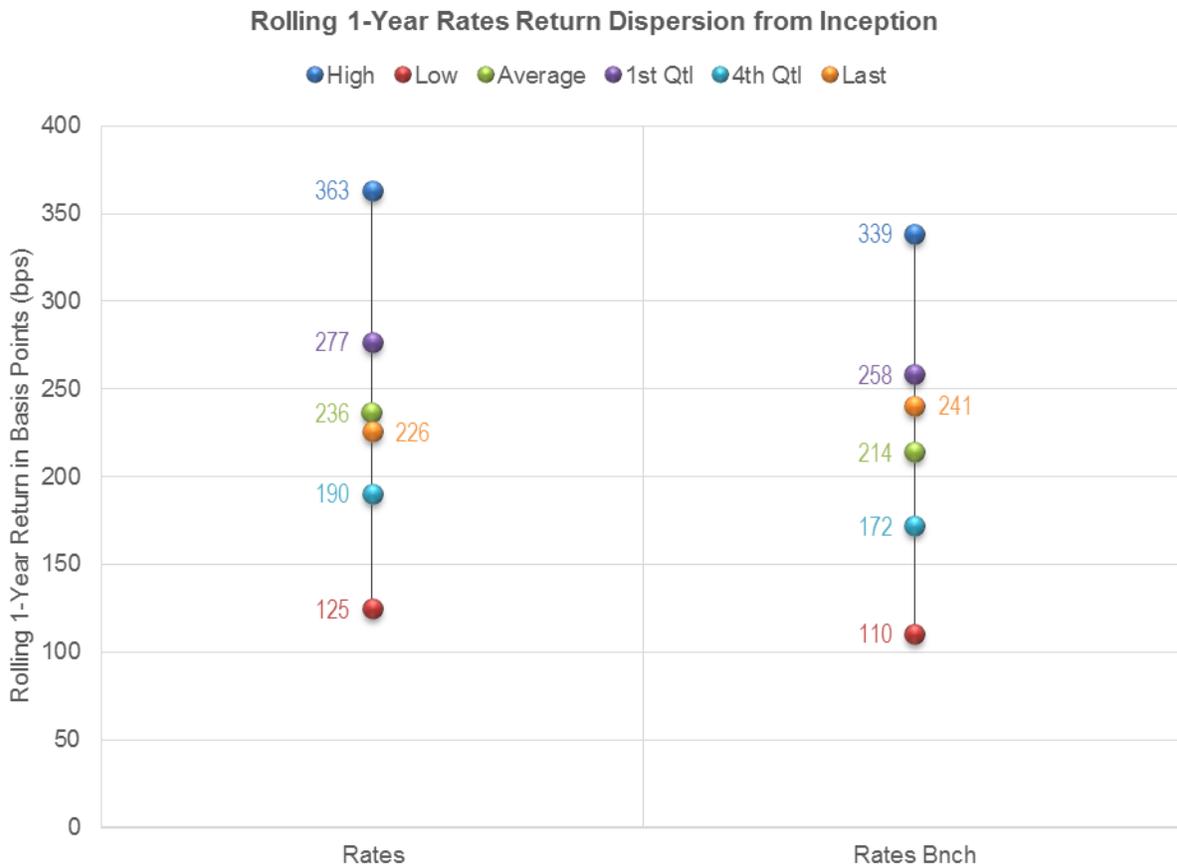
	Fiscal Year to Date (bps)	1 Year Ending 3/31/16 (bps)	2 Years Ending 3/31/16 (bps)
Rates	228	229	292
<i>Benchmark</i>	224	225	273
Excess Return	4	4	19
Credit	-203	-298	-33
<i>Benchmark</i>	-137	-366	-87
Excess Return	-66	68	53

In Rates the decline in excess return comes from the relatively lower return in government agency mortgage backed securities (“MBS”) than in Treasuries in January of this year. MBS are pools of home mortgages guaranteed by government sponsored entities. ERS had approximately 15% of the Rates portfolio invested in government agency MBS as of the end of March 2016. These securities trade effectively as a government obligation with an infinite string of inefficiently executed call options written against them. Exactly how the calls will be executed is unknowable, but investors are compensated for taking the call risk with higher yields. Generally, individuals are more likely to execute their calls when interest rates decline and less likely to execute when rates rise. The precise duration of an MBS is unknowable, but the market assumes that they will extend when rates rise and shorten when they fall. In January underlying interest rates fell dramatically, creating strong performance in Treasuries and relatively lower performance in MBS. This made MBS appear relatively attractive; staff expects them to more than regain lost performance via additional yield and price moves. MBS generally out-perform in flat or modestly rising interest rates environments, and under-perform in strongly declining ones like January. For context, the Rates benchmark returned 1.63% in January 2016 and 2.29% for the entire trailing year. The cumulative return comparison for Rates and its benchmark is provided below.

Rates Cumulative Performance Comparison

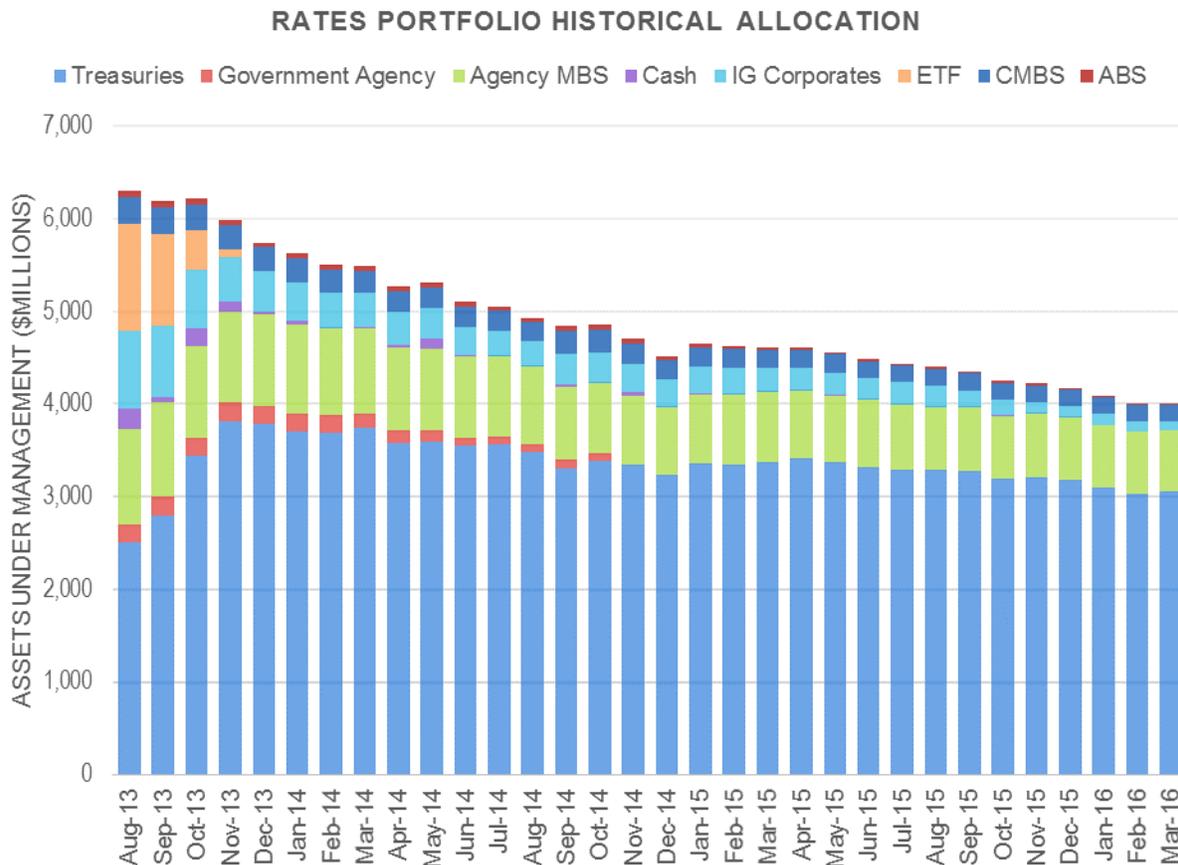


Below is a chart of the from inception returns of Rates and its benchmark in a floating bar format like that shown earlier for the major asset classes. The internally managed Rates portfolio with a 50 bps tracking error limit has produced an average annual relative return 12 bps greater than the benchmark (2.36% vs. 2.14%). Additionally, it has produced a relative 24 bps higher maximum (3.63% vs. 3.39%) and a 15 bps higher minimum (1.25% vs. 1.10%). The tails of each are similar, with 65 bps separating Rates' minimum return and 4th quartile break compared to 62 bps for its benchmark. The portfolio's recent decline in excess return appears to result from the benchmark returning 27 bps more in its last year than its average annual return, versus the Rates portfolio losing -10 bps over its average for the same period. This can be tied directly back to MBS performance.



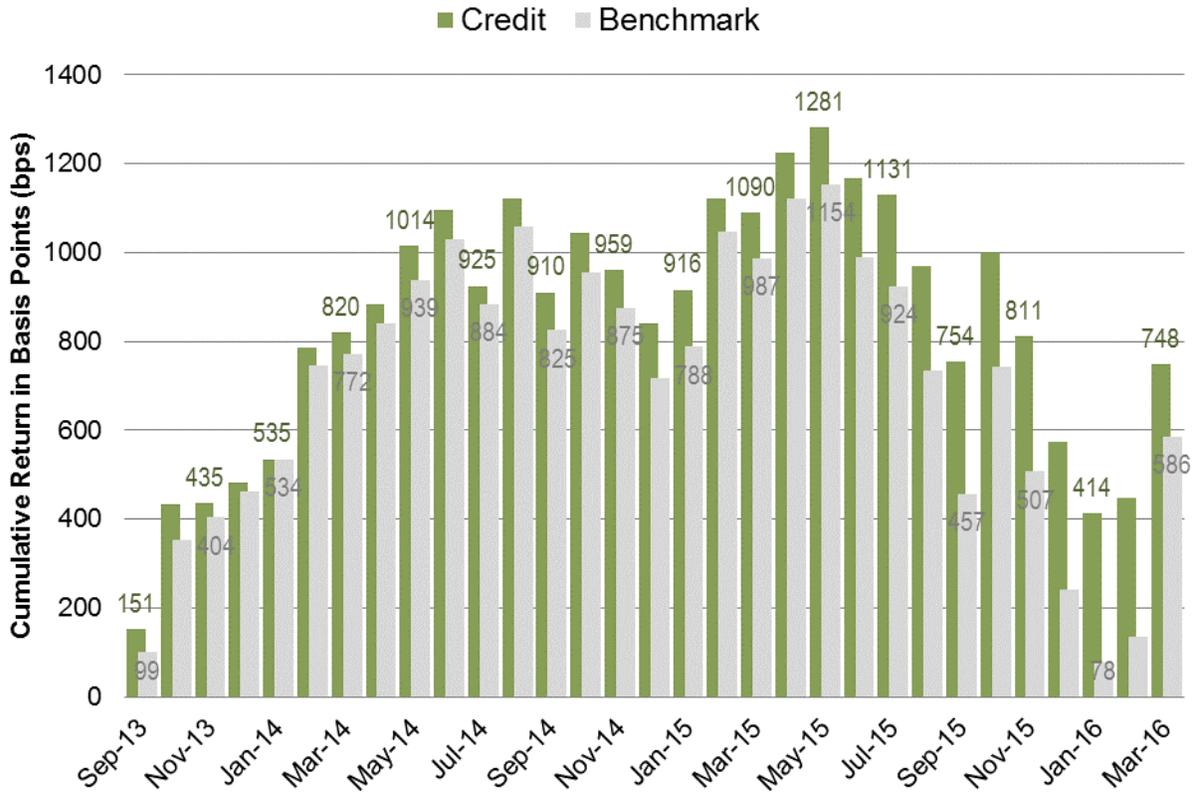
The legacy transition assets included in Rates have also detracted from returns in the last year. This was expected, and the portfolio added Treasury duration to hedge these very low interest rate risk securities. Recall these are the remnants of the prior IG positions when ERS utilized an Agg-style fixed income mandate. They still add modest spreads over Treasuries but are too illiquid and have so little risk that staff believes continued holding is appropriate. In total they comprise approximately 7% of Rates assets and are either close to mature IG corporates, commercial mortgage backed securities (“CMBS”), and asset backed securities (“ABS”). The IG corporates in particular are exceedingly short and are expected to all mature by the end of 2017. For the fiscal year to date the IG holdings returned 0.78% and the ABS 0.51% without any credit losses. CMBS returns mostly matched the benchmark returns.

The following chart illustrates the Rates portfolio's holdings through time as staff implemented the new program.



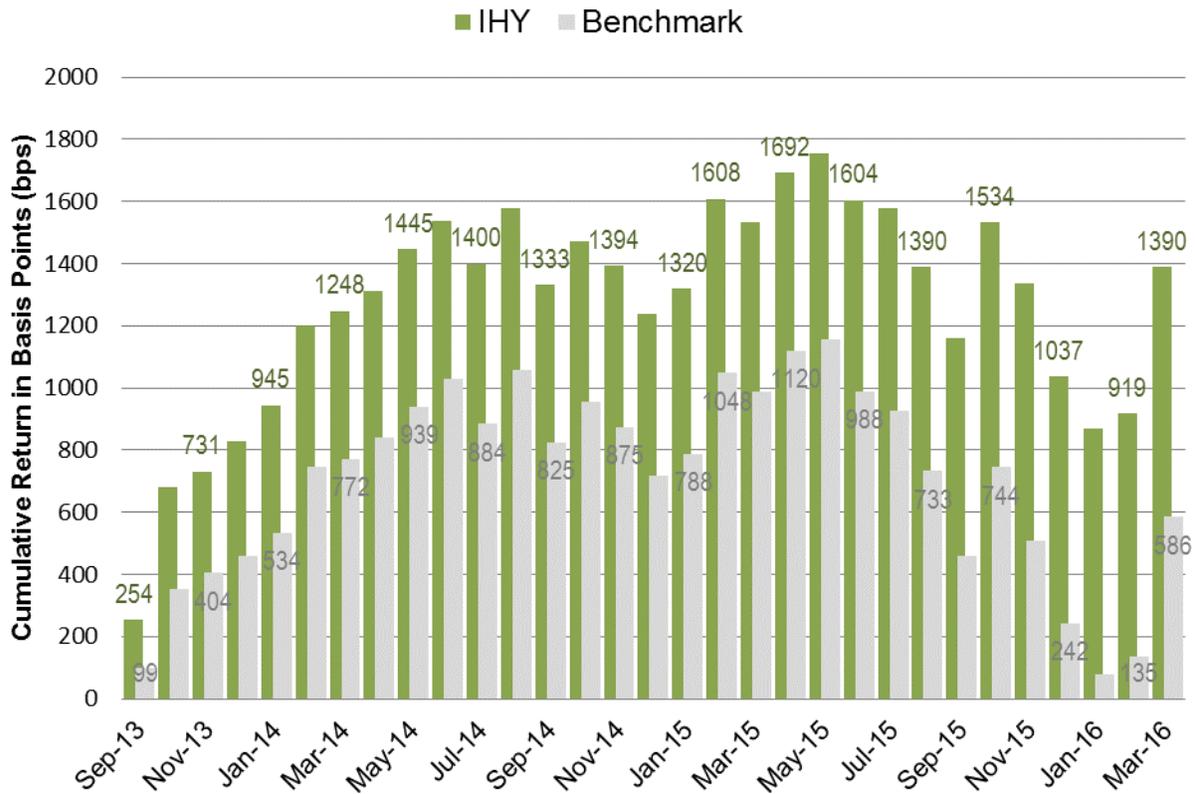
While the table at the beginning of the Performance section indicates that Credit is under-performing its benchmark for the fiscal year-to-date by -66 bps (-2.03% vs. -1.37%). Staff believes this is substantially a function of when the performance of the externally managed investments is recognized. Approximately 15% of the Credit portfolio is comprised of limited partnerships which report performance after the end of the month in which a return is earned. Those strategies, which earned -2.56% in February, were applied in March. The Credit benchmark in March returned 4.44%, creating a -700 bps relative performance deficit for these investments which equates to approximately -105 bps of total Credit under-performance for the month. To be clear, staff believes that some of the external managers under-performed in March, but does not believe it to be near that magnitude. Staff is confident that the performance in subsequent months will recover at least a portion of this shortfall. Even with the large relative under-performance in March, Credit's cumulative performance from inception is presented in the following chart. From inception the Credit portfolio has produced 7.48% of total return compared to 5.86% for its benchmark.

Credit Cumulative Performance Comparison



The IHY portfolio, as noted earlier, is 63% of Credit's assets, and it continues to perform well. Its total return for the fiscal year through March was 0.00% vs. the benchmark's -1.37%. Over the last 12 months, IHY lost -1.04% while the benchmark fell -3.49%. Since inception, IHY has produced 13.90% of return compared to 5.86% for the benchmark as shown in the following chart. Its excess return has come from security selection and active trading, and staff believes that it can continue to develop a quantifiable edge in IHY management. The key from this point is attracting and retaining qualified staff, which continues to be a challenge.

IHY Cumulative Performance Comparison



A partial consequence of the staffing challenge is that the Credit portfolio has needed to add more ETPs to cover its asset growth requirements which created performance drag, as these more liquid instruments theoretically deliver only benchmark performance less their management fees and expenses. Historically, staff was able to at least partially offset this drag by lending its ETP holdings, but ceased all securities lending in February 2016 (as covered in a subsequent Agenda item).

Credit's external mandates are comprised of higher risk and less liquid "satellite" strategies intended to complement the IHY mandate and ETPs. By design, these contain higher risk assets with higher expected returns than most stand-alone allocations to high yield bonds. The external portfolio effort is intended to give staff the ability to react quickly to market opportunities where no internal management capability, or advantage, exists. It may also be utilized when the opportunity is considered too transitory or resource dependent to warrant the development of in-house expertise. All four of the current external strategies are limited partnership structures: two are private equity type draw structures with finite investment periods (one already completed), one is CLO based strategy, and one is long/short special situations strategy. The last two have an evergreen investment period.

The selection process for external mandates is highly regimented and outlined in Fixed Income's Policies and Procedures. Each investment has been presented to and approved by fixed income's Internal Investment Committee, which has an IAC member serving in addition to the Chief Investment Officer and Executive Director.

Generally, staff develops relationships with a wide range of credit managers through frequent exploratory meetings, conference calls and participation in industry conferences. Managers can be sourced through multiple pathways, including inbound and outbound inquiries, referrals from other ERS private market teams, networking events and ERS' External Advisor website. Innovative and high-performing managers

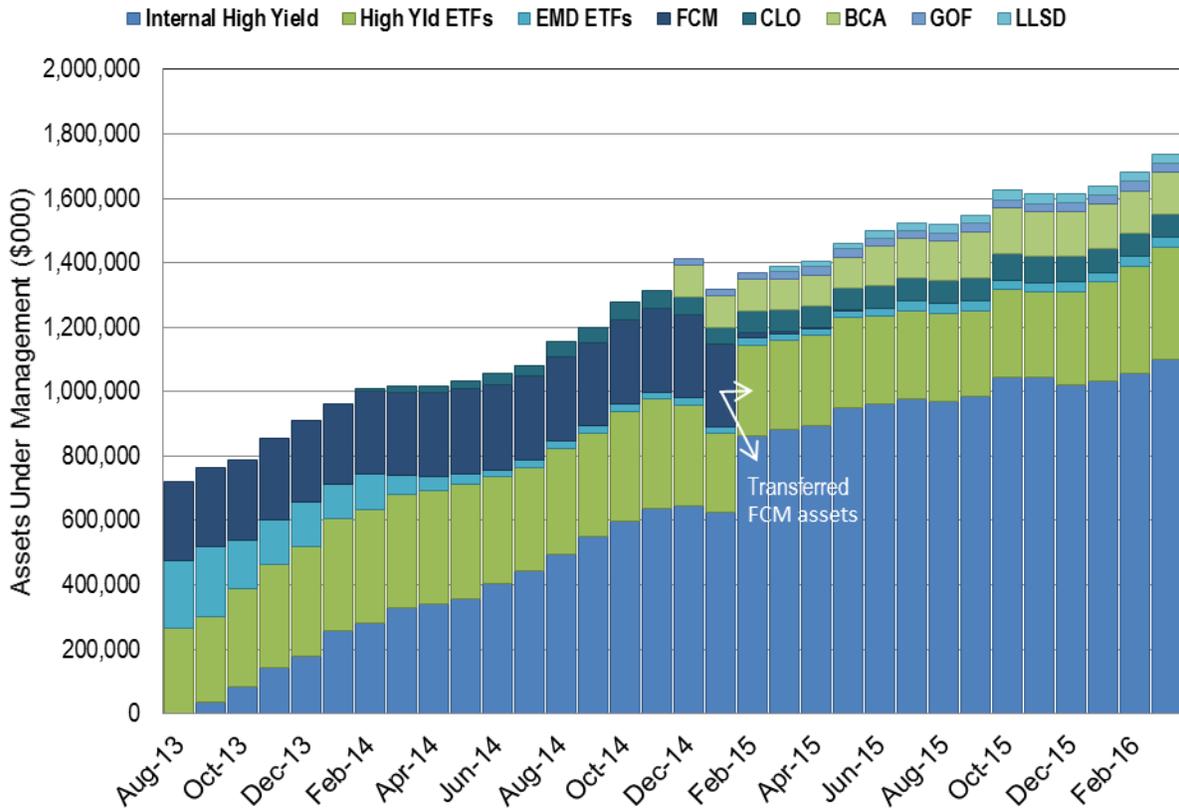
in low-priority strategies may still be evaluated for inclusion in the Select Pool, but not immediately funded. Strategies are prioritized based on a variety of factors and staff's perception of the economic and credit cycle versus what that strategy appears to be pricing. Because markets move quickly and the diligence effort is extensive, staff believes the Select Pool provides the flexibility to act in an appropriate timeframe.

As of March 31, 2016, the External Credit portfolio has committed \$406 million across these four strategies and invested approximately \$318 million. The table below is a summary of the investment characteristics of each strategy.

	CLO Equity/Mezz ("CLO")	Special Sits L/S Credit ("BCA")	Distressed Debt ("GOF")	Asset Liquidations ("LLSD")
Structure	Draw	Hedge Fund	Draw	Draw
Commitment	\$156,000,000	\$150,000,000	\$50,000,000	\$50,000,000
Invested	(\$100,000,000)	(\$150,000,000)	(\$32,500,000)	(\$35,000,000)
Investment Period	Evergreen	Evergreen	3 Years	Completed
Term	Evergreen	Evergreen	7 Years (+2)	3 Years (+1)

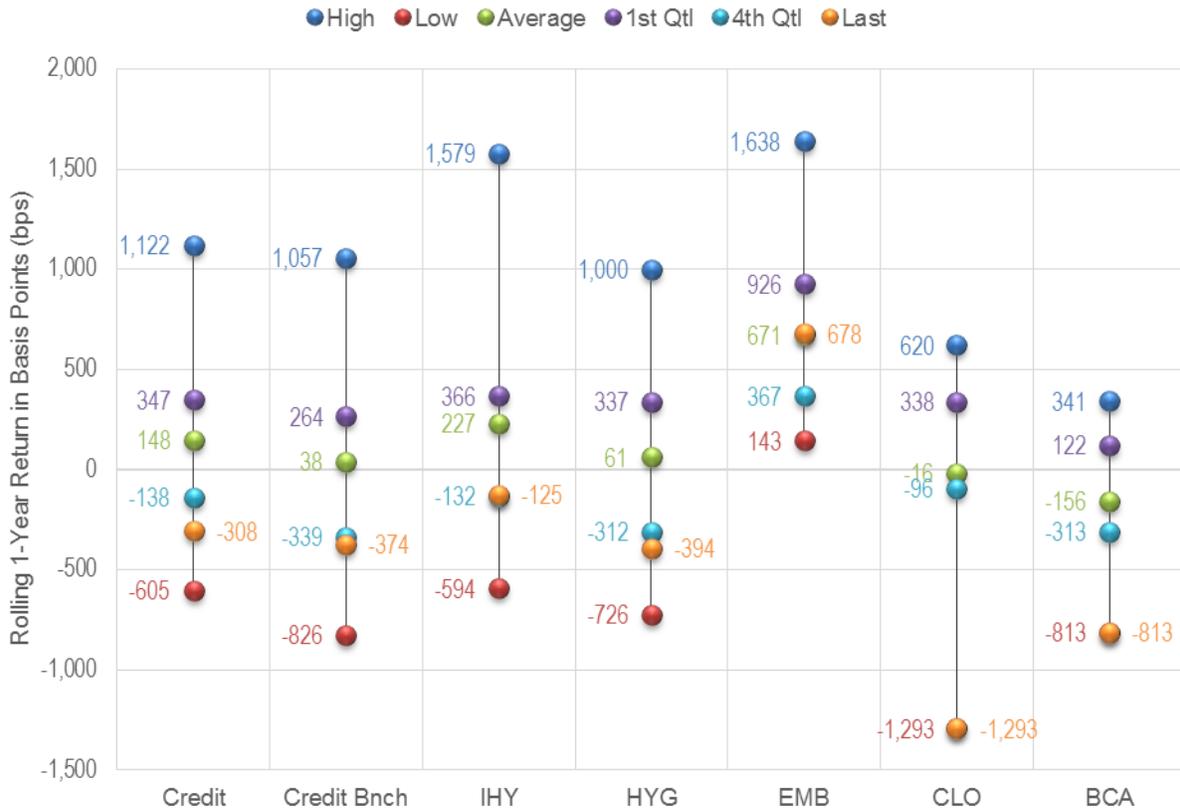
The following chart illustrates Credit's investment in all these different mandates through time along with the ETPs, IHY and its prior investment in Fountain Capital Management ("FCM") from the inception of the Credit portfolio.

Credit Mandate Historical Allocation



In order to more accurately reflect performance, the performance of the external satellite strategies is shifted to the period in-which its statement said it occurred, and presented in the following floating bar chart. It is admittedly too short a sample period make many deduction, but thus far Credit earned a higher maximum return (+11.22% vs. 10.57%), a higher minimum return (-6.05% vs. -8.26%), and higher average return (1.48% vs. 0.38%) for all available rolling 12-month periods. Additionally, it has a slightly narrower range of outcomes (17.27% vs. 18.83%) and a higher return per unit of range (9 bps vs. 2 bps), showing for this sample that it has not only produced higher returns but utilized less risk to do so. The primary source of the excess is IHY, with a 2.27% average rolling 1-year return, or 189 bps average rolling 12-month advantage.

Rolling 1-Year Credit Return Dispersion from Inception



WRAP-UP

ERS fixed income efforts continue to progress. Both Rates and Credit are earning excess returns while complying with their risk budgets. Rates produced strong absolute performance given its limited risk and the low level of yields, and Credit, after sustaining a sharp sell-off has rebounded and is on course to produce a strong year relative to other return seeking assets.

Staff remains confident it can sustain excess returns for Rates going forward with the existing team, but the ability to do so in Credit is more resource-dependent. The plan is to continue to focus on the IHY effort; as that portfolio grows, the task becomes increasingly complex. Nevertheless, the fixed income team is highly capable and remains confident that it can effectively manage this complexity.

STAFF RECOMMENDATION

The agenda item is presented for information and discussion purposes only. No action is required.

PUBLIC AGENDA ITEM - #8b*

Review, Discussion and Consideration of the Fixed Income Program:

8b. Review of Securities Lending Program

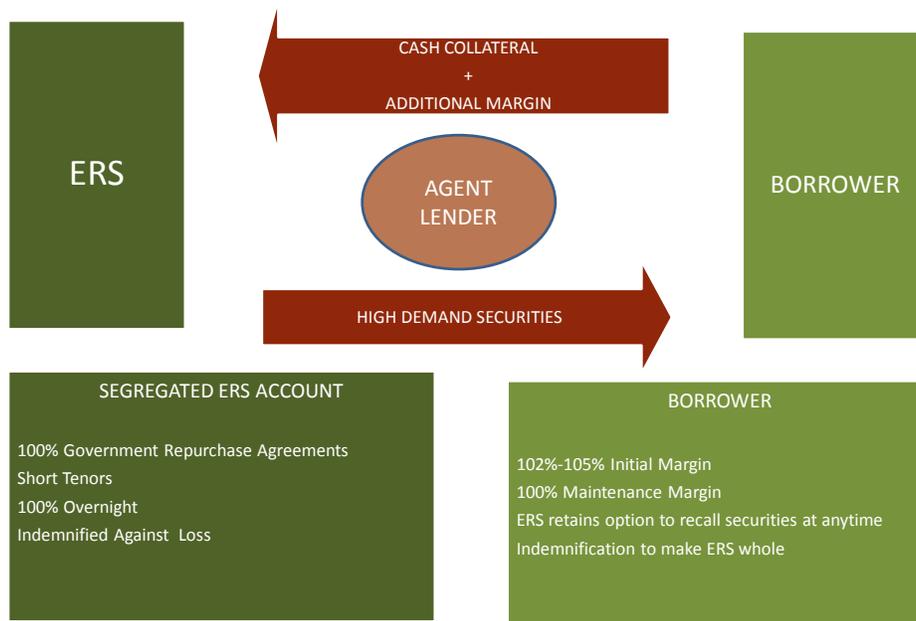
May 17, 2016

BACKGROUND:

In accordance with the ERS *Investment Policy*, Section 4.15, and Texas Government Code §815.303, on February 22, 2011, the Board of Trustees authorized staff to negotiate a contract with Deutsche Bank AG (“DB”) to act as its securities lending agent. The resulting contract took effect on September 1, 2011 and DB initiated activity for ERS as an actively managed third-party lending-agent separate from ERS’ custodian bank on September 6, 2011.

ERS hired DB to implement an intrinsic value program that employs a strategy focused on lending only highly sought-after securities to a diversified group of borrowers. Such securities (“Specials”) earn high fees for lending, and when combined with extremely low risk collateral management, produce attractive risk adjusted returns. These returns are additive to the overall ERS investment effort. They require no additional capital and do not inhibit or distort its other investment initiatives. The shortcoming to the program is that the volume of Specials held by the Trust are generally small, meaning that although it earns an attractive risk adjusted return; it does not earn a high absolute one. The following chart shows a high-level perspective of the program.

Securities Lending Investment Process



** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

Because DB indemnifies the Trust for both counterparty and collateral investment losses in government repurchase agreements (“Repo”), ERS’ counterparty exposure is effectively reduced to that of DB. This is not a risk staff takes lightly, and DB’s credit spreads are continually monitored. If their liquid spreads widen above threshold levels, staff has contingency plans to systematically reduce the amount on loan.

OVERVIEW:

A credit widening of DB’s spreads large enough to initiate these contingency plans occurred in late January and early February of this year. Part of staff’s continual monitoring is the credit default swap (“CDS”) spread level of DB, which it utilizes as a real-time measure of its credit quality, and thus assess its counterparty risk with DB and the meaningfulness of its indemnification. This spread, like many credit spreads in the market, was gradually increasing during the fiscal year from an October 2015 low of approximately 77 basis points (“bps”) to 99 bps in mid-January 2016. Beginning in late January 2016 DB’s CDS spread began to increase exponentially to a peak of 265 bps on February 11, 2016. When this spread implied a greater than 3% probability of default in the next year, staff instructed DB to begin to systematically recall all of its borrowed securities. Staff did not, and does not, believe that DB was in any immediate risk of default. However, they, in consultation with the Executive Director, believed revenues from the program were no longer sufficient for the risks implied by DB’s credit spread level. As a result, the decision was made to temporarily suspend the program. The following chart illustrates the daily closing level of DB’s five-year CDS spread for the fiscal year through February in the top half, and the net notional amount of DB CDS exposure registered with the Depository Trust & Clearing Corporation (“DTCC”) in the bottom, to provide the Joint Committee prospective.



Staff continues to monitor DB’s spreads and intends to re-implement the program in the manner in which it has been run since September 2011 as soon as it is appropriate to do so.

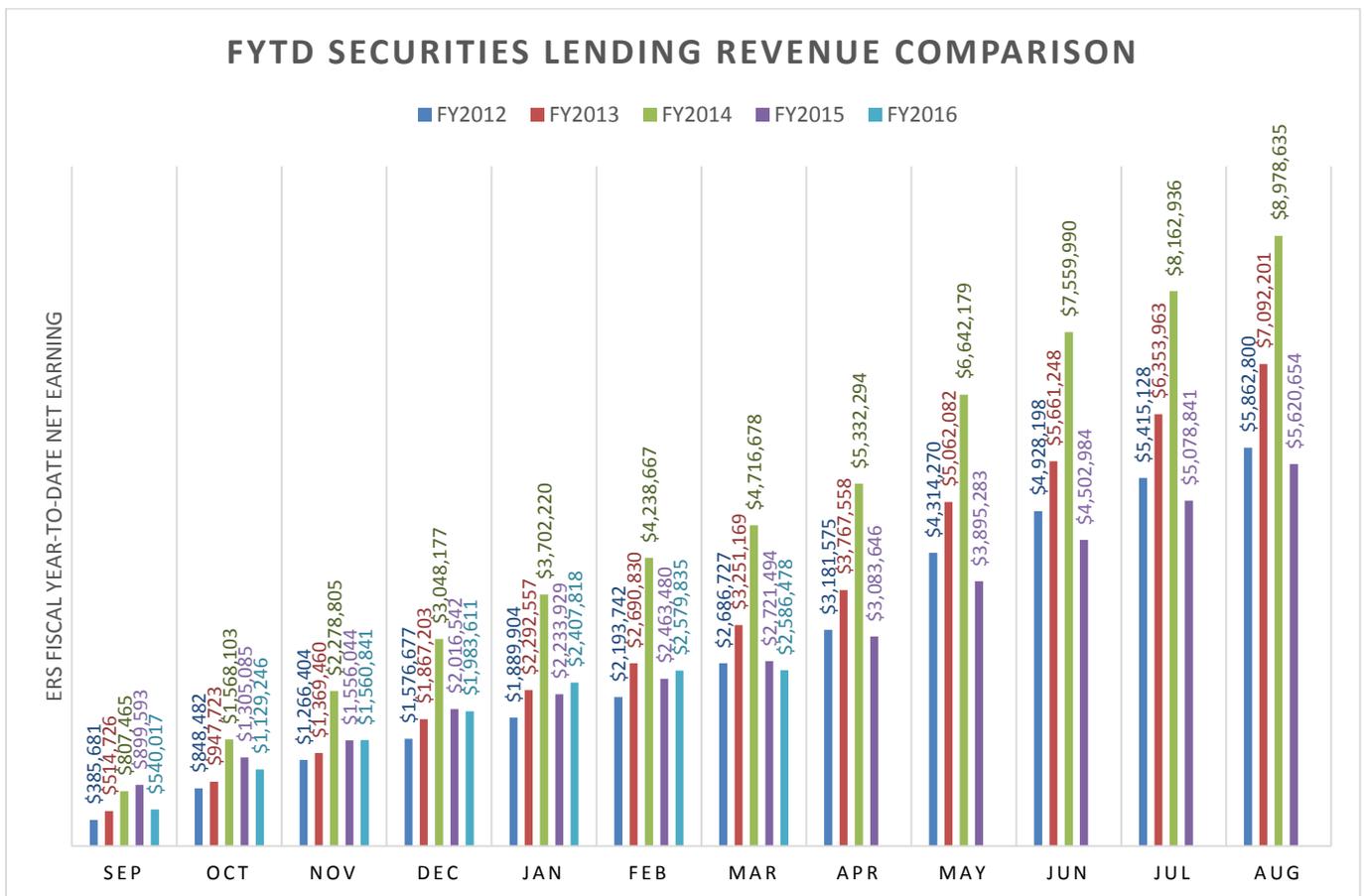
As a consequence of the suspension process of securities lending, ERS’ counterparty diversification requirements were violated, but its notional dollar exposure to all counterparties were materially diminished. The limiting single counter-party exposure being the reason for requiring the diversification in the first place made these violations pointless.

Going forward, diversification limits will be adhered to in a commercially reasonable format when the securities lending program is re-started. ERS will continue to implement an intrinsic value format,

meaning it does not intend on maximizing revenue to the Trust, but to continue maximizing the program’s risk adjusted return. ERS intends to lend only securities with rebates ≤ 0% (that is it rebates none of the collateral repo interest back to borrowers) and invest the collateral only in overnight government repos. Borrowers must post greater than 100% of the value of the loan in collateral, and maintain margin of at least 100%. As noted, ERS places strict diversification requirements on its borrower concentrations and actively monitors their credit spreads, and that of DB.

Staff is comfortable with the risk taken by the program when it is operating. Securities lending programs in general exhibit “right-way risk,” that is, when financial stresses emerge, asset managers tend to recall cash collateral from their prime brokers and return borrowed securities, causing the program’s utilization to decrease.

ERS’ risk controls reduced the program’s revenue compared with the prior fiscal years as is shown in the following chart, which provides a comparison of revenue since the start of the intrinsic value program in fiscal year 2012.



STAFF RECOMMENDATION:

The agenda item is presented for information and discussion purposes only. No action is required.

PUBLIC AGENDA ITEM - #9a*

Review, Discussion and Consideration of the Real Estate Program:

9a. Market Update and Program Overview

May 17, 2016

BACKGROUND:

At the August 19, 2008 Joint Meeting of the Employees Retirement System of Texas (ERS) Board of Trustees (Board) and the Investment Advisory Committee (IAC), an asset allocation was adopted that included investing 8% of the Trust's assets in real estate. At that time, approximately 2% of the Trust's assets were invested in real estate listed securities (Real Estate Investment Trusts or "REITs" and/or Real Estate Operating Companies or "REOCs") which were part of the public equity portfolio. With the approval of the asset allocation, Real Estate was deemed its own asset class. Consequently, the real estate listed securities portfolio was "moved" to the real estate asset class.

At the May 19, 2009 Joint Meeting of the Board and IAC, RVK, Inc (RVK) was selected as ERS' Real Estate Consultant. RVK's update on the real estate market is included with this agenda item as Exhibit A.

Subsequently, at the February 26, 2013 Joint Meeting of the Board and IAC, the Board approved an increase the real estate allocation from 8% to 10% of the Trust's assets.

Transition Plan - The real estate program is now fully funded and at a steady state. Depending on the drawdown of capital, proceeds received and other factors outside of staff's control such as the value of the overall System's assets, the exact private real estate weight is difficult to set unlike public equities where rebalancing is much easier. Staff will be tactical in committing new capital if attractive opportunities present themselves. Conversely, staff will slow down making new commitment if the opportunities do not present themselves or if assumptions are not being realized, resulting in a potentially higher weight to real estate than is desirable.

As the private real estate portfolio is at its "steady state", it should be emphasized that maintaining a precise constant weight for private real estate is extremely challenging. Due to the illiquid nature of the investments along with the factors outside of staff's control which are mentioned above, the private real estate weighting will vary from quarter to quarter and year to year. As a reminder, a typical fund's life can be anywhere from seven to ten years with the first three to four years being the investment period when capital is called and in the later years, the manager will sell the assets as they become stabilized after executing their business plans. Therefore, the capital called and returned can vary due to the market environment and other circumstances. The capital call and distribution schedules are never in an even measured pace or go as expected. In fact, it is not unusual for a fund to only call about 85% to 90% of the commitment amount as they like to keep reserves or just raise their successor fund.

Forecasting the cash flows for the private real estate portfolio is both a science and art. In anticipation of existing fund investments being liquidated, new commitments need to be made before that happens since the new fund capital will typically be drawn down over a number of years. Hence, it is a constant iterative process of determining when a fund will call capital and return it, as well as determining how much new capital to commit. Also, NAV and uncalled commitment amounts combined (i.e. economic exposure) will be greater than the target portfolio weight because of these timing differences. However, staff and the consultant are constantly monitoring the various moving parts to ensure the portfolio stays fully invested. It should be noted that impacts to the Trust whether positive or negative to the other asset classes in the System's portfolio also play a part in this calculation due to the denominator effect (e.g the size of the overall portfolio will vary as well due to increases or decreases in value to public equities, fixed income, etc). Most notably, severe market declines like that experienced in 2008 the overall System's portfolio value and consequently, the real estate weight.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

The annual tactical plan, which is a separate agenda item, will explain the details of future commitments and pacing.

Key points of the Real Estate Policies and Procedures located in the ERS *Investment Policy* are listed in the following table:

Category	Weighting	Investment Types	Geographic Weightings
Real Estate Listed Securities	30% (+/-10%)	Public Equities (REITs and REOCs)	Based on FTSE EPRA/NAREIT Index (and tracking error)
Private Real Estate	70% (+/-10%)	Private Equity and Private Debt (typically in a limited partnership structure)	<ul style="list-style-type: none"> • 70% Domestic (+/- 15%) • 30% International (+/- 15%)
Detailed Private Real Estate			
Core	30% (+/-15%)		
Non-Core	40% (+/-15%)		

Real Estate Team Staffing – In the early stages of implementing the real estate platform, a total staff of five to seven people was contemplated with personnel to be added over several years as the program matured. Current staffing is now at six people with the recent hire of an analyst.

Update of ERS' Real Estate Program – The real estate portfolio is comprised of publicly traded real estate securities (REITs/REOCs) and private real estate investments. As of March 31, 2016, the total portfolio was valued at \$2.6 billion, or 10.4% of the Trust's assets compared to a target weight of 10%. Investments in REITs are approximately \$730 million while private real estate is valued at \$1.9 billion. This mix will change as more money is committed to private real estate investments in achieving the 10% target of the Trust's assets.

Real Estate Performance (Time Weighted - net of fees)		
	Fiscal Year 2016 (7-month period through March 31)	Year (12 month period ending March 31)
REITS	9.1%	(1.2%)
Private Real Estate	7.0%	17.1%
Combined Real Estate Portfolio	7.6%	10.5%

Real Estate Listed Securities (REITs/REOCs) – As outlined in the Real Estate Policies and Procedures, listed securities are targeted at 30% (3% of the Trust's assets) of the overall real estate portfolio with a 5% band that allows a range of 0% to 8% of the Trust's assets. The Board increased the REIT weighting from 25% to 30% of the overall real estate portfolio at the August 21, 2012 Joint Meeting of the Board and IAC. At 3% of the Trust's assets, the portfolio is at its 3% target weight.

On September 22, 2014, ERS' internal real estate investment committee approved an investment of up to \$100 million into Wells Street Partners II L.P. which was underwritten by both the real estate and hedge fund teams. Wells Street is a long/short hedge fund focused on global real estate securities. On October 1, 2014, \$50 million was invested in the strategy and then on November 1, 2014 another \$50 million was invested.

Due to heightened concerns around REIT valuations along with uncertainty in the fixed income markets which potentially impact REITs, staff felt it was prudent to have a long/short strategy for global real estate securities. Unfortunately, the manager did not perform as expected and the strategy was defunded in two tranches with the last funds received in early March 2016.

There have been no changes to how the listed securities portfolio is managed internally. However, the tracking error is being increased as the internal resources have increased. Due to the build out of the private real estate program, the risk in the internal portfolio had been reduced. Historically, the global composite portfolio averaged over 150 basis points (bps) of tracking error. A majority of the tracking error was taken in the domestic portfolio. The last several years, the global composite portfolio was tracking around 30 to 40 bps, but currently stands at close to 130 basis points.

The Real Estate Listed Security Portfolio is managed as an enhanced index portfolio. The overall portfolio is comprised of two sub-portfolios: domestic and international. Risk controls include a tracking error limit of 300 bps to the FTSE EPRA/NAREIT Global Index. Consideration is also given to property and country weights to ensure the portfolio is not significantly over or under exposed to one particular area.

The real estate team attempts to enhance the portfolio return relative to the benchmark by applying various relative value disciplines. Relative weights are assigned versus that stock's weight in the index based on expected future total return versus its peers. This analysis is done within each country. Ideally, valuations would be compared across countries, but it is very difficult to come up with a robust model at this time. Many factors complicate a cross-country relative value analysis including reporting metrics, REIT structures, tax implications and data availability. In an attempt to further add value and diversify risk, stocks external to the benchmark may be included as long as they meet ERS investment policy guidelines.

Private Real Estate - The private real estate program began making commitments following the approval of the Policies and Procedures and Tactical Plan in August 2009, with the first real estate commitment being made in January of 2010. As of March 31, 2016, the net asset value of the private real estate program was \$1.9 billion representing 45 investments, \$2.9 billion worth of commitments and \$770 million in uncalled commitments.

The following table gives more detail on the unfunded commitments:

Risk/Return	Commitments (\$ million)	Called (\$ million)	Unfunded (\$ million)	% of Total Unfunded
Core	\$775	(752)	24	3%
Non-Core	2,070	(1,338)	746	97%
Total	\$2,845	(\$2,090)	\$ 770	

Note: Figures are in millions; Please note the numbers will not add up exactly as some funds recycle capital or we might have been in an early close whereby capital was returned after subsequent investors closed.

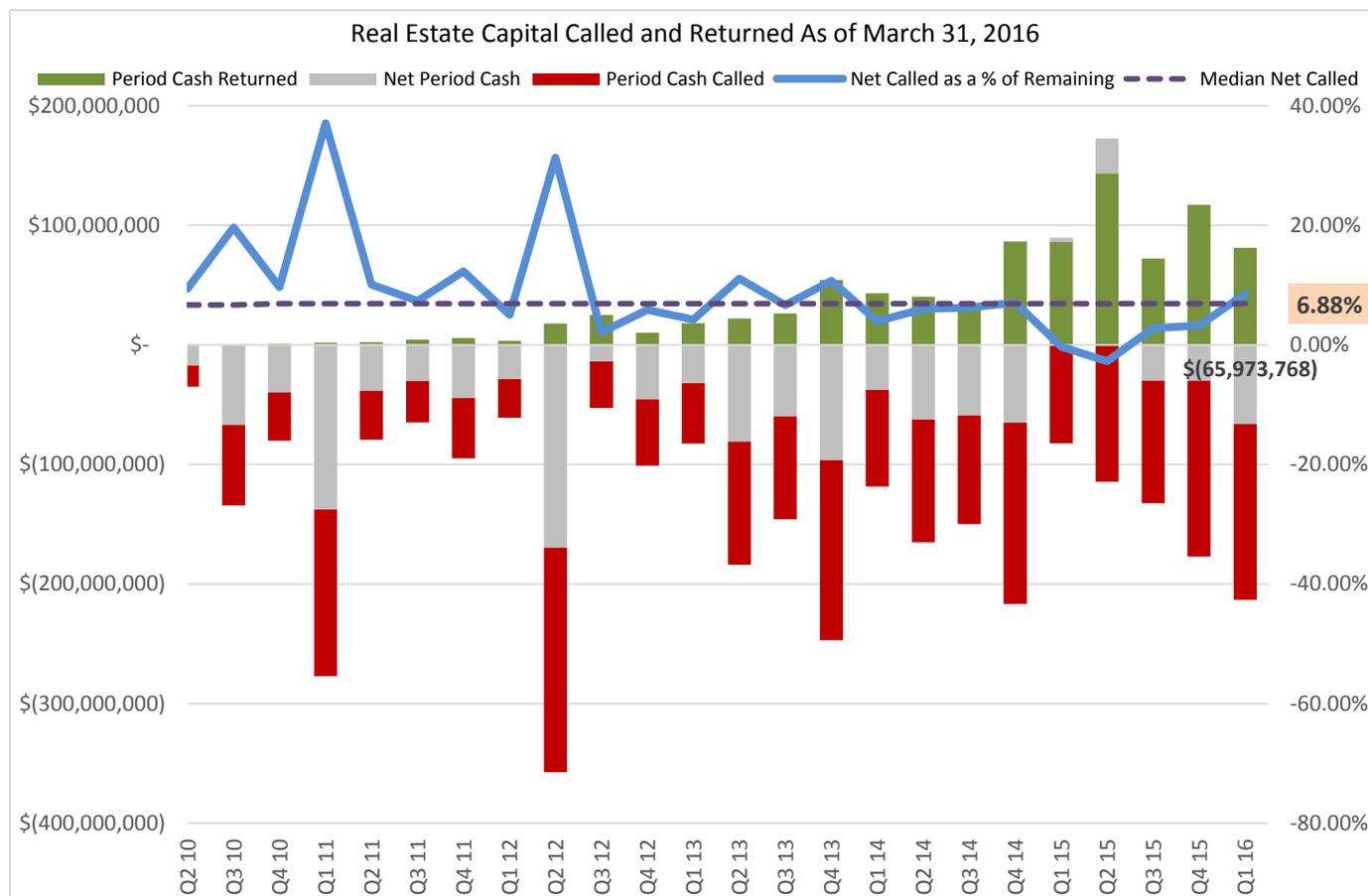
ERS has very little committed capital left to invest in the core space with the majority of future dollars invested devoted to the non-core strategies of value added and opportunistic. As a percent, core represents only 3% of total unfunded capital.

A listing of funds by risk/return strategy and geography is included with this agenda item as Exhibit B, and more details on private real estate investments through March 31, 2016 is included in Exhibit C. ERS has advisory seats on 34 funds.

As will be explained further in the tactical plan, which is a separate agenda item, RVK and ERS staff are proposing no hard commitments for fiscal year 2017, but with the potential to commit up to \$250 million. Through March 31, 2016, commitments made for fiscal year 2016 stand at eight investments totaling \$191 million. Capital called for the fiscal year through March 31 totals \$325 million with distributions of close to \$215 million.

The private real estate portfolio's net internal rate of return (IRR) was 12.74% since inception through March 31, 2016. This is unusual as typically a new portfolio will experience negative returns in the first few years due to the J-Curve effect. ERS' investments in the existing open-ended core funds mainly drove this phenomena as they experienced meaningful increases in their valuations, without any J-Curve effect. Subsequent yearly returns may be muted as the core funds returns moderate and the J-Curve impact of recently committed funds drags down returns.

The following chart shows the liquidity of the Private Real Estate portfolio comparing capital called and returned. The red bars represent "cash called" (cash outflows) and green bars represent "cash returned" (cash inflows) from the investments. The gray bar represents the "net cash" (cash outflows less cash inflows) into the portfolio. Also, the blue solid line in the chart reflects the net capital calls (calls net of distributions) as a percentage of remaining commitments over the different time periods.



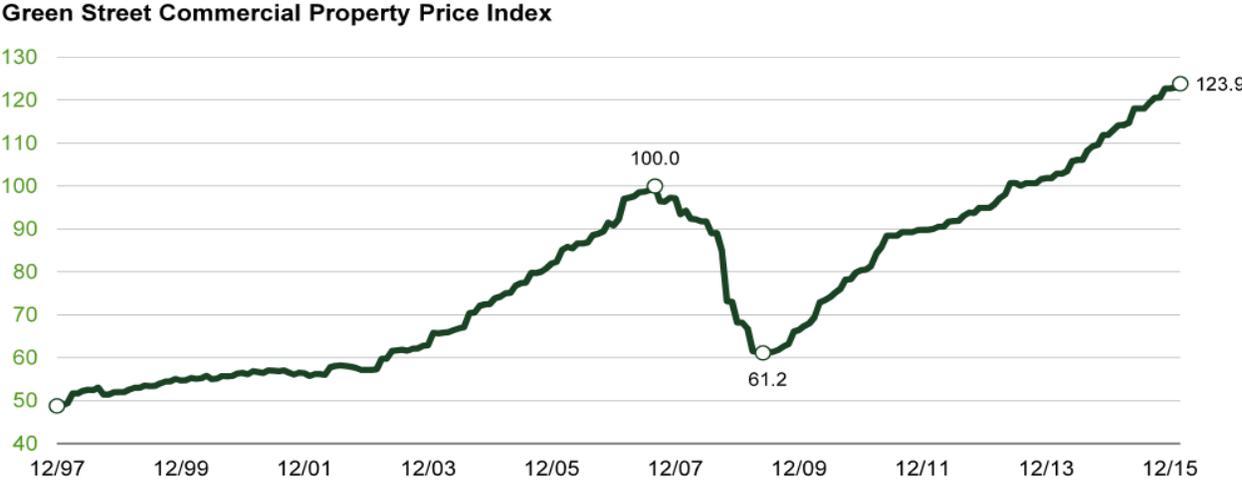
Source: eFront

The current portfolio is overweight industrial, multifamily and hotels while underweight office and retail. The industrial overweight is a tactical decision to invest in a property type with secular drivers at an attractive entry point. The overweight will naturally diminish as future commitments are made to other property types and as the industrial investments are liquidated. This is similar to the overweight the portfolio had to multi-family when it made two commitments to multifamily funds in 2011 and 2012. The portfolio now has just two industrial funds both of which are open ended core industrial funds, one focused on the US and the other focused on Europe. Two value added funds focused on the US have recently been liquidated and a redemption request has been submitted for a portion of the US open

ended core fund. Additionally, some exposure is gained through the diversified commingled funds. The industrial property space should benefit from a US (and to a lesser extent European) manufacturing renaissance as cheap energy will support the sector in addition to multi-national companies rethinking their supply chain logistics away from Asia. Ecommerce also has a significant impact as it drives demand from both online retailers and traditional retailers establishing an online presence.

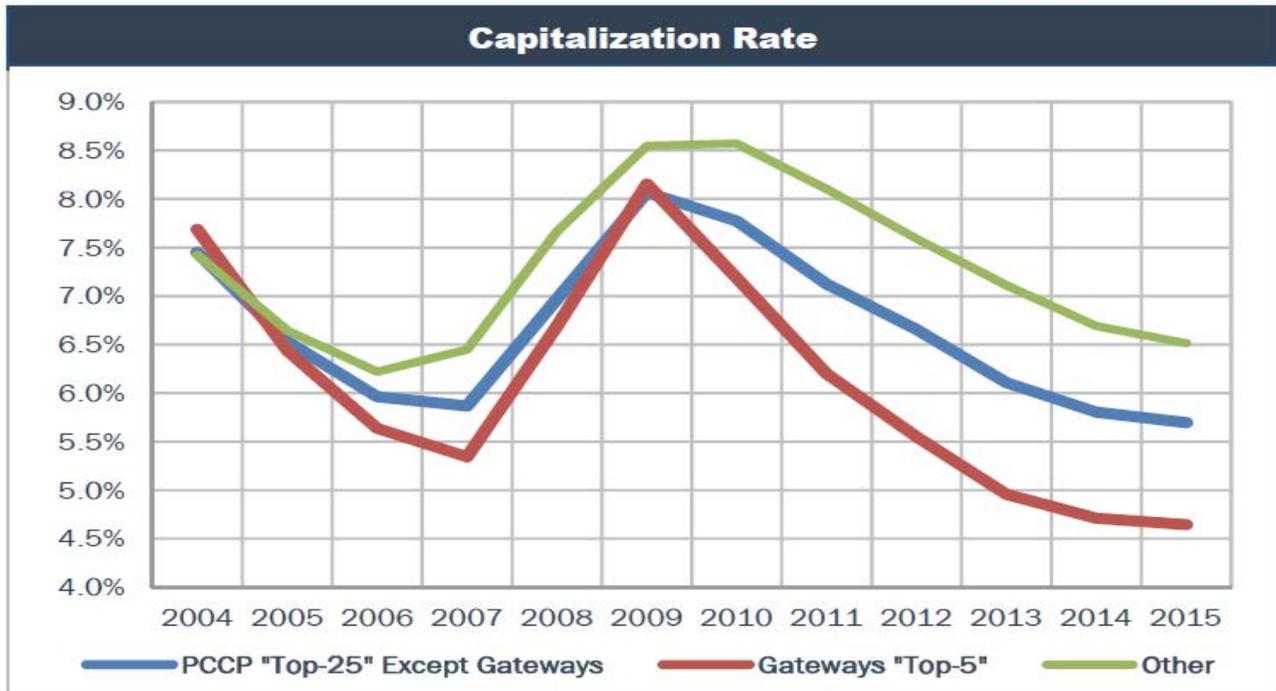
Staff, in collaboration with RVK, has primarily focused on niche strategies and non-core investments in the US and Asia for the current fiscal year. For the fiscal year through March 31, 2016, eight investments have closed for a total commitment amount of \$191. All but two of the investments were in the non-core space. In the core space, an additional \$15 million was committed to the Asian core fund bringing our total commitment to \$50 million. A \$20 million commitment was made to a portfolio of core retail properties in New York City as part of a club deal. A \$35 million commitment was made to a strategy focusing on buying manufactured housing communities whereby the land is leased to owners of the housing stock. A re-up of \$50 million was made to the Emerging Manager program and a \$50 million commitment was made to an India fund focused on stabilized office assets to high credit tenants (usually multinationals). An agreement was struck with a manager for a co-investment program with the potential to commit up to \$60 million (as the deals are closed the commitment amount will be recorded). Another self-storage investment was made for \$6 million. Finally, the second direct co-investment was completed for \$15 million as part of a debt deal in Asia.

Staff will continue to focus on non-core investment strategies as those appear to offer better risk adjusted return opportunities than core. With the search for yield and low funding costs, core properties in gateway markets have surpassed their valuations from the prior peak in 2007 by 24%. The chart below depicts this graphically with the Green Street Commercial Property Price Index, which is considered a measure of prime properties.



Source: Green Street

Additionally, the market has become bifurcated with prime quality assets (i.e. core) in gateway markets in high demand while assets in secondary and other cities have significantly lagged which can be seen by the capitalization rate spread across these groupings in the following chart.



Source: PCCP Market Commentary, First Quarter 2016

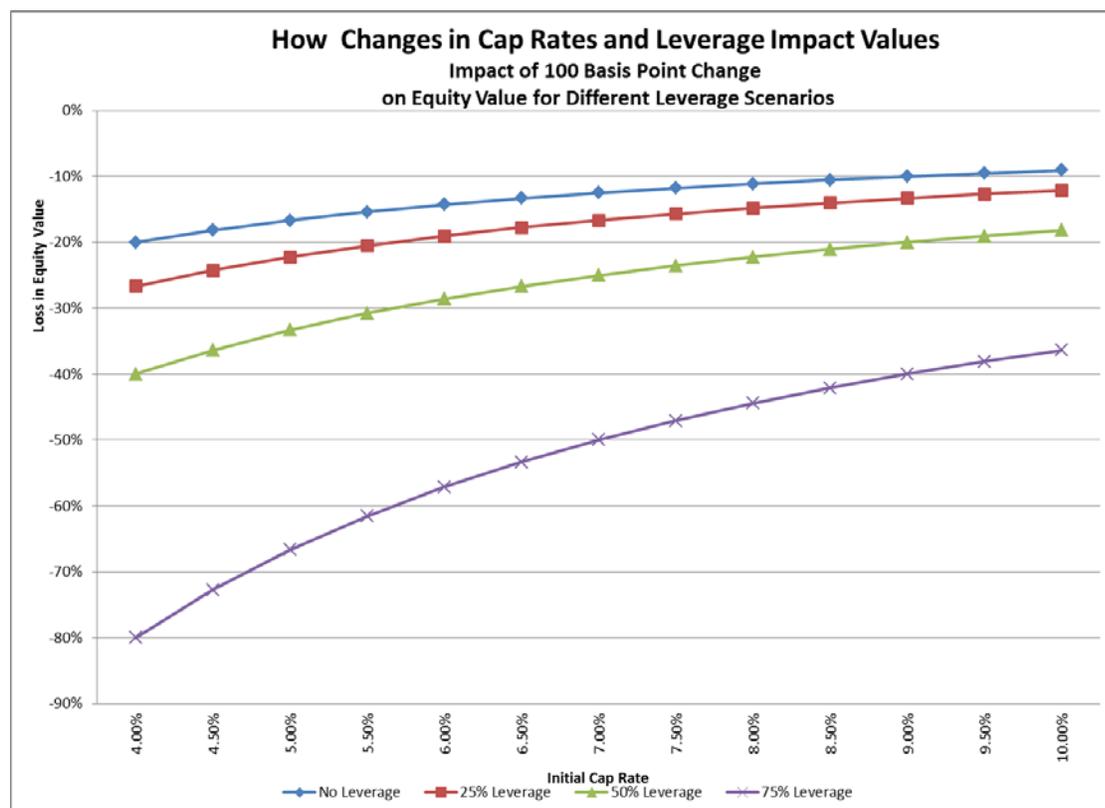
This pricing phenomena brings back memories of the “Nifty Fifty” stock bubble era of the 1960’s to early 1970’s. As a reminder, investors during this period focused on a select few “blue chip” stocks (50) that were deemed to be “buy and hold” or “one-decision” stocks due to their perceived superiority. However, investors threw caution to the wind and bid up some of these companies so that they were trading two to five times the typical market valuation. Since they were priced to perfection, they did not do too well in the ensuing stock market sell off and significantly underperformed the general market both in the short and long term. Properties in gateway markets should definitely command a price premium, but it is a cautionary tale that one can pay too much for a seemingly “safe” investment.

While these charts are for US real estate, the pricing differential between prime and non-prime assets is similar in other developed markets. Valuations as measured by capitalization rates¹ or “cap rates” for core properties have moved back to levels seen during the last pricing euphoria of 2006 and 2007. While interest rates are much lower now and net operating income (NOI) has more potential to increase now than during that period, the pricing still causes concern due to the sensitive nature of the equity value to cap rates.

For example, assuming no leverage and flat NOI, a property trading at a 4.5% cap rate would see an 18% loss in value if the cap rate increased 100 basis points to 5.5%. To maintain the same value, the property would need to experience a 22% increase in NOI if cap rates went up 100 basis points. Assuming the building had 25% leverage and a 100 bps increase from an initial cap rate of 4.5% occurred, the property would lose 24% in equity value. One must be aware of the potential for losses in core properties trading at such low cap rates, especially if leverage is utilized.

¹ Cap rates are a measure of value and inversely correlated to valuations similar to a bond yield. When cap rates increase, the value decreases.

The chart below shows the impact to equity values for different leverage levels assuming a 100 bps increase in cap rates.



Source: ERS, HFF and Gleacher & Company

Consequently, staff will focus on finding alternative core investments that appear better priced and that have lower correlations to traditional core property. Examples include medical office, timber, agriculture or core properties in international markets. Additionally, the portfolio will be overweight non-core (i.e. value added and opportunistic) risk return strategies and underweight core. The tactical plan provides more detail.

Intensive due diligence is critical to the process. Staff had over 125 meetings with approximately 80 different managers and extensive due diligence was conducted on over 12 funds for the fiscal year through March 31, 2016. Qualitative and quantitative factors are evaluated in considering an investment. For a prospective investment in the Private Real Estate Portfolio, significant consideration is given to the prior track record of a manager and the likelihood of that manager's success going forward. Attribution analysis is done to dissect the quantitative aspects of a manager's track record. Were the returns commensurate with the risk taken? Did they execute on their strategy? How much of the return was generated by leverage?

Investment structure and strategy, manager qualifications, advisory board participation, and control rights are also an important part of the due diligence process. Does the organization have personnel turnover issues? Do they have the capacity to handle existing investments along with a new fund? Does the strategy make sense and does it fit into ERS' portfolio? Is the GP aligned with the investors?

Another area to focus is the fee/return structures. Do the fees make sense and are they incentivizing behavior beneficial to the limited partners? Incentive compensation should be appropriate for the investment vehicle. If the Trust participates as a lead investor, it should expect a reduced management fee. Acquisition, financing, and disposition fees should be avoided in most situations. If such fees are

paid, the preferred return hurdles should be higher, promoted interest percentages should be lower, and/or the manager co-investment must be higher. Investment managers should provide a clawback to address a situation in which the investment manager potentially received more than the specified incentive compensation. This can be accomplished through an incentive fee reserve or holdbacks held in escrow.

Once an investment is made, monitoring becomes an essential part of the process. Attending advisory board meetings, frequent communication with management and other LP's, reading and analyzing quarterly reports and other GP information are all important to ensure the manager is executing the strategy as promised and to identify any potential issues that may arise.

Accomplishments and Initiatives – The real estate program is progressing as planned. REITs continue to complement the private real estate portfolio and have provided beneficial exposure to the asset class. The portfolio is now at a steady state and we expect our distributions to be close to our capital calls.

Tony Cardona joined our team in May 2015. Initially, he was going to support both the private and public real estate portfolios; but due to his expertise and career goals, he is now solely focused on the public domestic real estate portfolio. Both the domestic and international real estate portfolios have seen a marked increase in tracking error and active share which is contributing to better relative performance.

The private real estate portfolio added to its international investments with a commitment to India and a co-investment in the Asia region. This was our second co-investment and staff is putting more emphasis on this type of opportunity. Core fund redemptions were initiated to take advantage of the strong real estate market over the last 5 years and realize gains on these early core investments.

In the private real estate portfolio, staff will continue its strategy to focus on non-core (i.e. value added and opportunistic) investment strategies as well as to continue to explore separate accounts and co-investments. This will allow staff to be more tactical and efficient in deploying capital. Additionally, international exposure will be increased with potential investments in Asia and/or Latin America.

In collaboration with RVK, the real estate staff have negotiated favorable economic terms for most of the private real estate investments saving the Trust an estimated \$45 million over the life of the investments. Additionally, the legal staff along with the real estate team has negotiated favorable non-economic provisions that have strengthened ERS' position.

Staff will continue committing capital to private real estate as appropriate and consistent with Trust guidelines. This will be discussed in more detail in the Tactical Plan Agenda Item.

STAFF RECOMMENDATION:

This agenda item is for information and discussion purposes only. No action is required.

ATTACHMENTS – 3

Exhibit A – RVK, Inc Review of Real Estate Markets

Exhibit B – Private Real Estate Total Portfolio by Risk Return Strategy

Exhibit C – Private Real Estate Total Portfolio – Summary of Commitments by Fiscal Year



Memorandum

To	Employees Retirement System of Texas (“ERS”) Board of
From	Dan Krivinskas, Mark Bartmann, and Ryan Robinette, RVK, Inc. Real Estate Consulting Group (“RVK”)
Subject	Current Real Estate Market Conditions
Date	May 17, 2016

I. Executive Summary

This memorandum is intended to provide an overview of current real estate market conditions, both domestically and internationally, in order to highlight potential opportunities and pitfalls for Employees Retirement System of Texas (“ERS”) real estate portfolio investments for Fiscal Year 2017 and beyond. Fiscal Year 2016 showed continued valuation increases in domestic real estate markets and many developed international markets (particularly Europe) where ERS has deployed capital. The majority of core real estate assets located in major gateway U.S. cities having surpassed their pre-Global Financial Crisis highs. U.S. core real estate markets have appreciated considerably since 2010, and attractive pricing opportunities currently are limited. In the multifamily sector, a significant valuation rebound also has occurred, and most multifamily assets throughout the U.S. are trading well above pre-credit crisis peaks. In the past year, most of the other real estate sectors in the U.S. have followed suit, with valuations climbing either close to or higher than their prior peaks. Just like last year, the biggest bifurcation still exists in the office markets, as valuations of office buildings in large market central business districts (“CBDs”) are well above their pre-credit crisis peaks, while suburban office buildings continue to be the laggard in the real estate recovery thus far. However, even suburban office is starting to show signs of pickup in pricing, emblematic of buyers searching for yield despite long-term structural challenges impacting the sector.

While attractive opportunities still exist in some real estate markets, they are increasingly challenging to find. The ERS Real Estate Portfolio has benefited significantly from a robust recovery in real estate markets since 2010, given increasing demand for stable real estate from yield-starved investors. However, we caution that we may be closer to the end of this real estate cycle than the beginning. Almost certainly, U.S. real estate performance over the next several years will be more challenging than the “bounce-back” period from the Global Financial Crisis lows. While the pace of increases in the federal funds rate is likely to be slower than many real estate participants have forecasted over the past year, the impact on long-term interest rates still remains one of the most pertinent,

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and difficult to prognosticate, issues for real estate investors in the coming years.

While U.S. real estate investors may face monetary policy headwinds over the coming year, increasingly accommodative interest rate and quantitative easing policies are taking shape in Europe and Japan, which has already benefited early entrants (including ERS) in those real estate markets. Finally, emerging real estate markets have suffered over the past few years, given slumping demand for export commodities impacting real estate demand and increasing cap rates in many of those markets. While ERS has only recently started tip-toeing into emerging real estate markets, RVK believes that this weakness provides opportunity for ERS over the next several Fiscal Years. In particular, ERS' initial focus on emerging markets benefiting from lower crude oil prices may be a positive catalyst for real estate returns. Over the long-term, many other emerging real estate markets in Asia and Latin America are appealing venues for both income generation and capital appreciation, as they are likely to benefit from stronger economic growth and increased space demand (e.g., increased numbers of office workers needing space) than most developed real estate markets. However, as we continuously counseled ERS in past years, international real estate investment entails risks (e.g., legal, currency) which must be scrupulously examined, priced, and managed.

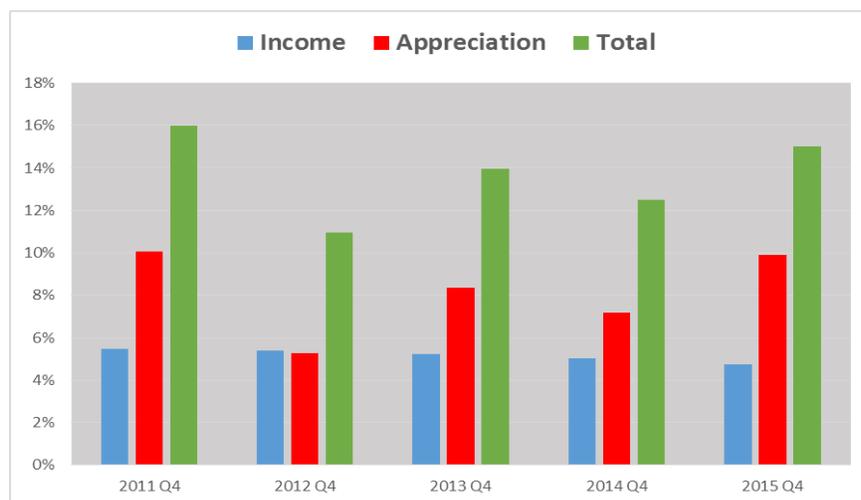
II. U.S. Real Estate Market Themes

A. Continued Increase in Core Real Estate Values

Over the past few years, yield-starved investors have flocked to income-producing real estate property types, with core real estate being the earliest beneficiary of this trend. The appreciation returns from core real estate have been significant over the past five (5) years, as measured by the appreciation component of the NCREIF-ODCE index. After strong growth in 2011 (appreciation returns of 10.1%, and total returns, including income and appreciation, of 16.0%), core fund appreciation leveled off to only 5.3% in 2012, leading to appreciation returns of 5.3% and total returns of "only" 10.9% in 2012. However, 2013, 2014, and 2015 demonstrated additional strong gains, with appreciation returns of 8.4%, 7.2%, and 9.9% (and total returns of 13.9%, 12.5%, and 15.0%), respectively, continuing to confound many critics of core U.S. real estate values. The graph on the following page illustrates this trend.

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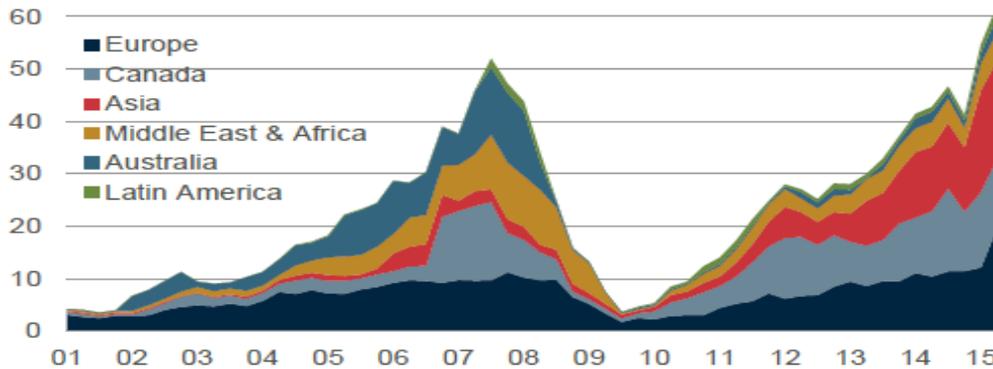
NCREIF-ODCE Index Returns, 2011 – 2015



Source: NCREIF, March 2016

This strong performance coupled with attractive income yields vis-à-vis other asset classes continues to drive record capital flows into the sector, and the weight of this capital should continue to result in rich pricing and low yields for dominant assets in primary markets, at least for the foreseeable future. Demand for U.S. real estate from foreign investors has been particularly strong and may increase in light of recent REIT and FIRPTA (Foreign Investment in Real Estate Property Tax Act of 1980) reforms that encourage foreign investment in the asset class. The following graph shows the level of foreign investment in U.S. real estate over the past 15 years.

Foreign Investment in U.S. Real Estate, 2001-2015



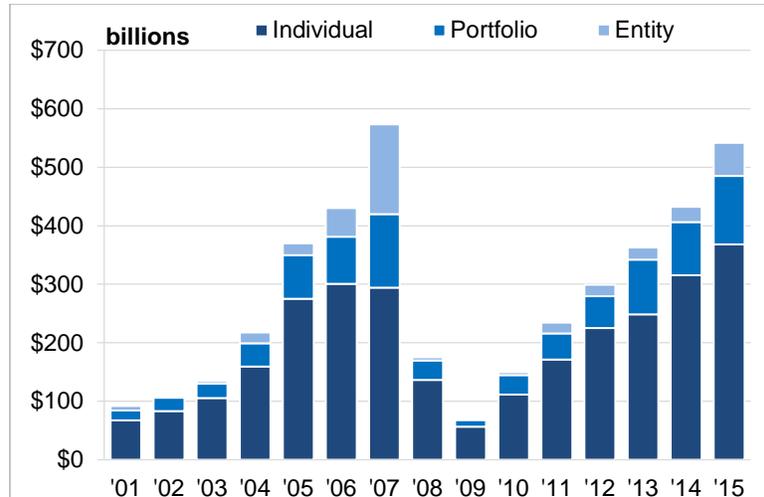
Source: Prudential Real Estate Investors, December 2015

Foreign investment flow into U.S. real estate is at a record high, with approximately \$60 billion of inflows in 2015 accounting for nearly 15% of all property purchases. Early 2016 showed no signs of change in this trend, as high profile transactions by foreign investors have been announced in recent weeks (most recently, China’s Anbang Insurance bidding for Blackstone’s recently-purchased Strategic Hotels & Resorts after purchasing the Waldorf-Astoria hotel in New York in 2015). While this pace has been impressive, we note that the strong U.S. dollar relative to most major foreign currencies and a potential pullback from some sovereign wealth funds reliant on oil revenues may dampen some of this exuberance in the coming years.

B. Transaction Volume and Pricing Continue to Surge, Although Very Recent Data Show Signs of Potential Slowing

Sales of significant commercial property totaled \$533 billion in 2015, a 23% increase over 2014. This level marks 2015 as the second highest level of investment volume over time behind the peak \$573 billion in activity seen in 2007. Commercial property prices also posted a healthy gain, with the Moody’s/RCA CPPI expected to be up 12% for the year. Though this represents impressive gains for the year, the price growth from this index was a slowdown from the 17% gains in 2013 and 16% gains in 2014. The below chart represents the annual transaction volume from 2001 through 2015.

U.S. Real Estate Transaction Volume, 2001-2015

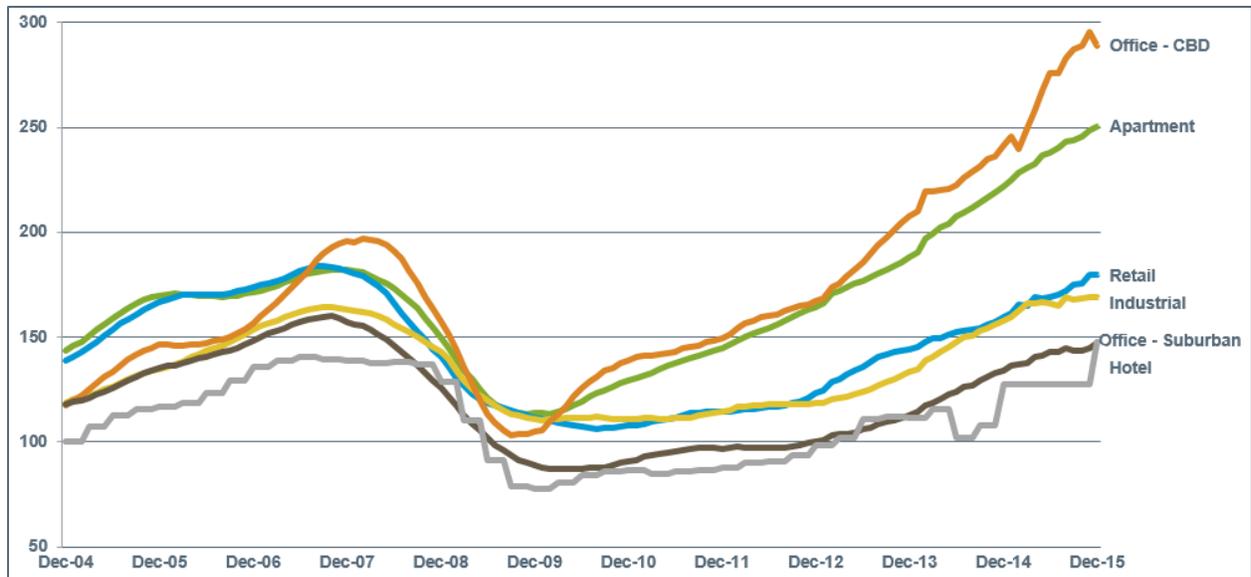


Source: Real Capital Analytics, March 2016

What 2016 portends remains to be seen, as January 2016 showed the first month-over-month **decrease** in the Moody's/RCA CPPI index since early 2010. While it is too early to determine whether this is the beginning of a new trend, it is notable given the unabated increases in pricing over the past several years.

Property prices at an aggregate level surpassed the 2007 peak and cap rates in many sectors are at all-time lows, while the CPPI for many property types continue to outpace pre-crisis levels. Of particular note is the persistent increase in valuations for the highest-quality office assets in major markets. According to Real Capital Analytics, valuations in the CBD-Office sector increased **another 19.8%** in 2015 (following a 17.5% jump in 2014) and are now approximately 47% above prior peak levels. Investors are acquiring urban office assets at record high prices and historically low cap rates, driven considerably by sovereign capital with a seemingly unwavering appetite for large “trophy” properties that allow these institutions to deploy large amounts of capital quickly and efficiently.

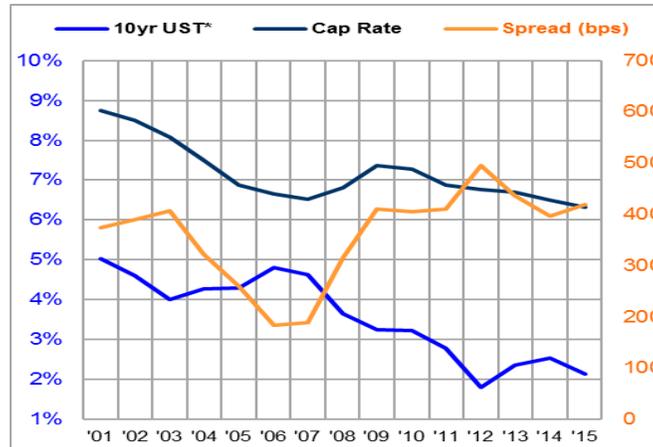
Moody's/RCA CPPI Index, Years Ended 2004-2015



Source: Real Capital Analytics, February 2016. Various property type indices represent measures of change based upon repeat sales transactions set out at a base of 100 at year-end 2004.

While cap rates have continued to compress and pricing has approached or surpassed pre-crisis levels, it is important to note that the spread between property cap rates and the ten-year treasury yield is significantly greater than pre-crisis levels. Year-over-year, the spread increased 22 basis points in 2015, up to 418 basis points, which is 234 basis points higher than the 2006 pre-crisis low of 184 basis points, and nearly 60 basis points above the average of 361 basis points dating back to 2001. Notably, the spread is in excess of 400 basis points across all major property types save for multifamily, which increased 24 basis points up to 379 basis points, while spreads in the hotel sector are the greatest at 622 basis points. The following graph depicts this relationship dating back to 2001, focusing on aggregate cap rate data for all major property types.

U.S. Real Estate Cap Rate Spread, 2001-2015

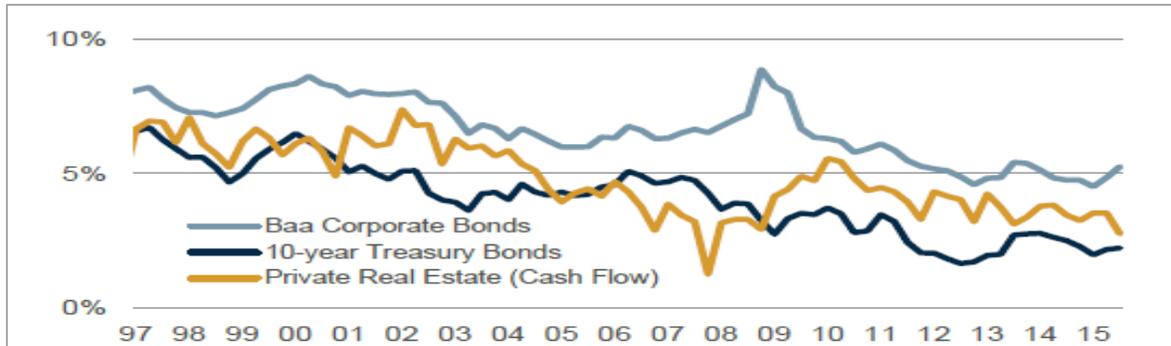


Source: Real Capital Analytics, March 2016

Additionally, given the yield characteristics of private real estate, it often trades between the yields of the 10-year Treasury bond and the Baa corporate bond index. Although private real estate traded at significantly higher valuations during the 2006-2008 boom period, it is notable that current valuations put private real estate squarely in between these two buffer zones, as noted in the chart on the following page.

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U.S. Real Estate Yields Relative to 10-Year Treasury Bonds and Baa Corporate Bonds, 1997-2015



Sources: Real Capital Analytics, NCREIF, NAREIT, Moody's Analytics, Prudential Real Estate Investors, December 2015

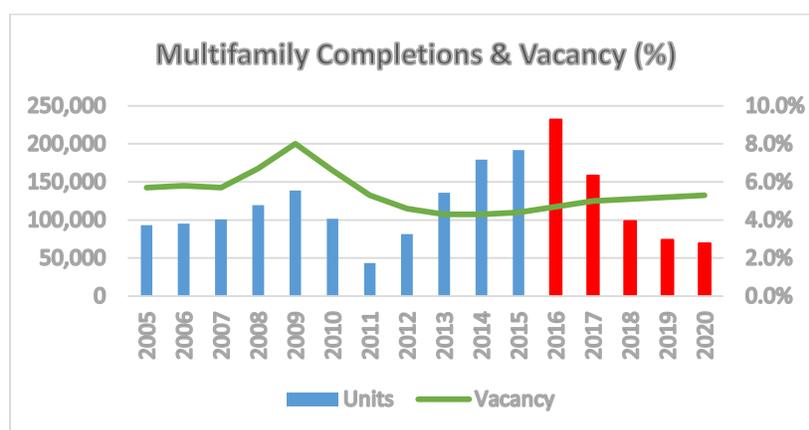
C. Multifamily Still Attracting Attention, But Caution Warranted Over “Class A” Product in Gateway Markets

Many believe demand for multifamily assets will continue its recent hot streak, aided by the current low-interest rate environment and the still declining homeownership rate, which fell to approximately 63.7% in 2015 according to the US Census Bureau, as an increasing number of existing households choose to rent rather than own. Further, the US Census Bureau estimates pent-up housing demand from approximately 22.4 million 18 to 34 year old young adults, the most prevalent renter demographic, is expected to be released as the economy continues to recover from the financial crisis and job growth accelerates. While we acknowledge many of these fundamental tailwinds, RVK believes caution is warranted in Class A product in major “gateway” U.S. markets, given current pricing in this sector, relative to long-term averages. Despite the fact that the market is long into this expansion cycle, the apartment market posted some of the strongest gains in 2015. Deal volume came in at \$150 billion, up 32% from 2014, the highest capital investment of any property sector.

Cap rates for apartment assets have generally hit a floor in the six (6) “Major Metros” defined by Real Capital Analytics (Boston, Chicago, Los Angeles, New York City, San Francisco, and Washington, DC). In general, cap rates for the Major Metros hit an average 5% floor in mid-year 2014. As we have discussed in previous years, cap rate compression is evident in secondary markets, with a narrowing of the spread to cap rates for comparable product in the “Major Metros.”

In response to escalating rents, new multifamily construction has picked up since 2011. According to Reis, 2015 completions totaled nearly 192,000 units, an increase of approximately 7.0% year-over-year, the most prolific volume dating back to 1999. This trend is expected to continue through 2016, with another 231,000 units projected to be delivered, prior to a

slowdown anticipated to occur between 2017 and 2020. Despite the significant number of completions in recent years, multifamily vacancy rates have remained very strong at approximately 4.5%, which are expected to increase slightly to 5.3% in 2020. The following graph shows new multifamily completions and vacancy rates dating back to 2005, with projected data through 2020.



Source: Reis, March 2016

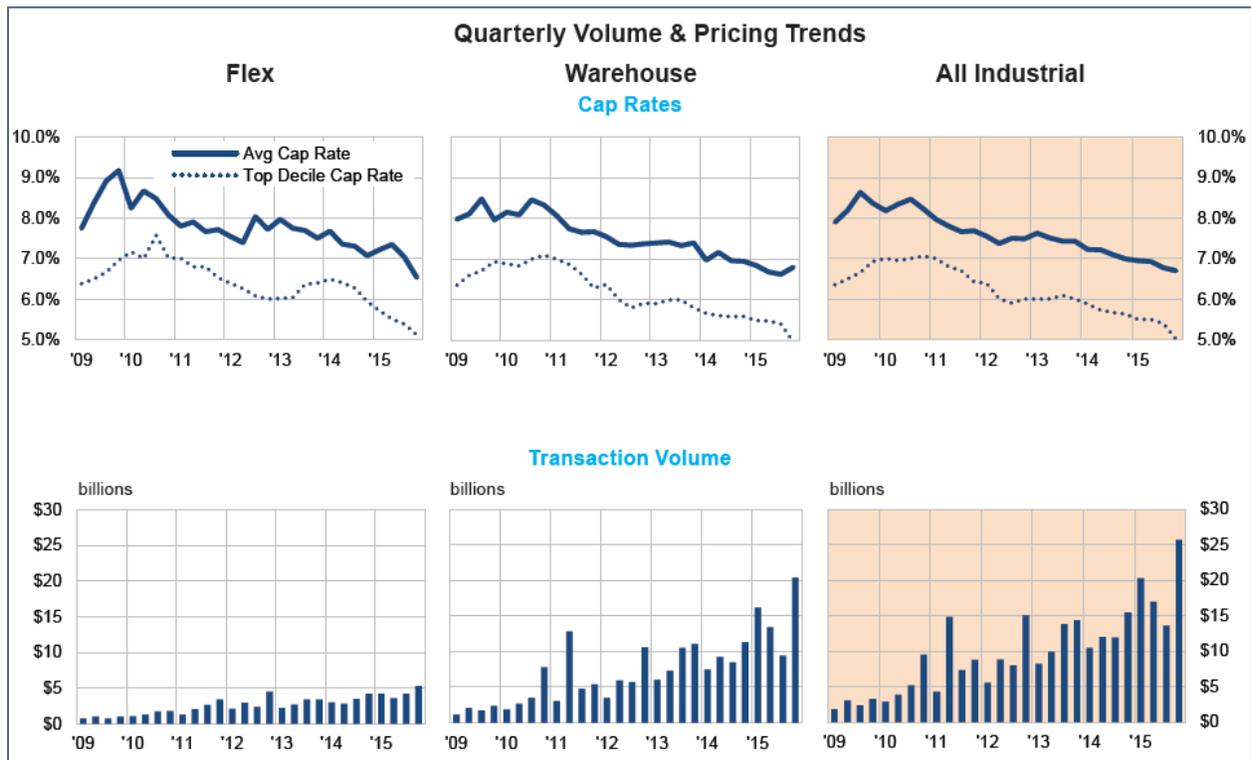
Similarly, effective rents have continued to increase, with a year-over-year increase of 4.7% in 2015 and a 4.1% increase projected in 2016. Beyond that, effective rent growth is anticipated to curtail, with 2017 through 2020 projections of 3.3% in 2017, 2.7% in 2018, 2.5% in 2019, and 2.2% in 2020.

D. Industrial Transaction Volume and Pricing Continues to Surge in Major Metros, While Opportunities Exist in Secondary Markets

The industrial property sector posted 54% annual growth in volume on sales in 2015, to \$77 billion. The year 2015 has created a new high water mark for sales volumes in the industrial sector, beating the \$59.6 billion sale volume level set in 2007 by a wide margin. Two stories drove these volume gains, portfolio and entity-level sales and foreign capital flows. The sale of individual industrial assets grew in 2015, but the growth was only 7% year-over-year on sales of \$38 billion. This figure is the same as the previous high water mark for the sale of individual industrial assets set back in 2007. The majority of the sales volume growth for 2015 came from the \$38 billion in deal volume tied up in portfolio and entity-level deals.

Cap rates in the industrial sector compressed 30 basis points from a year earlier to hit 6.7% in 4Q2015. Some of this decline is driven by the sudden 60 basis points drop in flex cap rates from 3Q2015. The warehouse subset constituted nearly 80% of all deal volume in 2015, and cap rates were down only 10 basis points from a year earlier, hitting 6.8%. There has been a bit

of a flattening in industrial cap rates, and price rises are starting to moderate, as initial estimates of the Moody's/RCA CPPI suggest that prices increased 6% year-over-year, down from an average 15% per annum in the previous two (2) years. While cap rates continued to compress in this sector, it is important to highlight the cap rate spread between the Major Metros and secondary markets grew to approximately 130 basis points in 2015, surpassing the previous high of 80 basis points previously achieved in 2007, 2008, and 2014. During 2015, cap rates fell approximately 56 basis points in the Major Metros while flattening in secondary and tertiary markets. This spread may lead to attractive, risk-adjusted investment opportunities going forward. The chart below provided by Real Capital Analytics represents the quarterly transaction volume and pricing trends in the aggregate industrial sector, broken down into Flex/R&D and Warehouse/Distribution subsets from 2009 through 2015.



Source: Real Capital Analytics, March 2016

In addition to improvements in transaction volume and pricing, according to Reis data, the industrial sector demonstrated positive fundamentals in 2015, as the sector absorbed approximately 114 million square feet of space, with both rental rate and occupancy improvements. Effective rental rates grew approximately 2% year-over-year, while vacancy



rates dropped 100 and 60 basis points across the Flex/R&D and Warehouse/Distribution subsets, respectively, as shown in the following chart.

Property Type	Net Absorption (millions of SF)	Effective Rent	Year-Over-Year Change (%)	Vacancy Rate	Year-Over-Year Change (bps)
Industrial - Flex / R&D	15.0	\$ 8.21	1.9%	11.8%	(100)
Industrial - Warehouse / Distribution	99.1	\$ 4.55	2.0%	10.6%	(60)

Source: Reis, February 2016

E. Positive Fundamentals Across Other Property Sectors

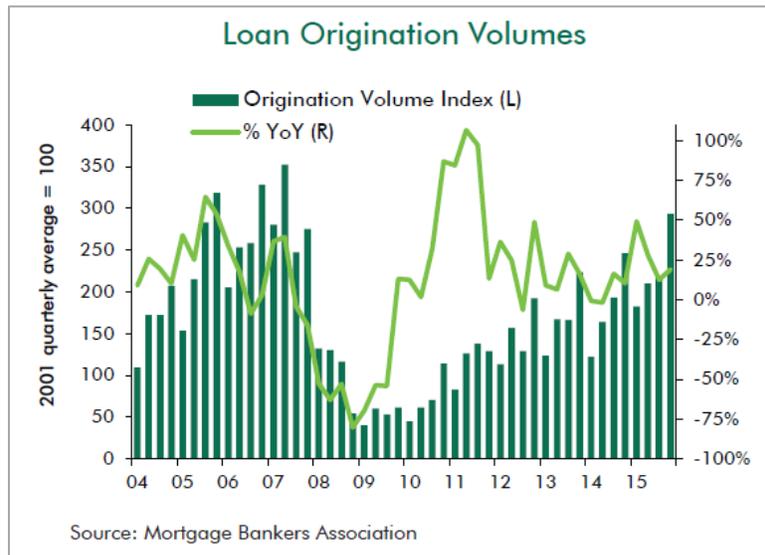
In addition to the multifamily and industrial property sectors, the office and retail property sectors exhibited strong fundamentals in 2015, including positive absorption, effective rent growth, and decreased vacancy rates. The office sector, led by assets located in urban centers, demonstrated positive effective rent growth of 3.2% and also saw a 40 basis points dip in vacancy, from 16.7% to 16.3%. Finally, the retail sector, specifically neighborhood & community centers, showed more muted improvements, including a 2.2% growth in effective rents and a 20 basis points decrease in vacancy.

Property Type	Net Absorption (millions of SF)	Effective Rent	Year-Over-Year Change (%)	Vacancy Rate	Year-Over-Year Change (bps)
Office	43.6	\$ 30.86	3.2%	16.3%	(40)
Retail - Neighborhood & Community Centers	11.6	\$ 17.53	2.2%	10.0%	(20)

Source: Reis, February 2016

F. Ample Amounts of Real Estate Debt Available in Most Markets

As the U.S. real estate recovery continues to gain steam, lenders have become more willing to originate debt to real estate investors. While most new loans still are being underwritten at lower loan-to-values (“LTVs”) with stronger covenants (e.g., debt service coverage ratios) than during the 2004-2008 real estate boom period, in our discussions with real estate lenders and borrowers alike, RVK has noted a continued loosening of covenants, debt service coverage ratios, as well as other lender protections during the last few years compared to the most stringent periods following the Global Financial Crisis. According to CBRE, although CMBS spreads widened considerably in the last quarter of 2015 and origination dropped, borrowing and lending by commercial banks, life insurance companies, Fannie Mae, and Freddie Mac continued to be robust, making 2015 among the strongest years in recent history. For 2015, total originations were up 24% from 2014 levels, based on preliminary estimates. The industrial sector experienced the biggest bump, with loans increasing by 100% from the prior year, while multifamily and hospitality loans were up 30% from 2014.



G. Continued Opportunity to Take Advantage of Mispricing in Secondary Markets

As we have counseled ERS over the last several years, we believe that there is an opportunity to take advantage of yield premiums in select secondary markets relative to primary markets. Indeed, while secondary market spreads are still historically wide of gateway cities, there are signs of this starting to reverse. Beyond short-to-medium term dynamics, though, we believe that with the *potential* (although certainly not a guarantee) for increasing interest rates over the next few years, the risk-reward dynamic is increasingly favoring secondary markets that are not priced as “bond alternatives.” Observed cap rates on asset sales in New York City and San Francisco are typically well below 5% and sometimes below 3%. While it is difficult to find quality assets in secondary markets trading above 8%, there is a substantial amount of “cushion” available in case the unexpected *does* happen, and trophy real estate assets in gateway markets are no longer seen as “bond alternatives.”

H. While Monetary Policy May Become a Headwind, Focus on Secular Long-Term Real Estate Trends Should Mitigate Long-Term Impact

As we discussed last year, RVK continues to be cautious about the sustainability of the current real estate market uptrend in the United States, given monetary policy tailwinds potentially becoming headwinds. Core real estate investors historically have viewed real estate yields relative to what is available from the U.S. Treasury markets (typically using 10-Year Treasury yield as their benchmark to calculate cap rate spreads). Thus, the fact that core real estate



values have increased significantly in light of rapidly decreasing U.S. Treasury yields is not surprising. What is more concerning, however, is the amount of activity in certain gateway markets, where recent entrants have priced real estate not only as a “bond alternative,” but also priced in substantial rental rate increases into their purchase prices. This is emblematic of the latter stages of a real estate bull market. Whether it be trophy hotels purchased by Asian insurers or trophy office towers purchased by European sovereign wealth funds, RVK believes that these recent buyers may be disappointed with these investments, in case longer term interest rates actually *do* rise. While RVK is not necessarily predicting a rise in long-term interest rates (many market prognosticators have tried, unsuccessfully, to call the top in the bond market) and is still constructive on real estate fundamentals, it is increasingly unlikely that valuations can keep increasing at their recent run rates. Given this, we believe that one of the best ways to cope with late-cycle real estate behavior is to focus on assets that benefit from longer-term secular trends that will be less exposed to cyclical downturns. In particular, ERS Real Estate Staff and RVK have taken advantage of secular trends such as the aging Baby Boomer demographic (e.g., medical office and self-storage), which provides a yield advantage compared to traditional property types, such as CBD-office and traditional apartment investments.

III. International Real Estate Market Themes

A. Rotation of European Real Estate Capital to More Non-Core Markets Likely to Continue in 2016, But Recent Fears Have Given Some Investors Pause

Discussions of a Eurozone collapse have generally subsided since their 2011 crescendo, and prognosticators have now shifted to anticipating the impact of European Central Bank policies on economic growth, inflation, and investment yields across the region. This has benefitted core real estate pricing in major European markets, although the uptick is still in its early stages in most markets outside of London, central Paris, larger German cities, and the Nordic capitals (where risk-averse capital continued to flow throughout the European economic crisis). During 2015, RVK noted a strong focus on secondary real estate markets of the United Kingdom and continental Europe, where secondary property yields are still attractive relative to primary markets. Real estate investor focus is also shifting to prime assets in Spain, Italy, Poland, and the Czech Republic and even towards other Southern and Eastern European markets. Such investments were perceived as unthinkable five (5) years ago, but this is emblematic of a rapidly recovering market.

However, the cycle of greed and fear is alive and well in Europe. To this point, RVK has noted the ongoing migrant crisis and recent terrorist attacks in Paris and Brussels has given some institutions pause from investing in European deals in recent weeks. Moreover, market participants have considered the potential for “Brexit” as serious enough to warrant caution about investment in Sterling-denominated assets before the June 23rd referendum on the United Kingdom’s potential exit from the European Union.

B. Asian Real Estate Markets

Concerns about slowing Chinese growth and falling commodity prices continues to impact real estate pricing throughout much of Asia. With that said, over the long term, real estate opportunities throughout Asia should be driven significantly by modernization, global production migration, and increasing spending power of the emerging middle class, particularly in “developed” Asian markets. Urbanization should continue in these countries over the long-term, providing opportunities to meet this demand, albeit with cyclicity and significant currency volatility. Given the scarcity premium for high quality Asian real estate assets and the relative strength of the US dollar to Asian currencies, ERS has taken advantage of the opportunity by selectively investing in core and non-core real estate assets in the region. Opportunities to take advantage of relatively attractive yields should persist in the coming Fiscal Year.

C. Emerging Real Estate Markets

1. Cyclical Downturn Provides Opportunity

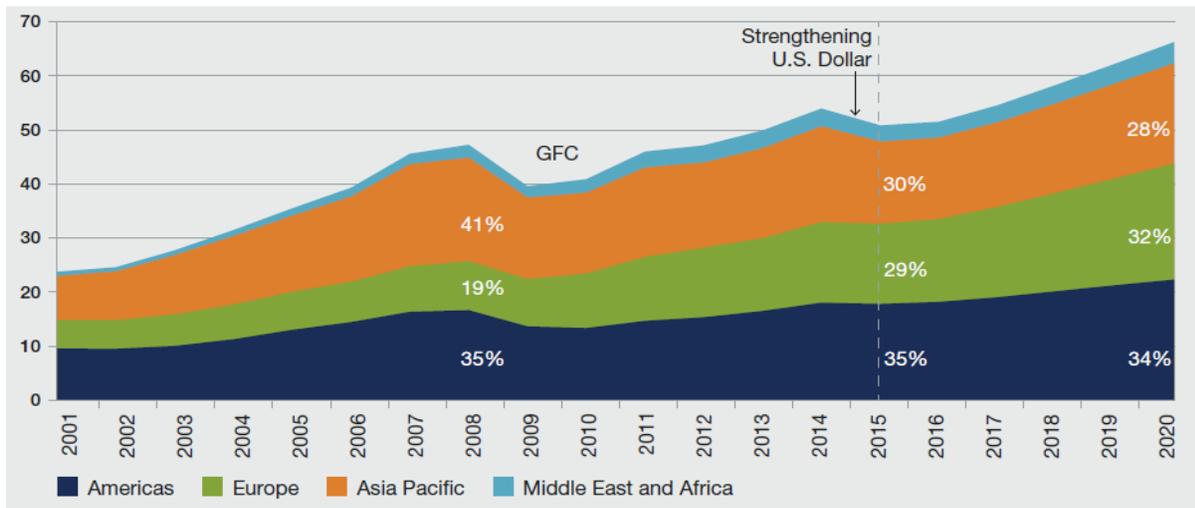
As we noted last year, the global “risk aversion” trade that impacted the United States, then Europe, then Asia, has caught up with most emerging markets. The relative perception of safety between developed and emerging markets has flipped. While most developed markets are seen as safe havens now relative to the instability of emerging markets, several years ago developed markets were seen as overleveraged compared to the growth opportunities available in emerging markets. As RVK has noted for the last several years, many institutions focused on emerging markets without properly evaluating the extent to which overly buoyant commodity markets were supporting their economic growth. Indeed, the overextension of credit in many emerging markets along with unjustified growth projections—just like many economic cycles before and like many economic cycles after—is now causing significant pain for many investors. This near-term pain provides potential long-term opportunity for ERS. RVK is now evaluating potential investment opportunities in many of these markets with more fervor than at any time since before the Global Financial Crisis. In many emerging markets, particularly in Latin America, the opportunity to take advantage of distressed sellers is similar to the opportunity set in the United States in 2008 and 2009 and in Europe in 2010 and 2011. Of course, while the opportunity to deploy capital to these markets without the need to employ significant leverage is enticing, investors must be willing to hold onto assets for longer periods of time, given that the precise timing of recovery is very difficult to accurately predict.

2. Secular Reform Has Created Better Environment for Institutional Investment, Despite Near-Term Volatility

Despite the near-term volatility impacting many emerging markets, political and economic reforms implemented over the last decade have led to better environments for foreign direct

investment over the long-term. Governments have recognized that investment in real estate and infrastructure is crucial to long-term economic growth. While it is difficult to predict with any precision, the share of institutional real estate capital focused on Asia and Latin America is likely to increase over the coming decades.

Size of Real Estate Markets Globally, 2001-2020 (Estimated) (US\$ Trillions)



Sources: LaSalle Investment Management, Oxford Economics, Citigroup, Bloomberg, NCREIF, MSCI, Investment Property Forum (U.K.), Sumitomo Mitsui Trust Research Institute, National Bureau of Statistics China, Hong Kong Rating and Valuation Department, Singapore Urban Redevelopment Authority, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Self-Storage Association (U.K.), January 2016

While we believe there are considerable opportunities within these markets, understanding and mitigating risks while underwriting and negotiating for a commensurate return is important. Local, well-aligned operating partners are critical to successful execution.

3. Latin American and Indian Markets May Be Well Positioned for Real Estate Investment Over the Next Several Years

While Latin American real estate markets held relatively firm through the impact of the global financial crisis, recent concerns about the end of quantitative easing in the United States and higher global interest rates have impacted real estate returns in many of these markets. Stronger internal demand, lower inflation, and reduced foreign debt have helped decrease the sensitivity to the U.S. and to other developed markets than during past downturns. Real estate capital flows to Latin America have built up in recent years, focusing predominantly on Brazil,



Chile, and Mexico. Markets such as Peru, Panama, and Columbia have gained attention, due to positive demographic trends and burgeoning middle class. While RVK believes that the opportunity is not yet “ripe” in most of these markets, we believe that deployment of capital over the next few years could be advantageous to the ERS Real Estate Portfolio. To that end, RVK recently completed an in-depth due diligence trip to the region to evaluate the investment environment, market fundamentals, and review strategies with top tier investment managers.

Beyond Latin America, ERS Real Estate Staff and RVK are evaluating opportunities among other emerging real estate markets. In particular, demographic growth trends in India create potential opportunities over the next decade. This is one of the fastest growing major real estate markets globally, and the current stock of institutional-quality real estate is low (by developed market standards). ERS has recently committed capital to a fund focusing on fully-leased, high-quality office buildings with credit tenants in India, and it continues to evaluate potential real estate debt opportunities in the market. With this said, RVK urges caution when considering investments in India and other emerging markets. Although the demographic growth trends are impressive, real estate investors can lose substantial amounts of capital (despite the demographic tailwinds), due in part to cyclical downturns but also due in part to corruption and the difficulty in enforcing legal remedies in many of these markets. Thus, selection of high quality managers with expertise in ethically navigating the markets, while dealing with inevitable economic cyclicalities, is vitally important. To this end, like the Latin American markets, the Indian market is illiquid, requiring a higher risk premium before considering allocation of real estate capital.

VI. Investment Focus for Fiscal Years 2017 and 2018

A. Due to Full Allocation and Full Pricing, Explore High Quality Real Estate Investment Strategies Selectively

While ERS and RVK have been building out the ERS Private Real Estate Portfolio over the last several years, we have counseled ERS to take advantage of distressed pricing. To this end, ERS over-committed to real estate relative to a more normalized investment pace between 2010 and 2014, with very good results. The corollary to over-commitment when pricing is distressed is to be very selective when real estate is fully priced. We suggest under-allocating in the near term, particularly considering the full allocation of real estate (over the 10% target) within the ERS total portfolio. ERS has recently redeemed some capital from some open-ended vehicles that were originally invested in 2011 and 2012. We suggest selective reinvestment in high quality real estate investment strategies in the coming years. As an example of ERS’ disciplined approach, during Fiscal Year 2016, ERS built upon its “starter” position in an open-ended core Asian real estate vehicle, benefiting from “Founding Investor” fee status. We counsel ERS to continue redeploying capital to high quality opportunities where pricing is more favorable.

B. Seek Opportunities in “Hybrid” Property Types as well as Selective “Unloved” Traditional Property Types

As ERS continues to build out its private real estate portfolio, RVK recommends ERS focus on “hybrid” real estate property types and “unloved” traditional property types that can provide a significant yield premium over alternative property types. ERS has already allocated capital to hybrid property types such as medical office, student housing, self-storage, and manufactured housing. Going forward with additional allocations to other hybrid property types (such as senior housing), focus should be on solid manager track records through different market cycles in given strategies, with the ability to extract value from net operating income growth rather than from capital appreciation. With this said, ERS should allocate capital only if it can properly price potential problems in the operating aspects of these strategies. Additionally, there has been a significant amount of capital raised focusing on these areas over the last few years, and caution is warranted regarding chasing after a smaller set of “institutional quality” assets that could attract multiple bidders and reduce realistic return projections. Selective development in these areas could be an attractive opportunity.

Retail, an industry hit with a confluence of negative factors over the last several years, including the emergence of on-line shopping and a lack of discretionary spending tied to the recession, continues to show signs of improvement based on historically low new supply and an improving economy. According to Real Capital Analytics, the retail sector is 2% below peak pricing levels, the furthest behind of all property sectors, save for suburban-office assets, while demonstrating strong liquidity. While RVK is not bullish on retail as a whole, we believe that there is some opportunity to find assets that have not received the same level of institutional focus as more “in vogue” property types (e.g., CBD-office, multifamily, and—more recently—industrial).

C. Focus on a Combination of “Direct Operators” and “Capital Allocators”

Given the gross-to-net spreads associated with investment with many real estate managers, ERS has benefited—and would continue to benefit—from focusing on direct operators as part of its overall real estate program design. Among direct operators, ERS should focus on managers that possess specialized competitive advantages and have developed the infrastructure to handle institutional capital. Track record verification is crucial to assessing these managers. In ERS’ evaluation of real estate capital allocators, ERS should target managers that have demonstrated consistent ability to make the right allocation decisions by property type and region throughout real estate market cycles, as well as the ability to source the best joint venture partners who can execute across a wide range of platforms.



D. Selectively Pursue Global Diversification

It is clear that the economic balance of the world is shifting. While emerging economies are currently suffering, their long-term importance as trade and financial centers will continue to grow. Expanding beyond domestic real estate provides exposure to this economic growth as well as diversification benefits. As part of its global diversification program, ERS should selectively pursue non-U.S. investments, with a focus on partners that can understand and manage the risks unique to local markets while capitalizing on aforementioned benefits. To this end, apart from selectively adding to ERS' already sizable allocations to Europe, a focus on Asian and Latin American investment opportunities with managers that can achieve returns utilizing lower leverage and taking on less risk than competitors may be an opportunity in the coming Fiscal Years.

Middle-market residential, industrial parks, and warehouse distribution centers can provide attractive long-term yields, as global economic growth is likely to outpace that of the United States over the long term. Given the scarcity premium for high quality real estate assets in many emerging markets, a potentially attractive opportunity is to invest in the operating companies with expertise in these markets that can deliver such assets and facilitate the geographies' real estate market development.

FY	Fund Investments	Commitment Date	Commitment ^(1,3)	Capital Called	% Paid-In	Distributions	Risk/Return Strategy	Description
2010	LaSalle Property Fund, L.P.	1/1/2010	\$100,000,000	\$100,000,000	100%	\$19,690,190	Core – Equity	US Open Ended
	Cornerstone Core Mortgage Fund I LP ⁽²⁾	5/1/2010	36,300,000	34,455,146	95%	28,365,380	Core – Debt	US Core Mortgages
2011	TIAA-CREF Asset Management Core Property Fund LP	9/1/2010	125,000,000	125,000,000	100%	34,901,390	Core - Equity	US Open Ended
	Madison International Real Estate Liquidity Fund IV, LP	10/1/2010	60,000,000	63,138,811	105%	57,237,487	Value Added - Equity	US focused with UK and W. Europe
	ERS Private Real Estate Emerging Manager I, L.P.	12/1/2010	50,000,000	54,622,133	109%	20,193,233	Opportunistic – Equity and Debt	US focused emerging manager fund of funds
	Invesco Core Real Estate – U.S.A., L.P.	1/1/2011	100,000,000	100,000,000	100%	37,091,267	Core - Equity	US Open Ended
	Waterton Residential Property Venture XI, L.P.	2/1/2011	100,000,000	106,022,846	106%	64,038,364	Value Added - Equity and Debt	Focused on apartments in select US markets
	M&G Real Estate Debt Fund LP	6/1/2011	47,000,000	43,718,667	100%	52,169,791	Value Added - Debt	UK & Western Europe
	Prudential U.S. Real Estate Debt Fund, L.P.	7/1/2011	125,000,000	118,753,152	95%	70,270,807	Value Added - Debt	US
2012	Aberdeen European Opportunities Property Fund of Funds LLC	2/1/2012	108,000,000	83,050,498	77%	19,042,018	Opportunistic – Equity and Debt	European fund of funds
	Private Real Estate Emerging Manager I, L.P. –Morgan Creek Abacus	1/1/2012	20,000,000	20,000,000	100%	28,576,237	Value Added - Equity	Focused on apartments in select US markets
	Prologis Targeted U.S. Logistics Fund, L.P.	3/1/2012	125,000,000	125,000,000	100%	43,206,447	Core - Equity	US Open Ended (industrial assets only)
	Rockpoint Real Estate Fund IV, L.P. ⁽²⁾	4/10/2012 and 3/15/2013	137,500,000	113,160,642	82%	74,040,151	Opportunistic – Equity and Debt	Predominantly US focused real estate opportunity fund
	Private Real Estate Emerging Manager I, L.P. –Morgan Creek Exeter	5/1/2012	20,000,000	19,698,964	98%	36,420,739	Value Added - Equity	Focused on industrial in select US mkts
	Northwood Real Estate Partners, LP	8/1/2012	50,000,000	46,703,930	93%	20,323,336	Opportunistic – Equity	Primarily US (with some European exposure)
	Latitude Management Real Estate Capital III, Inc.	8/30/2012 and 8/30/2013	100,000,000	93,921,472	94%	14,094,285	Value Added - Debt	US
2013	KTR Industrial Fund III LP	11/1/2012	120,000,000	65,924,592	55%	95,739,584	Value Added - Equity	US (Industrial)
	Madison International Real Estate Liquidity Fund V, LP	12/1/2012	80,000,000	88,729,148	111%	46,446,217	Value Added – Equity	US and Europe
	M&G Real Estate Debt Fund II LP	3/13/2015	70,000,000	40,662,976	58%	7,942,664	Value Added – Debt	Europe
	Brookfield Strategic Real Estate Partners B L.P.	7/13/2015	60,000,000	62,100,068	104%	15,745,350	Opportunistic – Equity	Global
	Prologis European Properties Fund II	8/26/2015 and 9/6/2013	63,951,921	63,951,921	100%	8,902,464	Core – Equity	Europe
2014	Lone Star Real Estate Fund III (U.S.), L.P.	9/13/2015	70,000,000	66,065,978	94%	16,680,174	Opportunistic – Debt	Global
	Torchlight Debt Opportunity Fund IV	10/13/2015	35,000,000	45,954,241	131%	15,045,819	Opportunistic – Debt	US
	Orion Capital Managers Fund IV, LLC	10/13/2015	81,000,000	45,531,232	56%	14,333,970	Opportunistic – Equity	Europe
	Pennybacker III, LP	1/1/2000	15,000,000	15,134,317	101%	5,549,890	Opportunistic – Equity	US
	Campus-Clarion Student Housing Partners, LP	12/13/2015	65,000,000	10,579,936	16%	570,628	Value Added – Equity	US
	Invesco Real Estate Asia Fund	12/13/2015, 2/23/2015, and 9/15/2015	50,000,000	35,422,123	71%	422,123	Core – Equity	Asia
	Hammes Partners II, L.P.	2/14/2015	50,000,000	12,221,763	24%	1267456	Value Added – Equity	US
	True North Real Estate Fund III	4/4/2015 and 7/6/2015	100,000,000	49,512,661	50%	21,516,235	Value Added – Equity	US
	Wheeloak Street Real Estate Fund II	4/14/2015	47,000,000	25,683,565	55%	1,960,202	Opportunistic – Equity	US
	DRA Growth and Income Fund VIII	6/14/2015	50,000,000	50,982,439	102%	2,502,869	Value Added – Equity	US

FY	Fund Investments	Commitment Date	Commitment ^(1,3)	Capital Called	% Paid-In	Distributions	Risk/Return Strategy	Description
2015	Waterton Residential Property Venture XII	10/14/2015	75,000,000	48,306,333	64%	8,680,531	Value Added – Equity	US
	Abacus MultiFamily Fund III	12/14/2015	50,000,000	12,175,206	24%	1,477,550	Value Added – Equity	US
	Rockpoint Real Estate Fund V	1/15/2015	100,000,000	4,351,047	4%	90,728	Opportunistic – Equity	US
	Devon US Self Storage Value Fund I	2/15/2015 and various deal specific commitments	16,000,000	21,695,173	136%	3,514,791	Value Added – Equity	US Self Storage
	Barings Asia Real Estate Fund I	3/15/2015	75,000,000	21,868,850	29%	795,406	Opportunistic – Equity	Pan-Asian
	Singerman Real Estate Opportunity Fund II, LP	4/3/2015	15,000,000	3,007,692	20%	0	Opportunistic – Equity	US
	Brookfield Strategic Real Estate Partners II, L.P.	4/17/2015	75,000,000	4,407,050	6%	0	Opportunistic – Equity	Global
	AMFP II Bartz Co-Invest LP	7/17/2015	5,800,075	2,171,359	37%	0	Opportunistic – Equity	US Multifamily Development
2016	Horizon Communities MH Fund I	9/1/2015	35,000,000	22,923,066	65%	5,900,638	Opportunistic – Equity	US Manufactured Housing
	Alliance Co-Investment LP (co-investment)	10/26/2015	15,000,000	9,331,524	62%	0	Opportunistic – Debt	Philippines Office Co-Investment
	Madison NYC Core Retail Partners	10/30/2015	20,000,000	16,666,667	83%	0	Core – Equity	US Retail Co-Investment
	Aviva Investors Real Estate Capital Global Co-Investment Fund, L.P.	1/12/2016	0	0		0	Value Added – Equity	US
	Oak Street Emerging Manager II, L.P.	1/12/2016	50,000,000	0	0%	0	Opportunistic – Equity	US
	Xander JV Fund II	2/17/2015	50,000,000	0	0%	0	Opportunistic – Equity	India

Total **39** **\$2,842,551,996** **\$2,092,607,188** **74%** **\$894,746,412**

	Commitment (1,3)	Capital Called	% Paid-In	Distributions
Total Commitments – FY 2010	\$136,300,000	\$134,455,146	99%	\$48,055,570
Total Commitments – FY 2011	607,000,000	\$611,255,609	101%	\$335,902,340
Total Commitments – FY 2012⁽³⁾	508,000,000	\$501,535,507	99%	\$235,703,213
Total Commitments – FY 2013⁽³⁾	430,451,921	\$321,368,706	75%	\$174,776,279
Total Commitments – FY 2014⁽³⁾	524,000,000	\$357,088,255	68%	\$79,849,366
Total Commitments – FY 2015⁽³⁾	445,800,075	\$117,982,710	26%	\$14,559,006
Total Commitments – FY 2016 through March 31, 2016⁽³⁾	191,000,000	\$48,921,256	26%	\$5,900,638
Total Commitments – Since Inception	\$2,842,551,996	\$2,092,607,188	74%	\$894,746,412

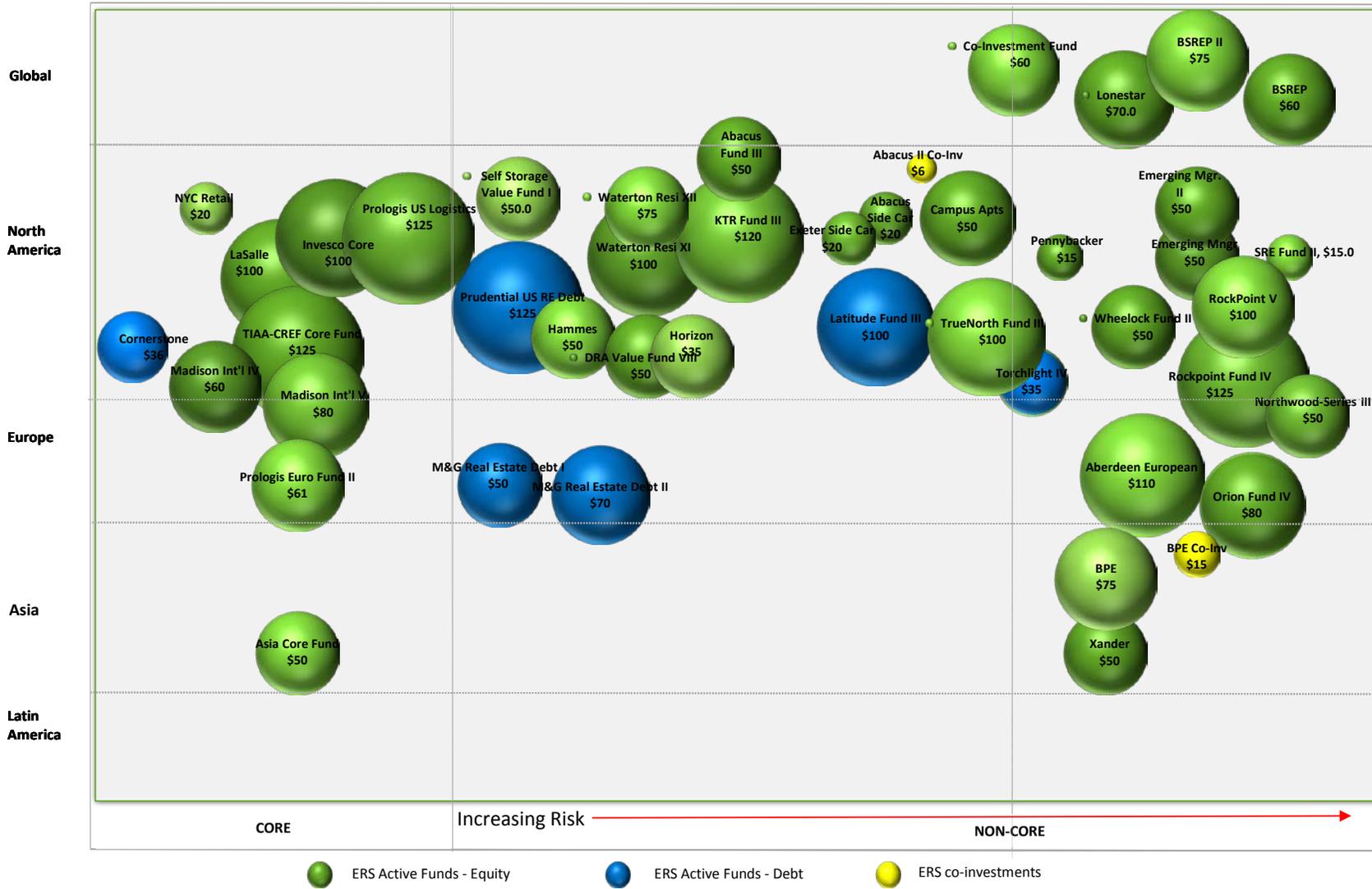
ERS Private Real Estate Portfolio Since Inception through March 31, 2016	
Commitments	\$2,842,551,996
Capital Called	2,092,607,188
Uncalled Commitments	770,944,808
Net Asset Value (NAV)	1,854,422,810
Economic Exposure (Uncalled commitments plus NAV)	2,625,367,618
Distributions	894,746,412

⁽¹⁾ Exchange rates on March 31, 2016: Euro/USD 1.14; Pound Sterling/USD 1.44. Please note that actual exchange rates are used when capital is called and the remaining uncommitted capital is converted as of the March 31 exchange rate. The funds affected are M&G Real Estate Debt Fund LP (€), M&G Real Estate Debt Fund II £, Aberdeen European Opportunities Property Fund of Funds (€), Prologis European Properties Fund II (€), Orion Capital Managers Fund IV (€).

⁽²⁾ ERS' original commitment of \$100 million was reduced to \$36.3 million on September 30, 2011

⁽³⁾ ERS commitments to the same fund across fiscal years: Rockpoint Fund IV - \$110 million in FY 12 and \$27.5 million in FY 13 (note this includes a 10% reserve); Latitude Fund III - \$75 million in FY 12 and \$25 million in FY 13; Prologis European Fund II - €34 million (\$45 million) in FY 13 and €12 million (\$16 million) in FY 14; Invesco Real Estate Asia Fund - \$10 million in 2014 and \$25 million in 2015; Aviva Investors Real Estate Capital Global Co-Investment Fund, L.P., up to \$60 million available for commitment, with \$0 committed in FY 2016; \$15 million additional commitment in FY 2016 to Invesco Asia Fund; \$10 million additional commitment to Devon Self-storage

Real Estate Portfolio - By Commitments as of March 31, 2016



PUBLIC AGENDA ITEM - #9b

Review, Discussion and Consideration of Real Estate Program:

9b. Proposed Private Real Estate Annual Tactical Plan for Fiscal Year 2017

May 17, 2016

BACKGROUND:

In accordance with the Employees Retirement System of Texas (ERS) Real Estate Policies and Procedures, Section III.B.1, staff is charged with preparing and presenting an Annual Tactical Plan (Plan) to the ERS Board of Trustees (Board) for its review and approval. The Plan reviews the current status of the real estate portfolio, recent historical and prospective market conditions, and proposes the steps to implement the real estate program over the next fiscal year. These steps include the types and number of investments to be sought as well as any other actions or considerations germane to the success of the program.

The proposed Plan will be incorporated into the ERS *Investment Policy* as Appendix A of Addendum II: ERS Private Real Estate Policies and Procedures. It is intended to be a planning document and is a guiding reference only; it is not intended to overrule prudent real estate investment decision-making.

The proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2017 is included with this agenda item as Exhibit A. Highlights are summarized as follows:

Fiscal Year 2016 in Review – Currently, the value of the private portion of the Real Estate Portfolio is approximately \$1.9 billion.

As reported in the market update and program overview agenda item, the targeted commitments for fiscal year 2016 are \$200 million. Over the course of this fiscal year, Staff attended over 125 meetings with approximately 80 different managers. Extensive due diligence was conducted on at least 12 funds. Fiscal year 2016 commitments made through March 31, 2016 total \$191 million to eight investments. All but two of the investments were in the non-core space. In the core space, an additional \$15 million was committed to the Asian core fund bringing our total commitment to \$50 million. A \$20 million commitment was made to a portfolio of core retail properties in New York City as part of a club deal. A \$35 million commitment was made to a strategy focusing on buying manufactured housing communities whereby the land is leased to owners of the housing stock. A re-up of \$50 million was made to the Emerging Manager program and a \$50 million commitment was made to an India fund focused on stabilized office assets to high credit tenants (usually multi-nationals). An agreement was struck with a manager for a co-investment program with the potential to commit up to \$60 million (as the deals are closed the commitment amount will be recorded). Another self-storage investment was made for \$6 million. Finally, our second direct co-investment was completed for \$15 million as part of a debt deal in Asia. Staff does not anticipate recommending additional commitments for the remainder of fiscal year 2016.

STAFF RECOMMENDATION:

Funding Levels for Fiscal Years 2017-2020 – Staff will continue committing capital to private real estate on a selective basis, but currently targets \$0 to \$250 million in commitments for fiscal year 2017.

As of March 31, 2016, the current private real estate portfolio stands at 7.5% of the overall System's assets and therefore, ERS has achieved its allocation target of 7%. As a result, Staff is taking a cautious approach to new commitments for the remainder of fiscal year 2016 and 2017 to see how the broader markets will impact the other asset classes and hence the overall value of the System's assets as well as to ensure our

expected distributions from existing investments are received. While Real Estate staff and the Real Estate Consultant, RVK, Inc (RVK) believe that 2017 will be a decent vintage year, albeit one where opportunities will be more selective than prior years, this proposed Annual Tactical Plan may require amending based upon the opportunities available in the real estate market and the broader equity markets.

For fiscal year 2017, ERS Real Estate staff and RVK believe that opportunities to target non-core real estate will be the most attractive area to focus on similar to the strategy for the current fiscal year. Recognizing the importance that income plays in long-term real estate returns, strategies and managers will be the focus where the portion of return derived from income, as opposed to capital appreciation, is significant relative to the respective risk return strategy. Separate accounts and co-investments will also be an area of focus for staff.

It is clear that the economic balance of the world is shifting. Not only are emerging economies growing in terms of income and demand for space, but the importance of trade and financial centers are growing and shifting around the world. Expanding beyond domestic real estate will provide opportunities as well as diversification benefits. In addition to Europe and Asia, Latin American investments will be given consideration in fiscal year 2017.

The proposed Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2017 was prepared by ERS Real Estate staff and RVK. Staff recommends that the plan be approved and adopted in accordance with ERS' Real Estate Policies and Procedures.

A recommended motion is included with this agenda item.

ATTACHMENT – 2

Exhibit A – Proposed ERS Private Real Estate Portfolio Annual Tactical Plan for Fiscal Year 2017

Exhibit B – Private Real Estate Portfolio Pacing Analysis

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

PRIVATE REAL ESTATE PORTFOLIO
ANNUAL TACTICAL PLAN FOR FISCAL YEAR 2017EFFECTIVE
MAY 17, 2016**I. EXECUTIVE SUMMARY**

This *Private Real Estate Portfolio FY 2017 Tactical Plan* (“*Annual Tactical Plan*”) has been prepared by the Employees Retirement System of Texas (“ERS”) Real Estate Staff and real estate consultant RVK, Inc. Real Estate Consulting Group (“RVK”). It is intended to be a planning document which outlines the steps to be taken during Fiscal Year 2017 to further ERS Real Estate Portfolio objectives and to address considerations germane to the administration and success of the Private Real Estate Portfolio. This *Annual Tactical Plan* is a guiding reference only, and it is not intended to overrule prudent real estate investment decision-making.

As of March 31, 2016, according to custodial data, the Private Real Estate Portfolio stands at approximately \$1.9 billion, with total invested plus currently committed yet uncalled capital totaling approximately \$2.6 billion (approximately \$770 million of committed yet undrawn capital). Many of the non-core Private Real Estate Portfolio funds approved by ERS during Fiscal Years 2012 through 2015 are drawing capital on a faster schedule than initially anticipated. Nonetheless, some funds approved during these Fiscal Years may not call all of their capital commitments, and several funds are disposing of assets on a faster-than-expected schedule. Real estate valuations have continued to rise in the vast majority of sectors in the US and most sectors in Europe, where ERS has committed the vast majority of its private real estate capital. Given the buoyancy in these markets, it is likely that ERS will see an increase in the already brisk pace of capital distributions in Fiscal Year 2017 and beyond. During Fiscal Year 2016, in concert with the *FY 2016 Annual Tactical Plan* approved by the ERS Board of Trustees, ERS increased its capital commitment to a core Asian open-ended vehicle with an attractive “founding investor” fee schedule. It also invested in a high quality portfolio of retail assets in the New York City metropolitan area through a club deal. Beyond core real estate, ERS committed to non-core separate accounts and commingled funds focused on (i) manufactured housing, (ii) global real estate co-investment opportunities, (iii) real estate emerging managers, and (iv) stabilized Indian office investments, all of which should help to continue to diversify the drivers of returns in the ERS Private Real Estate Portfolio. ERS also committed capital to a co-investment in the Asian real estate debt arena. With these investments, ERS is just under the \$200 million real estate commitment target for Fiscal Year 2016, as approved in the *FY 2016 Annual Tactical Plan*. As discussed in previous *Annual Tactical Plans*, the accelerated pace of investment from Fiscal Years 2011 through 2015 has benefited the ERS Real Estate Portfolio and has caused the ERS Total Portfolio to reach its 7.0% target in Private Real Estate earlier than a more normal investment pace would have caused. Accordingly, this *Annual Tactical Plan* anticipates few, if any, new allocations during Fiscal Year 2017, allowing ERS to evaluate the pace of capital distributions back to the ERS Trust while contemplating increased capital commitments during Fiscal Years 2018 through 2020. Given that there will be difficulty of keeping the Private Real Estate Portfolio precisely at 7.0%, with fluctuations in (i) Total Portfolio growth and (ii) distributions back from current Private Real Estate Portfolio managers, ERS Real Estate Staff and RVK request flexibility to deploy capital during Fiscal Years 2017 and 2018.

Since initiating its Private Real Estate Portfolio in Fiscal Year 2010, ERS has approved a wide variety of private real estate funds focused on (i) multifamily real estate, (ii) student housing, (iii) medical office, (iv) self storage, (v) manufactured housing, (vi) industrial real estate, (vii) discounted secondary real estate positions, (viii) subordinated debt collateralized by U.S. real estate, (ix) subordinated debt collateralized by U.K. and continental European real estate, (x) U.S. opportunistic real estate strategies, (xi) European opportunistic real estate strategies, (xii) Asian opportunistic real estate strategies, and (xiii) diversified global opportunistic real estate strategies, in addition to core real estate strategies spanning the United States, Europe, and Asia. Moreover, ERS has progressed on allocation of its \$50 million commitment to ERS’ Private Real Estate Emerging Manager I, L.P., an emerging real estate manager of managers program, with commitments to underlying managers totaling \$60 million (inclusive of recycled capital) and invested capital totaling over \$50 million, as of March 31, 2016. This success has led to a follow-on \$50 million commitment to ERS Private Real Estate Emerging Manager II, L.P. Moreover, ERS has continued to identify real estate opportunities with smaller real estate groups in Europe, benefiting from distressed real estate pricing throughout the United Kingdom and continental Europe. As of March 31, 2016, the Aberdeen European Opportunity Property Fund of Funds LLC has committed €80 million (US\$ 91 million) to 7 underlying managers and about €55 million (US\$ 62 million) has been called.

ERS' Private Real Estate Portfolio investment strategy has worked very well, with the Private Real Estate Portfolio generating a 12.74% net internal rate of return since inception through March 31, 2016, according to custodial data, utilizing significantly less risk than many public pension plans, particularly in terms of leverage. Moreover, the Private Real Estate Portfolio has started to generate significant income distributions for ERS. As has been articulated by ERS Real Estate Staff and RVK in previous *Annual Tactical Plans*, income traditionally has driven well over 75% of long-term returns in core real estate. Additionally, recognizing the importance that fees play in long-term real estate returns, ERS Real Estate Staff and RVK are always focused on negotiating favorable investment terms on ERS' behalf, including lower asset management fees and more favorable incentive compensation structures, in order to boost net returns for ERS or mitigate the share of profits GP's earn if their realized returns are below expectations.

ERS Real Estate Staff and RVK propose targeting \$0 in capital commitments for Fiscal Year 2017, with the potential to allocate up to \$250 million if attractive opportunities present themselves. We ask for this flexibility, as ERS has opportunistically pruned some of its overvalued real estate investments in the core arena over the past year, preserving "dry powder" to allocate to potentially attractive opportunities that may arise during the upcoming Fiscal Year. With this proposed commitment amount, ERS should continue its "steady state" real estate allocation going forward (7.0% of the ERS Total Portfolio for the Private Real Estate Portfolio and 3.0% of the ERS Total Portfolio for the Public Real Estate Portfolio). Due to the faster pace of capital commitments over the previous several years and due to the amount of capital commitments left to deploy within the currently approved funds, this proposed capital commitment proposal is a shift from the significant "ramp up" period from Fiscal Years 2011 through 2016. While ERS Real Estate Staff and RVK wish to be judicious with respect to new allocations this Fiscal Year, any proposed investments will likely be focused on taking advantage of what appears to be better risk adjusted returns in the non-core real estate markets, particularly "hybrid" real estate asset classes such as senior housing and medical office and markets outside of the United States. While ERS Real Estate Staff and RVK will focus primarily on non-core real estate opportunities in the coming Fiscal Year, they will also continue to carefully evaluate core real estate investment opportunities for addition to the Private Real Estate Portfolio. Similar to Fiscal Year 2016, the focus in the core portfolio during Fiscal Year 2017 will be primarily on alternative core investments such as international core and medical office, providing better risk adjusted returns and diversification benefits than "traditional" core real estate investments. Given the relative attractiveness of valuations in non-core real estate, ERS Real Estate Staff and RVK propose overweighting non-core real estate and underweighting core real estate in the Private Real Estate Portfolio for the foreseeable future. Due to continued valuation increases in the "traditional" core space, ERS submitted redemption requests from its commingled open-ended and industrial-focused core funds in early 2016. ERS was able to take advantage of the buoyancy in the market to sell part of its position in its industrial-focused core fund in the secondary market at a premium to net asset value, providing additional returns to the ERS Trust. In Fiscal Year 2017 and beyond, ERS may consider separate accounts for certain strategies or geographic focus to enhance net returns with potentially more control. For example, during Fiscal Year 2015, ERS implemented an innovative separate account focusing on self-storage, allowing ERS flexibility in allocating capital. In Fiscal Year 2016, it continued its innovations within the separate account arenas focusing on real estate co-investments and a re-up to its successful real estate emerging manager platform.

II. FISCAL YEAR 2016 IN REVIEW AND SET UP FOR FISCAL YEAR 2017

Thus far during Fiscal Year 2016, ERS has committed approximately \$191 million in the Private Real Estate Portfolio, just below the target articulated in the *FY 2016 Annual Tactical Plan* of \$200 million. This pace of capital deployment kept ERS on track towards achieving its full Private Real Estate Portfolio allocation by the end of Fiscal Year 2016 (7.0% of the ERS Total Portfolio for the Private Real Estate Portfolio). Indeed, ERS achieved this goal earlier in the Fiscal Year, and ERS Real Estate Staff and RVK have been working to identify situations to prune the portfolio when opportunities are ripe (including sales to secondary purchasers of highly-sought after positions within the ERS Private Real Estate Portfolio), while continuing to identify opportunities where new capital commitments may bear fruit in the coming years. We anticipate continuing to identify positions in the ERS Private Real Estate Portfolio that may be sold at premiums to net asset value in the secondary market, to free up capital to deploy to new opportunities that can generate higher returns. While ERS Real Estate Staff and RVK will work to meet the 7.0% target over the long term, it should be noted that given the inherent fluctuations of the ERS Total Portfolio, it will be difficult to precisely match the 7.0% Private Real Estate Portfolio target on an ongoing basis. For this reason, after achieving a "steady state," the ERS Total Portfolio asset allocation provides flexibility, providing for a five (5) percentage point "buffer" around the Private Real Estate Portfolio target of 7.0%. Thus, the Private Real Estate Portfolio can range from 2.0-12.0% of the ERS Total Portfolio.

Early in the development of its Private Real Estate Portfolio, ERS has been able to take advantage of trough valuations in many U.S.-based real estate property types with commitments to a variety of multifamily-focused, industrial-focused, and broadly-diversified private real estate funds. During Fiscal Year 2014, ERS took advantage of trough valuations in many European markets through several European allocations as well as a “starter” position in a core open-ended Asian real estate fund. During Fiscal Year 2015, ERS continued its international diversification by increasing its allocation to its core open-ended Asian real estate fund and allocating to its first Asian opportunistic real estate fund, taking advantage of opportunities stemming from the Chinese economic growth slowdown. During Fiscal Year 2016, ERS furthered this diversification trend, by allocating to an Asian real estate debt co-investment and a commingled Indian real estate fund focused on stabilized, high cash-flowing office assets leased to high credit tenants. This international diversification has occurred alongside ERS’ continued funding of its European fund-of-funds account. This customized account has allowed ERS to selectively deploy capital with niche European real estate managers at an opportune time in the real estate market cycle in Europe. Importantly, this account provides ERS a wide variety of safeguards, including a veto and tag-along rights with respect to any particular investment proposed.

By August 31, 2016, the overall level of real estate invested capital and capital commitments to the Private Real Estate Portfolio will total approximately \$2.6 billion. However, this does not mean that ERS will have invested this amount of capital. Currently, ERS has committed approximately \$2.7 billion, while it has invested approximately \$1.8 billion of this commitment thus far; the total ERS Private Real Estate Portfolio is valued at approximately \$1.8 billion, which does not include income and capital gain distributions received back by ERS. Private real estate funds have the ability to draw down capital over a period of years, and some funds do not draw all of their capital commitments. Thus, proper pacing and planning for potential differences between committed and invested capital is crucial when evaluating private real estate funds and establishing subsequent *Annual Tactical Plans*.

For Fiscal Year 2017, ERS Real Estate Staff and RVK believe that opportunities to target non-core equity-oriented real estate should be compelling on a *selective* basis. However, compared to prior Fiscal Years, the ability to garner favorable investment terms will become even more challenging than what ERS has been accustomed to since the initiation of its Private Real Estate Portfolio development. The vast majority of the real estate investor universe that had stopped deploying capital to real estate opportunities in the wake of the global financial crisis has returned, which (all other factors being held constant) will reduce ERS’ negotiating power with general partners. While ERS has been able to and should continue to be able to garner favorable investment terms, including lower asset management fees and more favorable incentive compensation structures with many managers, some established managers have been able to raise substantial amounts of capital without the need to provide favorable investment terms. While ERS Real Estate Staff and RVK continue to negotiate for the best interests of the ERS Trust, we believe that this dynamic will become increasingly prevalent during Fiscal Year 2017 and beyond. Prudence about which opportunities to commit to in this environment is warranted.

Importantly, while this *Annual Tactical Plan* highlights a continued capital commitment over the next several Fiscal Years (notwithstanding the low commitment proposal for Fiscal Year 2017), not all of the capital committed may be invested by ERS’ selected real estate funds. The ranges given in Section III of this *Annual Tactical Plan* provide flexibility to the targeted commitment amount to provide for varying market opportunities as well as availability of ERS resources. For example, capital may be invested in co-investments, which can provide greater net returns to the Private Real Estate Portfolio. Moreover, ERS Real Estate Staff and RVK may request a change of pace of investment in subsequent *Annual Tactical Plans* in order to adjust to market opportunities.

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III. FUNDING LEVELS FOR FISCAL YEARS 2017 - 2020

The ERS Private Real Estate Portfolio Pacing Analysis (*Attachment 1*) projects the following capital commitments through the end of Fiscal Year 2020:

Funding Tables

	Current Funding Position (as of March 31, 2016)	Projected Funding Position as of FY-End 2016 ¹	Projected Funding Position as of FY-End 2020 ²
Total ERS of Texas Portfolio Size	\$24,770,637,779	\$25,577,833,352	\$34,798,359,895
Total ERS Real Estate Allocation at 10.0%	\$2,477,063,778	\$2,557,783,352	\$3,479,835,990
Total Private Real Estate Allocation at 7.0%	\$1,733,944,645	\$1,790,448,335	\$2,435,885,193
Private Real Estate Value	\$1,854,422,810	\$1,918,676,938	\$2,435,614,538
Private Real Estate Value (Deficit)/Surplus	\$120,478,165	\$128,228,603	(\$270,654)
Total Public Real Estate Allocation at 3.0%	\$743,119,133	\$767,335,001	\$1,043,950,797
Public Real Estate Value	\$730,947,950	\$767,335,001	\$1,043,950,797
Public Real Estate Value (Deficit)/Surplus	\$12,171,183	\$0	\$0

Fiscal Year	Target Commitment	Ranges (+/- 50%)
2017	\$0	\$0 - \$250,000,000
2018	\$225,000,000	\$112,500,000 - \$337,500,000
2019	\$550,000,000	\$275,000,000 - \$825,000,000
2020	\$425,000,000	\$212,500,000 - \$637,500,000
Total	\$1,200,000,000	
Yearly Average	\$300,000,000	

As of March 31, 2016, the Private Real Estate Portfolio value stands at approximately \$1.9 billion. A low capital commitment pace during Fiscal Year 2017 is proposed, taking into account the significant amount of capital commitments during Fiscal Years 2010 through 2015. Increased capital commitments are proposed in Fiscal Years 2018 through 2020 to maintain ERS' Private Real Estate Portfolio allocation near 7.0% of the ERS Total Portfolio. ERS Real Estate Staff and RVK continue to believe that 2016 and 2017 will be attractive vintage years for real estate investment, particularly in property types with significant operating components, such as medical office or self-storage as well as in Europe and Asia.

¹ Per Attachment 1 Employees Retirement System of Texas Private Real Estate Portfolio Pacing Analysis

² Per Attachment 1 Employees Retirement System of Texas Private Real Estate Portfolio Pacing Analysis

The accelerated commitment pace in Fiscal Years 2010 through 2015 took advantage of opportunities available in a variety of real estate markets. Thus far, ERS has benefited from its heightened investment pace during these years, achieving very good performance with lower overall risk (e.g., leverage ratios) than many similarly-sized private real estate portfolios. Through March 31, 2016, ERS' Private Real Estate Portfolio net internal rate of return is approximately 12.74% according to custodial data. With this said, should real estate returns falter over the next few years, ERS real estate returns would suffer relative to a slower ramp-up schedule. ERS *Annual Tactical Plans* going forward will document the then-current real estate market conditions and will adjust the commitment pace based upon fundamental changes occurring in the real estate markets (e.g., capitalization rates peaking, interest rates rising, new construction increasing). Also, as the size of the ERS Total Portfolio and the performance of early Private Real Estate Portfolio investments become clearer in subsequent periods, future *Annual Tactical Plans* will adjust accordingly.

IV. RISK/RETURN MIXTURE IN THE PRIVATE REAL ESTATE PORTFOLIO

Sentiment surrounding private real estate has continued to improve throughout Fiscal Year 2016, with both manager and institutional investor confidence increasing. The private equity real estate asset class saw further growth through the year, with assets under management reaching an all-time high of \$743 billion and increasing levels of dry powder. As of November 2015, uncalled capital stood at approximately \$202 billion. The fundraising rate in 2015 remained broadly in line with 2014 levels, as closed-end private real estate funds raised \$107 billion of capital in 2015, increasing the torrid pace of 2013 and 2014 which saw \$92 billion and \$90 billion of equity raised, respectively. While fund managers have continued to deploy a significant amount of capital, these firms are also exiting many of their existing investments, and more capital is being distributed to limited partners. According to Preqin data, approximately \$103 billion of capital was distributed back to investors from private real estate funds during the first half of 2015. The fundraising market is becoming even more concentrated in the hands of “mega GPs,” however, as the number of closed-end private real estate funds held steady at 177 in 2015 (with 177 closed in 2014 and 239 closed in 2013), while the average fund size increased to \$627 million (a record level), demonstrating the increased concentration among the largest players. Indeed, the top 10 closed-ended real estate funds that had a final closing in 2015 accounted for 45% of all of the capital raised (including Blackstone’s record \$15.8+ billion capital fundraise in early 2015 for its eighth global real estate opportunity fund). This trend has continued in 2016, with groups such as Rockpoint and Westbrook closing funds approximately \$3 billion in size, substantially more than their initial targets. While there is a significant divide between real estate “haves” and the “have nots,” general partners that have performed through the global financial crisis generally have been able to raise capital. However, the current fundraising market treats untested and emerging real estate managers extremely skeptically, and typical lead times to finish fundraising range from 18 to 24 months (with even longer times needed for general partners with more checkered track records).

Given this still-challenging fundraising market for many firms, ERS continues to take advantage of its scale, establishing strategic investments with key investment managers for more attractive investment terms. In Fiscal Year 2017 and beyond, ERS' Private Real Estate Portfolio will continue to be positioned to take advantage of the opportunities available in non-core funds with lower management and acquisition fees, few or no ancillary fees, and more appropriate incentive compensation structures. ERS will continue to take advantage of the current market by strategically investing with key investment managers, benefiting from its ability to commit considerable capital, garnering fee breaks and other rights afforded to large institutional investors. The following tables provide proposed funding by risk/return for Fiscal Years 2017 through 2020.

Proposed Funding for Fiscal Year 2017

Category	Number of Investments	Target Commitment	Ranges
Core	0 - 3	\$0	\$0 - \$250,000,000
Non-Core	0 - 5	\$0	\$0 - \$250,000,000
Total	0 - 8	\$0	\$0 - \$250,000,000

Proposed Funding for Fiscal Year 2018

Category	Number of Investments	Target Commitment	Ranges
Core	0 - 3	\$0	\$0 - \$300,000,000
Non-Core	2 - 12	\$225,000,000	\$50,000,000 - \$337,500,000
Total	2 - 15	\$225,000,000	\$112,500,000 - \$337,500,000

Proposed Funding for Fiscal Year 2019

Category	Number of Investments	Target Commitment	Ranges
Core	1 - 7	\$250,000,000	\$125,000,000 - \$375,000,000
Non-Core	2 - 12	\$300,000,000	\$125,000,000 - \$475,000,000
Total	3 - 19	\$550,000,000	\$275,000,000 - \$825,000,000

Proposed Funding for Fiscal Year 2020

Category	Number of Investments	Target Commitment	Ranges
Core	1 - 4	\$125,000,000	\$50,000,000 - \$250,000,000
Non-Core	2 - 12	\$300,000,000	\$125,000,000 - \$475,000,000
Total	3 - 16	\$425,000,000	\$212,500,000 - \$637,500,000

It should be noted that the number of commitments made by ERS may be higher or lower than projected by this *Annual Tactical Plan* and the accompanying Employees Retirement System of Texas Private Real Estate Portfolio Pacing Analysis (*Attachment 1*) and will depend on the real estate investment opportunities available in a given vintage year. ERS Real Estate Staff and RVK believe that prudent diversification by vintage year, strategy, geography, and property-type (as well as other factors) is important. However, over-diversification into too many investment vehicles hampers the ability to prudently take advantage of opportunities, as many managers and the investment strategies they pursue tend to overlap. Moreover, there are advantages to creating strategic relationships with fewer real estate managers, including separate accounts and “club deals,” rather than investing in a larger number of funds with smaller commitment amounts. Prudent diversification, in terms of geographies, property types, investment leverage, and other diversification elements (e.g., life cycle, property-level investment size, property-level investment concentration) can be achieved when examining the Total Real Estate Portfolio as a whole.

Importantly, not all of the capital allocated may be invested by selected Real Estate Funds and Separate Accounts. Moreover, ERS Real Estate Staff and RVK may request a change in the pace of investment in subsequent *Annual Tactical Plans* in order to better take advantage of market opportunities. A detailed discussion of current real estate market opportunities addressed to the ERS Board of Trustees has been provided by RVK and is included as an addendum to the Market Update and Program Overview agenda item.

**Employees Retirement System of Texas
Private Real Estate Portfolio Pacing Analysis**

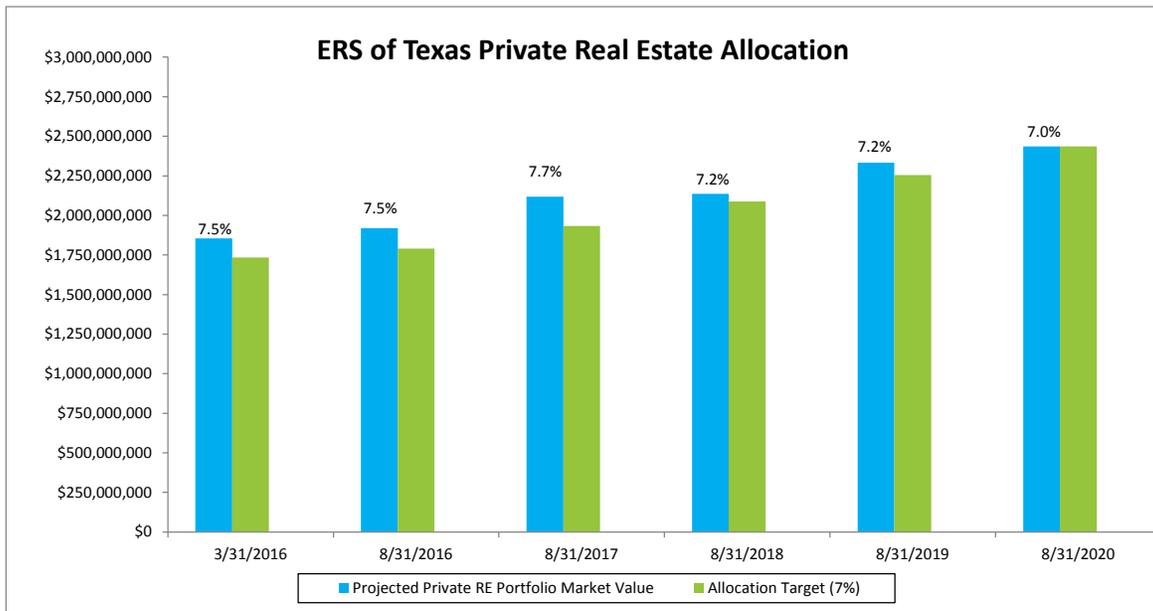
EXHIBIT B

	3/31/2016	8/31/2016	8/31/2017	8/31/2018	8/31/2019	8/31/2020
Estimated Total ERS Portfolio	24,770,637,779	25,577,833,352	27,624,060,020	29,833,984,821	32,220,703,607	34,798,359,895
Portfolio Growth Rate (8%)	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Projected Allocation to Real Estate	7.49%	7.50%	7.67%	7.16%	7.24%	7.00%
Allocation Target (7%)	1,733,944,645	1,790,448,335	1,933,684,201	2,088,378,937	2,255,449,252	2,435,885,193
Over/Underfunded Allocation (5%)	120,478,165	128,228,603	184,767,780	48,357,505	77,244,827	(270,654)

	3/31/2016	8/31/2016	8/31/2017	8/31/2018	8/31/2019	8/31/2020
Total Core Real Estate	\$922,577,595	\$747,042,223	\$730,841,381	\$697,759,318	\$945,913,239	\$1,077,141,669
% of Total Private RE Portfolio	50%	39%	34%	33%	41%	44%
Total Non-Core Real Estate	\$851,078,307	\$1,171,634,715	\$1,387,610,600	\$1,438,977,125	\$1,386,780,841	\$1,358,472,869
% of Total Private RE Portfolio	46%	61%	66%	67%	59%	56%
Total Real Estate Portfolio	\$1,854,422,810	\$1,918,676,938	\$2,118,451,981	\$2,136,736,443	\$2,332,694,080	\$2,435,614,538

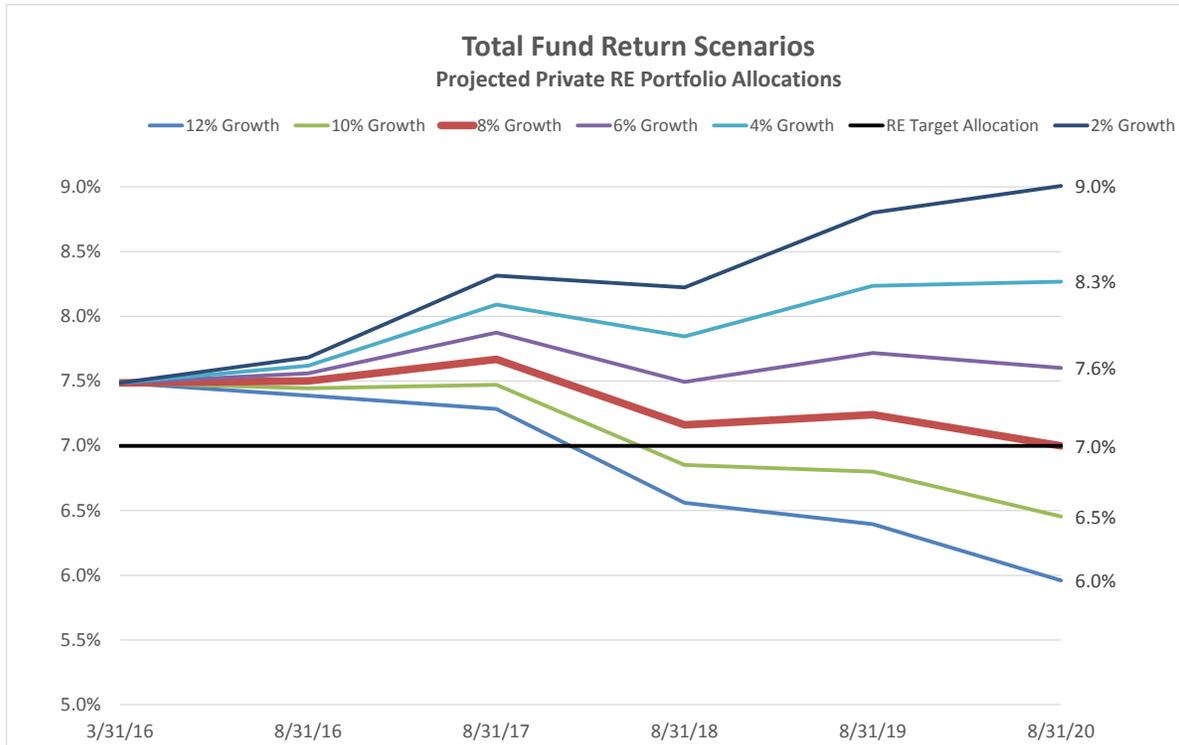
Projected Private Real Estate Allocation						
8/31/2020						
	Target % of Total Portfolio	Target % of Private RE Portfolio	Target \$	Projected \$	% of Projected Private RE Portfolio	Over/(Under)
Core Portfolio	3.0%	42.9%	\$ 1,043,950,797	\$ 1,077,141,669	44.2%	\$ 33,190,873
Non-Core Portfolio	4.0%	57.1%	\$ 1,391,934,396	\$ 1,358,472,869	55.8%	\$ (33,461,527)
Total Real Estate Portfolio	7.00%	100.0%	\$ 2,435,885,193	\$ 2,435,614,538	100.0%	\$ (270,654)

	3/31/2016	8/31/2016	8/31/2017	8/31/2018	8/31/2019	8/31/2020
Projected Private RE Portfolio Market Value	\$ 1,854,422,810	\$ 1,918,676,938	\$ 2,118,451,981	\$ 2,136,736,443	\$ 2,332,694,080	\$ 2,435,614,538
Allocation Target (7.0%)	\$ 1,733,944,645	\$ 1,790,448,335	\$ 1,933,684,201	\$ 2,088,378,937	\$ 2,255,449,252	\$ 2,435,885,193



	3/31/2016	8/31/2016	8/31/2017	8/31/2018	8/31/2019	8/31/2020
Over (Under) Funded	\$ 120,478,165	\$ 128,228,603	\$ 184,767,780	\$ 48,357,505	\$ 77,244,827	\$ (270,654)

New Investment Assumptions			
Investment Year	# of Investments	Total Allocation	Detail
2017	0	\$0	-
2018	3	\$225,000,000	3 Non-Core
2019	6	\$550,000,000	2 Core, 4 Non-Core
2020	5	\$425,000,000	1 Core, 4 Non-Core



Total Portfolio Sensitivities	3/31/16	8/31/16	8/31/17	8/31/18	8/31/19	8/31/20
12% Growth	24,770,637,779	25,968,370,462	29,084,574,917	32,574,723,907	36,483,690,776	40,861,733,669
RE Allocation	7.5%	7.4%	7.3%	6.6%	6.4%	6.0%
10% Growth	24,770,637,779	25,774,137,486	28,351,551,234	31,186,706,358	34,305,376,993	37,735,914,693
RE Allocation	7.5%	7.4%	7.5%	6.9%	6.8%	6.5%
8% Growth	24,770,637,779	25,577,833,352	27,624,060,020	29,833,984,821	32,220,703,607	34,798,359,895
RE Allocation	7.5%	7.5%	7.7%	7.2%	7.2%	7.0%
6% Growth	24,770,637,779	25,379,396,995	26,902,160,814	28,516,290,463	30,227,267,891	32,040,903,965
RE Allocation	7.5%	7.6%	7.9%	7.5%	7.7%	7.6%
4% Growth	24,770,637,779	25,178,764,357	26,185,914,932	27,233,351,529	28,322,685,590	29,455,593,014
RE Allocation	7.5%	7.6%	8.1%	7.8%	8.2%	8.3%

PUBLIC AGENDA ITEM - #10

Recognition of Investment Advisory Committee Members

May 17, 2016

BACKGROUND:

The Investment Advisory Committee (IAC) was established at the discretion of the Board of Trustees in Texas Administrative Code §63.17(b) and is composed of at least five and not more than nine members. The members are selected by the Board of Trustees on the basis of experience in the management of a financial institution or other business in which investment decisions are made or as a prominent educator in the fields of economics, finance or other investment-related area. The IAC members serve at the pleasure of the Board of Trustees.

The IAC assists the Board of Trustees in carrying out its fiduciary duties with regard to the investment of the assets of the system and related duties. The IAC reviews investment strategies and related policies of ERS to provide comments and recommendations to assist the Board of Trustees in adopting prudent and appropriate investment policies. In addition, from time to time, together with the ERS staff and investment consultants or advisors, they recommend to the Board of Trustees asset mix, portfolio strategy, investment policies, and eligible securities.

Overview:

These industry leaders, in addition to attending quarterly Board Meetings, are in regular communication with the CIO and ERS staff. ERS staff utilizes the expertise of IAC members to assess investment strategies and requests members to participate on ad-hoc selection and review committees and to provide insights from such participation to the Board of Trustees.

As ERS evolved the Investments division and implemented new asset classes, so did the IAC. ERS sought investment professionals for the IAC that would add guidance to the Board and investments division regarding the implementation of new asset classes.

The tenure of the IAC members shows their commitment and loyalty to ERS. Below is a list of the IAC members and their appointment year.

IAC Member	Appointment Year
Mr. Vernon Torgerson	1984
Ms. Laura Starks	1990
Mr. Robert Alley	1999
Mr. Ken Mindell	2006
Ms. Lenore Sullivan	2010
Mr. Jim Hille	2011
Mr. Monty Jones	2013
Ms. Caroline Cooley	2013

ERS would like to express its gratitude to the IAC for their excellent service and commitment to ERS.

STAFF RECOMMENDATION:

This agenda item is for information and discussion purposes only. No action is required.

PUBLIC AGENDA ITEM - #11

11. Adjournment of the Joint Meeting of the Board of Trustees and Investment Advisory Committee and Recess of the Board of Trustees

May 17, 2016

Following a temporary recess, the Board of Trustees will reconvene to take up the remaining Board of Trustee agenda items.

PUBLIC AGENDA ITEM - # 12

12. Review and Approval of the Minutes to the February 23, 2016
Meeting of the Board of Trustees

May 17, 2016

BACKGROUND:

The minutes to the Employees Retirement System of Texas Board of Trustees meeting held on February 23, 2016 are included with this agenda item as Exhibit A. The minutes are submitted to the Board for review and approval.

PROPOSED MOTION:

Staff recommends the following motion to the Board of Trustees:

I move that the Board of Trustees of the Employees Retirement System of Texas approve the minutes to the meeting held on February 23, 2016.

ATTACHMENT – 1

Exhibit A – Proposed Minutes to the Board of Trustees Meeting of February 23, 2016



Meeting of the Board of Trustees

February 23, 2016



Presented for Review and Approval

May 17, 2016

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**BOARD OF TRUSTEES MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**February 23, 2016
ERS Board Room
ERS Building – 200 E. 18th Street
Austin, Texas 78701**

TRUSTEES PRESENT

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

TRUSTEES NOT PRESENT

Frederick E. Rowe, Jr., Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Catherine Terrell, Deputy Executive Director
Shack Nail, Special Projects and Policy Advisor
Paula A. Jones, General Counsel and Chief Compliance Officer
Tony Chavez, Internal Auditor
Robin Hardaway, Director of Customer Benefits
Robert Kukla, Director of Benefit Contracts
Wendy McAdams, Co-Director of Operations Support
Machelle Pharr, Interim Chief Financial Officer
DeeDee Sterns, Acting Director of Human Resources
Kathryn Tesar, Director of Benefits Communications
Tom Tull, Chief Investments Officer
Charles Turner, Chief Information Officer
Nora Alvarado, Benefit Contracts
Brannon Andrews, Legal Services
Georgina Bouton, Benefit Contracts
Lisa Caffarate, Benefit Contracts
Leena Chaphekar, Legal Services
Ashley Collier, Legal Services
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Pablo De La Sierra, Investments
Blaise Duran, Benefit Contracts
Leah Erard, Governmental Affairs
Lindsay Feldner, Enterprise Planning Office
Liz Geise, Benefits Communications
Ginger Grissom, Benefit Contracts
Megan Hunter, Benefit Contracts
Jennifer Jones, Governmental Affairs
Deborah Legg, Enterprise Planning Office
Pamela Maas, Benefit Contracts
Michelle Moore, Benefits Contracts
Davis Peacock, Investments
Matt Riermersma, Information Services
Lauren Russell, Benefit Contracts
Randi Schultz, Benefit Contracts
Gabrielle Stokes, Legal Services
Bernely Tharp, Benefit Contracts

Angelica Torres, Benefit Contracts
Glenda Workman, Benefits Communications
Keith Yawn, Enterprise Planning Office
Serena Zetina, Benefits Communications

ALSO PRESENT

Steve Alexander, UnitedHealthcare
Andrew Clark, Office of the Speaker of the House of Representatives
David Dorman, AHM
Katy Fallon, Legislative Budget Board
Kris Hefner, Caremark
John Hryhorchuk, Office of the Governor
Seth Hutchison, Texas State Employees Union
Peter Jansen, CBRE
Emily Johnson, Sunset Commission
Andrea Kearekordos, Wells Fargo
Felice Herrera Kish, Texas Department Of Transportation
Jeremy Mazu, Sen. Van Taylor office
Brittany McCollum, Caremark
Emily Morganti, Legislative Budget Board
Joel Pardu, Aetna
Laura Pinkard, Humana
Lola Shores, Self
Trina S. Smith, Texas Department Of Transportation
Nora Velasco, Legislative Budget Board
Brad Young, Altius

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

“A public notice of the Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 9:23 a.m. on Thursday, February 11, 2016 as required by Chapter 551, Texas Government Code, referred to as “The Open Meetings Law.”

Upon adjournment of the Audit Committee, the Board of Trustees convened as a committee of the whole to consider these following Board agenda items. Minutes to the February 23, 2016 Audit Committee Meeting are located under the Audit Committee agenda minutes.

XII. REVIEW AND APPROVAL OF THE MINUTES TO THE DECEMBER 4, 2015 MEETING OF THE BOARD OF TRUSTEES

Board of Trustee Chair, Mr. Craig Hester opened the floor for a motion on the approval of the minutes to the Board of Trustees Meeting held on December 4, 2015.

MOTION made by Ms. Cydney Donnell, seconded by Mr. Brian Ragland and carried unanimously by the present members of the Board of Trustees of the Employees Retirement System of Texas to approve the minutes to the meeting held on December 4, 2015.

XIII. REVIEW, DISCUSSION AND CONSIDERATION OF THE TEXAS EMPLOYEES GROUP BENEFITS PROGRAM

a. *Health Insurance Financial Status Update for the First Quarter Fiscal Year 2016 -*
Health care cost trend is higher than expected at 10.2% with prescription drug cost as the driver. Increased prescriptions of Diclofenac for off label use increasing costs at a 780% trend from FY 2014 to date. If claims are submitted for off label use, they will be denied.

Fiscal Year 2016 is projected to have a larger than expected fund balance in excess of \$428 million. Cost-saving measures were instituted with shared provider payments, specifically with Patient-Centered Medical Homes, Dependent Eligibility Audits, and the soft launch of the Virtual Visits program. While no data is yet available for the Virtual Visit program as it began in January cost savings for all three programs are expected to have a positive impact. Discussion of the new telemedicine program, Virtual Visits, explained that phone or computer visits scheduled with a doctor to address routine medical issues, such as cold and flu symptoms is a convenient way to see a doctor without an unnecessary trip to the emergency room, at a substantial cost savings.

In response to a Legislative interim study, ERS was tasked with studying cost and prevalence of prediabetes in our member population and evaluating potential solutions. As a result, ERS is implementing the new UnitedHealthcare prediabetes management program called Real Appeal. It is an online program for pre-diabetic and diabetic patients to aid in prevention and to help control weight and disease.

ERS is exploring the potential benefits and cost savings from a new payment model called Bundled Payments and anticipates issuing a request for proposal. Under this prospective program, a provider puts together "an episode-based bundled payment" which combines all necessary services such as the facility, surgeons, anesthesiology, radiology, and pathology – whatever services are needed for a successful outcome, for a single unit price. An example is knee replacements, at about 700 per year, which are scheduled in advance and can widely vary in cost. Under this program, members work with the provider to get into one of the bundled payment programs for lower cost and high quality care. This takes out much of the variability, with standardization of the process using quality products and services. The board expressed positive remarks concerning the alleviation of anxiety experienced by members knowing the procedures total cost with provider coordination of an in network total care package without balance billing.

Ms. Lola Shores addressed the Board of Trustees concerning her daughter's health issue and scheduling a specialist. Ms. Shores asked for more genetic doctors in Austin. Staff noted they offered Ms. Shore's daughter an appointment in Houston or Dallas. ERS legal counsel, Ms. Paula A. Jones, noted this is not an issue with coverage or delivery of benefits. It is a market issue with the availability of specialists in Austin. Chair Hester empathized with Ms. Shores issue and thanked her for her bringing it to their attention. ERS staff noted they will facilitate a resolution of Ms. Shore's daughters care issue.

After public comment, the Board continued with the presentation by Mr. Rob Kukla and Mr. Blaise Duran.

This agenda item is provided for informational and discussion purposes only. No action is required.

b. Plan Design for the High Deductible Health Plan for Fiscal Year 2017 - The Texas legislature, HB 966, required ERS to establish a Consumer Directed Health Plan (CDHP) which has two parts, the High Deductible Health Plan (HDHP) – the insurance plan and a Health Savings Account (HSA) – the bank account for health care savings. ERS is charged with keeping the plan as revenue neutral as possible. Administered by UnitedHealthcare, the HDHP is another insurance plan under the same cost structure as HealthSelect, so there are no changes in rates or administrative fees to ERS.

The CDHP and the HSA have many IRS requirements for in-network benefits and HSA tax savings. All preventive services provided by in-network providers are covered at 100% and are not subject to the deductible. All prescription drugs are subject to the deductible. Board members expressed concerns, noting this is a legislative mandate and a risk/reward proposition emphasizing personal responsibility.

Communications by ERS and UnitedHealthcare will be the key to understanding this product. UnitedHealthcare will have projection tools to compare both HealthSelect and the CDHP. ERS plans to use multiple communications tools among them in person, print, video and web contact. Each member's family will need to have a critical conversation about current health care needs.

The CDHP is another insurance option, no one has to participate. Deductibles and out-of-pocket maximum accumulations do not usually cross apply between in-network and out-of-network and can be incurred separately.

Assumptions for the pricing model were reviewed. A variety of plan designs, including rates and out-of-pocket maximums were discussed. Board members asked for clarification on selection of UnitedHealthcare as the 3rd party administrator with staff stating this is a plan design change and another insurance option without additional cost, so should be administered by the same entity as HealthSelect. Board members asked about ongoing plan monitoring to make sure the program is working and members know what they are getting into. Staff reiterated that preventive services are covered at 100% with no deductible and that prescription drugs will have the deductible applied. Members that enroll in HDHP in July cannot change their choice later, not until the next year's open enrollment.

There being no further questions or discussion, the Board took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Ms. Cydney Donnell and carried unanimously by the present members of the Board of Trustees of the Employees Retirement System of Texas approve the High Deductible Health Plan Design in order to meet the legislative requirement of HB 966, passed by the 84th Texas Legislature as presented as option #3 in this agenda item to be made available for participation in the Texas Employees Group Benefits Program in Fiscal Year 2017 beginning September 1, 2016 and ending August 31, 2017.

c. Selection and Contract Award Recommendation for Health Savings Account Administrator – Health Savings Account (HSA) is a tax-advantaged medical savings account, authorized by IRS code 223 and is triple taxed advantaged. Members contribute pre-tax dollars, earnings are not taxed and if you use these funds for healthcare, they are not taxed when taken out of the HSA. Impact on other plans,

- If a member has a standard flexible spending account (FSA) they cannot have an HSA.
- IRS code allows members to have a limited purpose flexible spending account (LPFSA)
- The LPFSA can only be used to reimburse qualified dental and vision expenses.
- The HSA doesn't affect the Dependent care flexible spending account.

An RFP was issued in September, 2015 and ERS received proposals from eight vendors. After evaluation on minimum requirements, five proposals received further review. Finalist proposals were presented by UnitedHealthcare and Wells Fargo bank. After reference checks, face to face interviews, site visits and analysis of best value under current procurement guidelines, UnitedHealthcare Services was recommended for a one year term.

There being no further questions or discussion, the Board took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Ms. Cydney Donnell and carried unanimously by the present members of the Board of Trustees of the Employees Retirement System of Texas and Based on the information provided to ERS in response to the Request for Proposal, the evaluation process and results presented to the Board at this meeting, we have received sufficient information to determine the best value to the retirement system for the selection of a third-party administrator for the health savings accounts. Therefore, move that the Board of Trustees of the Employees Retirement System of Texas approve the selection of UnitedHealthCare Services, Inc. to provide administrative services for the Health Savings Accounts offered under the Texas Employees Group Benefits Program pursuant to the terms and conditions in the governing contract.

It is further move that the Board of Trustees of the Employees Retirement System of Texas authorize the Executive Director to negotiate and execute a contract with UnitedHealthCare Services, Inc. with terms that are fully acceptable to ERS, and to authorize the Executive Director to thereafter administer the contract agreed to by the parties.

In the event that a contract fully satisfactory to ERS is not timely executed with UnitedHealthCare Services, Inc., or if it appears to the Executive Director during the term of the contract that UnitedHealthCare Services, Inc. will not be capable of performing the required HSA administrative

services to ERS' satisfaction, then the Board authorizes the Executive Director to resume the due diligence process and contract negotiations with one or more of the other qualified respondents, and to negotiate and execute contract terms with the next top-ranked qualified respondent that are fully acceptable to ERS, and to authorize the Executive Director to thereafter administer the contract agreed to by the parties.

XIV. REVIEW, DISCUSSION AND CONSIDERATION OF THE RULES OF THE BOARD OF TRUSTEES, TEXAS ADMINISTRATIVE CODE, TITLE 34, PART IV, REQUIRED RULE REVIEWS AND AMENDMENTS TO:

a. Chapter 61 (Terms and Phrases) and Chapter 65 (Executive Director)- Ms. Paula A. Jones, ERS General Counsel and Chief Compliance Officer presented the required rule review and proposed amendment to Chapter 61 (Terms and Phrases) and the required rule review and proposed amendments and addition of new rules to Chapter 65 (Executive Director).

Section 61.1 (Definitions) is proposed to be amended to include a term "interested person" to clarify who an interested person may be with regard to ERS rules. The reasons to readopt Chapter 61 continue to exist with the proposed amendment.

Section 65.3 (Records of the System) is proposed to be amended to repeal subsection (c) since it is not necessary. ERS is required to follow the Office of the Attorney General's rules regarding costs associated with producing information for Public Information Act requests pursuant to §552.262, Texas Government Code. Chapter 65 (Executive Director) is also proposed to be amended to add new rules §65.11 and §65.13 pursuant to the 84th Legislature, Regular Session.

Additions to Rule 65

New rule 65.11 (Reimbursement for Training or Education) is proposed to comply with Chapter 366 (H.B. 3337) Acts of the 84th Legislature, Regular Session, 2015, which added §656.047(b) to the Texas Government Code, requiring agencies to adopt rules requiring the agency's executive head to authorize tuition reimbursement payments for employees.

New rule 65.13 (Enhanced Contract Monitoring) is proposed to be added to comply with Chapter 326 (S.B. 20), Acts of the 84th Legislature, Regular Session, 2015, which added §2261.253 to the Texas Government Code. This new law requires state agencies to establish procedures to identify each contract that requires enhanced contract or performance monitoring, and to submit information on the contract to the Board.

Ms. Jones informed the Board that notices of the proposed amendments, and addition of new rules were published in the January 8, 2016 issue of the *Texas Register*, as required by statute. No comments were received on the proposed amendments or new rules. The Board was also informed that the law requires ERS to review its rules every four years to determine if the reason for adoption still exists. Notices of the intent to review Chapters 61 and 65 were published in the May 8, 2015 issue of the *Texas Register*, as required by statute. No comments were received on the proposed rule reviews.

The reasons to adopt Chapter 65 continue to exist with the proposed amendments.

There being no further questions or discussion the Board then took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Brian Ragland, and carried unanimously by the members of the Board of Trustees of the Employees Retirement System of Texas take the following actions with regard to the Rules of the Board of Trustees, Texas Administrative Code, Title 34, Part IV, as presented in this agenda item:

- Adopt the proposed amendments to:
 - Chapter 61, Terms and Phrases, §61.1 (Definitions); and

- Chapter 65, Executive Director, §65.3 (Records of the System), and addition of new rules §65.11 (Reimbursement for Training and Education) and §65.13 (Enhanced Contract Monitoring).
- Readopt the following chapters of the Rules of the Board of Trustees because the reasons to adopt the rules in these chapters continue to exist:
 - Chapter 61 (Terms and Phrases) as Chapter 61 was amended by the Board as provided by this agenda item and
 - Chapter 65 (Executive Director) as Chapter 65 was amended by the Board as provided by this agenda item.

The adopted amendment to 34 TAC, §61.1 was subsequently published in the March 11, 2016 issue of the *Texas Register*, 41 TexReg 1858;

The adopted amendments to 34 TAC, §§65.3, 65.11 and 65.13 were subsequently published in the March 11, 2016 issue of the *Texas Register*, 41 TexReg 1859; and

The re-adoptions of Chapters 61 and 65, were subsequently published in the March 4, 2016 issue of the *Texas Register*, 41 TexReg 1725.

b. Chapter 63 (Board of Trustees) - Mr. Mike Ewing, Governmental Affairs, addressed the mandated rule review of Chapter 63 concerning the Board of Trustee election process and suggested changes.

63.1 - Clarification that the Board's appellate jurisdiction of appeals is provided in Chapter 67, Hearings on Disputed Claims.

63.3 –Concerning Election of Trustees (Nomination Process) – amended to clarify the maximum number of signatures ERS will accept on a petition (at least 300 but no more than 600 signatures). Petitions must include original signatures.

63.4 – Concerning Election of Trustees is amended to clarify that ERS will set the time and location for the drawing for the order of names to appear on the ballot and to remove reference to a run-off election.

The board questioned what kind of information can be asked of a candidate and received clarification on current information requested of candidates, such as background checks. There are statutory questions that specify information required of candidates. The board may be asked to approve any additional information and consequences if a candidate does not comply.

There being no further questions or discussion, the Board took the following action:

MOTION made by Mr. Brian Ragland, seconded by Mr. Doug Danzeiser and carried unanimously by the members of the Board of Trustees of the Employees Retirement System of Texas to adopt the proposed amendments to Chapter 63, concerning Board of Trustees, as reflected in Exhibit A and presented in this agenda item and re-adopt Chapter 63, which includes the changes adopted by the Board, because the reasons for initially adopting the chapter continue to exist.

c. Chapter 85 (Flexible Benefits) Required Rule Review - The proposed amendment will expand the voluntary benefits available to active employees under the State of Texas Employees Flexible Benefit Program (TexFlex). TexFlex is currently funded by pre-tax salary contributions that are used to reimburse participants for health and day care expenses. The benefits have been expanded to include a Qualified Transportation Fringe Benefits (QTFB) plan which allows employees to use pre-tax dollars to pay for qualified expenses associated with their daily commute such as mass transportation and parking fees.

85.1 – Clarifies that the grace period still applies to employees participating in dependent care reimbursement accounts.

85.1, 85.4 – Update the rules to offer TexFlex participants a qualified transportation benefit plan as permitted by Internal Revenue Code 132.

85.7 – Provides that carryover amounts less than \$25.00 shall be forfeited to pay the administrative costs of the plan.

85.9 – Clarifies that a health care reimbursement account participant with insufficient funds to pay for the monthly election amount during the plan year will be liable to make after-tax contributions to pay the monthly election.

85.13 – Clarifies that after a Qualifying Life Event, claims will be accounted for using a non-blended approach.

In the May meeting, Chapter 85 – A proposal will be made to amend the Rules to include a limited purpose flexible spending account (LPFSA)

- Only HealthSelect participants are eligible to participate in a limited-purpose health care reimbursement account.
- Allows participants to defer additional funds to defray the costs of qualifying expenses
- Qualifying expenses are limited to vision, dental and orthodontia expenses incurred during the benefit plan year. Staff noted that an employee enrolling into the High Deductible Health Plan and the HSA will no longer be able to have a health care flexible spending account.

The Board expressed concern and discussed the need for participants to receive warnings about the nuances of this program and clarification on participants' potential loss of funds.

There being no further questions or discussion, the Board took the following action:

MOTION made by Mr. Doug Danzeiser, seconded by Mr. Brian Ragland and carried unanimously by the members of the Board of Trustees of the Employees Retirement System of Texas take the following actions with regard to the Rules of the Board of Trustees, promulgated in 34 Texas Administrative Code, Part IV, as set forth in Exhibit A, which is attached to the incorporated by reference into the Agenda item:

- Adopt the proposed amendments to Chapter 85, concerning Introduction and Definitions, Separate Plans, Enrollment, Payment of Claims from Reimbursement Accounts, and Funding, as reflected in Exhibit A and this agenda item and
- Readopt Chapter 85, which includes the changes adopted by the Board as provided by Exhibits A and this agenda item, because the reasons for initially adopting the chapter continues to exist.

XV. REVIEW AND DISCUSSION OF ELIGIBILITY AND COMPLIANCE FOR CALENDAR YEAR 2015 OF THE INVESTMENT ADVISORY COMMITTEE (IAC)

Chair Hester called upon Tom Tull, ERS Chief Investments Officer, to discuss the required annual review of the IAC members' eligibility and qualifications to serve. Using revised Investment Policy and pertinent Texas government codes, ERS staff confirmed that all IAC members affirmed their eligibility pursuant to ERS Investment Policy.

This agenda item is provided for informational and discussion purposes only. No action is required.

XVI. REVIEW, DISCUSSION AND CONSIDERATION OF REAPPOINTMENT OF ERS INVESTMENT ADVISORY COMMITTEE MEMBER

Chair Hester called upon Tom Tull, ERS Chief Investments Officer, to discuss the board's reappointment of Ms. Lenoir Sullivan to a three year term on the Investment Advisory Committee to end February 28, 2019 and to authorize the Executive Director to execute and administer contracts in connection with the reappointment of Ms. Sullivan. Ms. Sullivan's qualifications and other supporting information accompanied the agenda item.

There being no further questions or discussion, the Board took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser and carried unanimously by the members of the Board of Trustees of the Employees Retirement System of Texas to reappoint Ms. Lenore Sullivan to the Investment Advisory Committee for a three-year term ending February 28, 2019 and move that the Executive Director be authorized to execute and administer contracts in connection with the reappointment of Ms. Sullivan.

XVII. REVIEW AND DISCUSSION OF SECURITY AWARENESS

Mr. Chuck Turner, ERS Chief Information Officer discussed initiatives to maintain security at ERS:

- Annual Assessment of information security,
- Incident Response Plan – ERS has a plan (2013) and currently updating. Working with business partners to be ready update plan and be prepared for potential breaches,
- TAC 202 changes for 2016 and 2017 from DIR – ERS is 88% compliant and will be 100% compliant by February 2017 the date communicated by DIR.

Mr. Matt Riemersma, Information Security Officer discussed results and sustainability:

- Vulnerability analysis has been improved with sophisticated scans,
- Patch management capacities added,
- IS performed a third party penetration test, without any exploited vulnerabilities,
- Instituted an intrusion prevention device which blocked over 140,000 undesired attempts over the last quarter,
- Monitoring all email traffic for known and suspected viruses,
- Data Loss Prevention – IS systems monitors for protected health information moving outside ERS environments,
- all enterprise level and workstation storage is encrypted and
- 100% of ERS staff have completed required annual training. Covered all required topics with live presentations on phishing.

Board asked for clarification on policy on incidental use of personal email and ransomware. Personal email access is permitted and scanned. Use of business email address for personal business is minimal. Mr. Turner mentioned that phishing is a tremendous issue with security in general, and a common entry point for ransomware. ERS has addressed through continuous training, and demonstrated good results on unannounced internal phishing campaigns. We get the most recent signatures for all viruses, but there is no foolproof in information security. There are always zero day or new exploits identified. We keep virus definitions as current as possible so anything that is identified as a vulnerability is usually on our detection system within 24 hours, if not sooner. ERS has also invested to improve Intrusion Detection systems.

This agenda item is provided for informational and discussion purposes only. No action is required.

XVIII. REVIEW AND DISCUSSION OF THE SPACE PLANNING STUDY

Ms. Wendy McAdams, Co-Director of Operations Support, presented an update on the multiyear space planning study. The purpose of the project was to identify the options available to accommodate expected growth in personnel and, based on the study, provide options to the board. The genesis of the

project is our space needs. We identified that ERS budgeted positions had increased from 340 in FY 2010 to 375 in FY 2014. Which is an average increase of seven positions per year, and this year's budgeted positions has grown to 384 for FY16. Staff growth is due to a number of factors and is needed to properly support programs and members such as the addition of Investment Asset Class Managers and staff throughout the agency. Current space utilization is well below industry standards. Overviews of the Feasibility and Massing Studies as well as the outcomes of an RFI for the development community were presented. Four massing options showed what could fit on the ERS city block. While there is sufficient space for today, it's not the right type or amount of space to effectively deliver services in the future.

Mr. Peter Jansen, CBRE, suggested there were multiple options ranging in cost from \$7 to \$25 million. Parking for ERS staff will always be provided by the Texas Facilities Commission and is not a consideration. Board and staff need to establish a consensus on priorities and risks related to future building plans.

The Board and Executive Director discussed direction and forming a smaller group to explore most likely options with risks and benefits. Ms. Cydney Donnell, Board member, will lead a work group made up of the Executive Office, Operations Support, Legal Services and Investment staff over the summer. They are charged with identifying major policy issues directing the RFP focus. A discussion of RFP timing concluded with projected award in December 2016. Chair Hester asked that the group work to prepare this data and develop a questionnaire for the board to be able to move forward.

This agenda item is provided for informational and discussion purposes only. No action is required

XIX. PRESENTATION AND DISCUSSION OF AGENCY PERFORMANCE MEASURES

Ms. Dana Jepson of Governmental Affairs reported on the Data Dashboard, a cross-divisional roadmap project to provide strategic decision support to the Executive Office, the strategic planning team and the budgeting process. A team of agency data experts is centralizing key program statistics to identify emerging trends, priorities and resource needs. They are also developing agency performance measures to report to the Board. The Data Dashboard has formalized a process for triage and tracking of external data requests from the Governor's Office, the legislature, agencies and stakeholder associations. The team has responded to 35 requests since December. An executive advisory group guides Data Dashboard policy. The ultimate goal is to ensure ERS always has the most accurate, consistent, and up-to-date information for decision-making and stakeholder communications. Entering phase 2 of this project, we are coordinating with other ERS data projects to build true dashboarding capabilities into the SharePoint content management system.

Ms. Kathryn Tesar, Director of Benefits Communications, representing a 13-member team, presented an overview of agency communications. BCOM is responsible for communications to both ERS members and employers that participate in the Texas Employees Group Benefits Program. The most often used communication tool is the ERS website www.ers.state.tx.us. BCOM produces a monthly electronic newsletter for active employee members called **News About Your Benefits**, and an online and printed quarterly newsletter for retirees, **Your ERS Connection**. We also produce a number of additional printed and online publications about ERS retirement, the various GBP offerings and related programs, many in print form, all of them online.

We also do presentations and events. We have a two-person team who travel the state and meet with our members face-to-face during two annual enrollment periods and for other events. And we engage in social media, specifically through Facebook and YouTube.

For employers, BCOM manages the Benefits Coordinator Community Group (BCCG), an online community group for HR professionals and benefits coordinators. We also produce a biweekly e-newsletter, **Update-express**. The BCCG includes two very detailed manuals essential to processing benefits and enrolling agency employees in those benefits.

This year, unique website visits grew to 25,000. Mobile device access almost doubled over the last two years. This is an important development because we know some of our members don't have regular access to computers. As a part of the upcoming web site assessment we will be developing the site to be mobile responsive, so no matter what type of screen a visitor is using, the website will actually adapt to that screen so it is more efficient and readable.

Other important publications are:

- Annual enrollment packets – About 340,000 annual enrollment packets are printed and mailed.
- New Employee Benefits Guide, a 38-page booklet available in print and on the website. We depend on benefits coordinators and HR departments at state agencies and institutions to make sure new employees are aware of and have access to the guide. ERS prints about 50,000 copies of the guide each year, at considerable expense. Although the Guide is supposed to be for new employees, we think some employers are using it as a recruitment tool, to explain benefits to prospective employees. To reserve the guide for its appropriate use, last year we developed a one-sheet overview of state employee benefits that agencies and institutions can print at almost no cost for their recruitment efforts.

The most well attended events are the enrollment fairs and presentations in the summer for employees and retirees who are not eligible for Medicare and in the fall for Medicare-eligible retirees. Attendance is expected to increase because of the introduction of the consumer-directed health plan (CDHP) as well as vision insurance. The Ready, Set, Retire! and Medicare Preparation sessions are well attended too.

As for social media, we are active on Facebook and YouTube. We are developing a video explaining the overall concepts of the CDHP to members and we will be promoting that as we're educating them about the CDHP.

Engaging the employer is challenging. There are about 1,800 people registered in the BCCG. They also automatically receive the biweekly newsletter, **Update Express**. As the first source of benefits information for many active employees, these coordinators are really important to us.

Ms. Robin Hardaway, Director of Customer Benefits, presenting monitored customer benefits performance measures and interesting data monitored in our division.

Customer Benefits main core functions are:

- Administration of retirement benefits for state employees and
- Insurance enrollment benefits for state and higher education employees.

Customer Benefits boils down to the service provided to members. Numerous surveys help measure performance and measures are used to continuously improve. Call center contacts are measured for thorough, accurate and timely communication and how friendly and knowledgeable they are with customers. Quarterly customer service surveys were presented with performance measurement for Customer Benefits contact center staff and the performance of the overflow vendor, ACT. Customer service survey results are used in reporting CB performance measures to the LBB and used internally.

Board asked what percent of calls go to overflow at ACT. Ms. Hardaway stated ACT answers over 200,000 calls annually. These calls are more customer service oriented and directed to beneficiary updates or updating personal data information. Not the complex calls answered by the ERS contact center. Survey measurement for one-on-one counseling sessions with our membership reflects a 100% of our members' strong satisfaction with counselor's assistance.

All new retirees are surveyed monthly. On average, we have about 400 retirees per month, 6,000 per year. That survey reflects 97% member satisfaction with retirement and payment process for both FYs 15 and 16. Surveys are reportable measures we report to external sources as well our customer satisfaction.

Although member satisfaction is high, Customer Benefits does have challenges. Internal measures

are in place to monitor performance. The contact center is our main point of contact for counseling and educating our members. Delivering service by phone, email and in person counseling, the ERS Contact Center is not a typical call center environment although we have an internal measure for call management - answering 70% of our calls in 60 seconds which is an industry standard.

Insurance calls take about eight and a half minutes. A retirement call could take about eleven minutes with the cost for retirement call being close to \$6 per call for that interaction. Call volume increases due to the complexity of the calls on insurance and retirement benefit plan changes and new benefit plan designs. This fluctuates from quarter to quarter and year to year.

Attracting and retaining quality staff in this demanding work environment is a challenge. The contact center is considered an entry point into ERS, but that entry point requires a lot of knowledge about our benefits. Typically, this lower paying position delivering complex information can lead to high burnout. Because of their knowledge and work ethic, many staff are promoted out of the contact center but within our division, and sometimes to other ERS divisions.

Ms. Hardaway, answered staffing questions from the board and asked Ms. Carol Chapnek, Customer Service Assistant Director, to address contact center recruitment. Using a staffing agency to attract candidates, Customer Service does a temp-to-hire model. This model gives us an opportunity to try them out in the job, to ensure we get the right people in a high demand work environment. The same pool of 10 staff, work with members on the phone, email and member visits – the same pool of staff do all those functions. Daily work is not deferrable. Member visits average 35 to 37 minutes per interaction and cost more than \$17 per interaction.

Customer Benefits monitors and reviews member data. As an example, first retirement eligibility analysis shows that more than 15,000 current active employees, 11% of our workforce, are currently eligible to retire. This number does not consider the non-contributing population that may age into retirement at some point or could purchase some type of service credit to help meet eligibility sooner; or have service with Teacher Retirement System that may transfer to help them meet eligibility; or have proportionate service with a city or county that helps them meet eligibility sooner. This is strictly our active population; so many more could be eligible to retire.

Customer Benefits has identified agencies with the highest volume of employees eligible to retire. Texas Department of Criminal Justice is our largest employer with over 7,000 retirement eligible employees, followed by the Texas Department of Transportation, Department of Aging and Disability Services, State Health Services and Health and Human Services.

Monitoring retirement account withdrawals is another function in CB. The 83rd legislative session decreased account interest from 5% to 2%; which led to a large number of withdrawals - over 14,000 that year. A normal withdrawal average is about 9,000 members annually. The board asked about retirement withdrawals. Ms. Hardaway reviewed retirement payout options and choices. Sixty percent of retirees choose the standard annuity, which is the highest benefit that they can receive for their lifetime. Survivor options were also reviewed. In FY '15, almost 5,800 retirees, close to 27% of retirees, took a partial lump sum option.

This agenda item is provided for informational and discussion purposes only. No action is required

XX. REVIEW AND DISCUSSION OF PENSION FUNDING POLICY

Ms. Jennifer Jones, Governmental Affairs, presented research on pension funding policies. This agenda item is informational in nature and not an action item.

Ms. Jones asked the board for feedback to gauge the board's interest in developing a Pension Funding Policy for ERS. A multi-division workgroup including staff from Finance, Governmental Affairs and the Executive Office researched funding policies and their components. A funding policy is a document outlining the objectives and procedures for pension contributions. An emerging best practice, the funding policy objective is to outline methods to fund the expected cost of the all the promised benefits, manage contribution volatility from year to year for budget predictability, and intergenerational equity, as well as

balancing all these objectives.

Because of nationwide pension funding challenges and new GASB 67/68 requirements, there is an increased focus on systems setting their own funding standards through a funding policy. Examples of systems creating policies are in the meeting materials, such as the City of Austin, Texas County and District Retirement System and the Texas Municipal Retirement System.

In response to the board asking about existing funding policy, Ms. Jones stated ERS has most of the components of a funding policy, but that a full funding policy helps the Board set priorities. That document serves as a guideline for legislative funding requests and as a publicly defined document outlining priorities and methodologies.

Key components of a funding policy are:

- **Actuarial cost method:** Allocates the total present value of benefits between past service (actuarial accrued liability) and future service (normal cost);
- **Asset smoothing:** The technique used to recognize pension assets gains and losses over time to reduce the effects of market volatility and stabilize year-to-year contributions and
- **Amortization period:** The length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded actuarial accrued liability or surplus.

In particular, with unfunded liabilities to pay down, the long term goal is to return to a 100% funded ratio. Texas Government Code 811.006 sets a de facto standard of a 31-year period for paying off any unfunded liabilities. Some entities view a 31-year standard as outside the norm of what is considered an emerging best practice. Within Texas, the Texas Pension Review Board (PRB) oversees all Texas public plans. They publish a set of actuarial soundness guidelines. The current PRB standard for a system with unfunded liabilities is a max of 40 years but ideally no more than 15 to 25 years. Similar recommendations come from other groups (typically actuarial panels like the Conference of Consulting Actuaries and the Blue Ribbon Panel). The board discussed funding standards and Ms. Jones used the example of the PRB's recommendations for fewer years and a finite funding period.

The Legislature controls benefit enhancements. But a funding policy document is a statement of priorities. As an example, the City of Austin's policy outlines their viewpoint on cost of living adjustments (COLAs) and using its policy, sets criteria for granting any future COLAs. A board approved funding policy will guide funding and benefit enhancement discussions with legislative offices and the Governor's Office.

ERS has not previously adopted a funding policy because the main plan was scheduled to deplete and the focus was on getting the plan on a sound path.

There are limitations to developing a policy. The legislature funds the plan on a fixed percent of payroll and sets the contribution rates. That rate is not adjusted year to year based on what the actuary determines is needed to meet current statutory requirements (although the legislature reviews the latest actuarial information during the legislative session when setting contribution rates). However, once rates are set through the appropriations process for a given biennium, the rate is not adjusted even if the need changes based on an actuarial valuation. This dynamic would need to be recognized within the funding policy.

A comprehensive funding policy will guide board and legislative discussions. The policy can be updated as needed based on any trends or changes. The goal today was to provide an educational background and start the process of getting informal feedback. If the board is interested in moving forward, staff can present a draft document as early as the next Board meeting.

After lengthy discussion and noting a consensus to move forward, the board asked for a draft funding policy to be presented at the May 2016 board meeting.

XXI. EXECUTIVE DIRECTOR'S REPORT

Mr. Porter Wilson, Executive Director proceeded with the next agenda item, Executive Director's Report. His report¹ to the Board is included with these minutes.

XXII. SET DATE FOR THE NEXT JOINT MEETING OF THE ERS BOARD OF TRUSTEES AND INVESTMENT ADVISORY COMMITTEE, THE NEXT MEETING OF THE BOARD OF TRUSTEES AND THE NEXT MEETING OF THE AUDIT COMMITTEE

The dates for the 2016 meetings of the ERS Board of Trustees and Investment Advisory Committee, the Meeting of the Board of Trustees and the Meeting of the Audit Committee are as follow:

Tuesday, February 23, 2016

Tuesday, May 17, 2016

Tuesday, August 16, 2016

2 Day Workshop:

Thursday – Friday, December 1 & 2, 2016

XXIII. ADJOURNMENT OF THE BOARD OF TRUSTEES

The February 23, 2016 Meeting of the Board of Trustees adjourned at 4:58 p.m.

PUBLIC AGENDA ITEM - # 21

21. Executive Director's Report

February 23, 2016

Legislative Update

ERS was asked to testify before the Senate State Affairs committee last Thursday, February 18th. The committee examined issues related to the Texas judiciary, and asked ERS to provide information on the link between judicial salaries and the retirement annuities of elected officials.

On January 25, 2016, Attorney General Ken Paxton issued his opinion in response to the request made by Chairman Dan Flynn last July. Chairman Flynn asked the Attorney General "what procedure a state agency should follow if the U.S. or Texas Supreme Court recognizes a new constitutional right and compliance with that ruling requires the expenditure of additional state funds."

In the opinion, the Attorney General noted that in light of the *Obergefell v. Hodges* decision, ERS, TRS, UT, and A&M were all extending state insurance benefits to same-sex couples, and that all four entities were able to do so without the need for additional appropriations. The rest of the opinion described the methods for requesting emergency appropriations when necessary.

On January 20, 2016, Governor Greg Abbott sent a letter to the statewide retirement systems reminding them of the prohibition of investment in Iran. The retirement system's investment policy, as adopted by the Board of Trustees, continues to prohibit such investments.

Sunset Commission Review Update

Since December, ERS staff have continued to work closely with the Sunset review team to provide requested information, access to files and operational materials, and coordinate internal discussion meetings and opportunities to observe program activities. ERS completed two consolidated data requests submitted by the Sunset team – the first completed in December, and the second completed at the beginning of February. ERS is now responding to specific ad hoc requests from Sunset as received.

As of February 10, 2016, ERS staff participated in 37 unique program discussions and observational meetings to allow Sunset staff to view various operational activities in action. In addition, there have been numerous discussions with staff by phone and email regarding more detailed program data or histories. The agency has created more than 125 unique reports, analyses, flow charts and documents in response to Sunset requests for historical data, process descriptions, and program explanations. Agency wide, staff has expended more than 2,500 staff hours in support of the review.

The research stage of the review is scheduled to conclude in April 2016, with a report published at the beginning of May. The Sunset staff report will be presented to the Sunset Commission in a pair of open public meetings during the summer of 2016. At that time the Commission will also hear public testimony regarding ERS. Sunset Commission members will approve final recommendations related to ERS during the second meeting; these recommendations will form the basis of legislation that will be prepared for the 85th Regular Legislative Session. In Addition, some recommendations may take the form of management directives to the agency.

The Texa\$averSM 401(k)/457 Program Continues Its Winning Streak

Texa\$aver submitted award entries for its "Pump Up Your Savings" video and has been awarded the following:

MarCom Awards announced Texa\$aver as the winner of three 2015 Gold MarCom Awards in the following categories: Digital Video Creation: Animation, Video / Film: Government and Web Video: Educational.

MarCom Awards is a creative competition for any individual or company involved in the concept, writing and design of print, visual, audio and web materials and programs. Entries come from corporate marketing and communication departments, advertising agencies, PR firms, design shops, production companies and freelancers. The MarCom competition has grown to perhaps the largest of its kind in the world with about 6,000 entries per year. A look at the winners shows a range in size from individuals to media conglomerates and Fortune 50 companies.

Videographer Awards announced TexaSaver as the winner of three 2015 Videographer Awards. In the category Creativity: Graphics/Design, Award of Distinction, the highest honor in the competition; in category of Video Production: Government and Web Based Production: Government, Award of Excellence.

The Videographer Awards is one of the oldest and most respected awards programs in the industry. Judging for the Videographer Awards was done this year by the Association of Marketing and Communication Professionals (AMCP). AMCP is a third party evaluator of creative work by marketing and communication professionals and has been judging competitions for two decades. AMCP judges are chosen based on their extensive experience and proven creativity in the video field. The Videographer Award of Excellence is awarded to those entries whose ability to capture the event or communicate the message is exceptional. The Award of Distinction is presented for projects that exceed industry standards.

Pension & Investments announced TexaSaver as the winner of a 2016 Eddy Award in the category of Special Projects. The award place of First, Second or Third will be announced on March 7, 2016.

The P&I Eddy Awards were created over 20 years ago to identify and reward the best practices in providing investment education to defined contribution plan participants. The awards are judged by an independent panel of plan sponsors and consultants. Awards are given out in seven categories; broken down by corporate employee size and/or type of firm.

AVA Digital Awards announced TexaSaver as the winner of two 2016 AVA Digital Awards. In the category Video for the Web: Government, Platinum Award, the highest honor in the competition and in the category, Video for the Web: Informational, Gold Award.

AVA Digital Awards is an international competition that recognizes excellence by creative professionals responsible for the planning, concept, direction, design and production of digital communication. Work ranges from digital engagement campaigns, audio and video production, website development, social media interaction and mobile marketing.

In an effort to generate awareness about the benefits of the program, TexaSaver created the custom, educational and informative "Pump Up Your Savings" video that used facts and relatable animation to bring attention to the importance of enrolling in TexaSaver to help close the income gap some people may face in retirement. It also focused on how increasing participant contributions, in conjunction with compounded growth, could result in greater savings at retirement.

The video, released on June 17, 2015, was promoted from **www.texasaver.com** via a clickable web banner and a targeted email which resulted in a 40% open rate, well above the industry average. From the video's release through September 28, an additional 4.4% of eligible participants enrolled in TexaSaver and 10,148 participants increased their contribution percentage in TexaSaver. This is a 123% increase from the same time period last year.* The "Pump Up Your Savings" video educated and informed current and prospective participants of how TexaSaver can help close the savings gap and help them PUMP UP THEIR SAVINGS.

*Contribution percentage may include individuals automatically enrolled at 1% in the 401(k) plan.

2016 Get Fit Texas!

The 2016 Get Fit Texas! Challenge kicked off on January 17. At ERS, Get Fit is considered “operation bring home the gold.” Since Get Fit’s inception in 2013, ERS has dominated the mid-size agency category. In 2013 and 2014, ERS earned #1 Fittest State Agency. In 2015 we slipped to second place but intend on reclaiming the top spot.

By providing employees multiple times daily for group walks, ERS employees are working to earn bragging rights of the #1 Fittest State Agency again this year. Nine Get Fit “champions” throughout the building are encouraging their co-workers during the challenge to log 150 minutes of physical activity each week.

ERS employees who successfully complete the challenge will earn an 8 hour leave incentive. In addition, there will be door prize drawings at the end of the 10 weeks.

2015 State Employee Charitable Campaign

The ERS 2015 State Employee Charitable Campaign (SECC) won awards in all of the categories for Capital Area state agencies from 300 to 499 due to the generosity of ERS employees who contributed \$47,939.00. The awards were:

1. Highest Participation – 67% (252 employees donated)
2. Largest per Capita Gift - \$127.84
3. Rising Star Award – Most improved campaign

It is the second year in a row, ERS won Largest per Capita Gift and Rising Star Awards under the leadership of SECC Committee Chair, Beth Gilbert. Core team members were Carla Lawrence, Shastina Smith, Dawn Eserini and Martha Whitted.

The SECC is the only statutorily authorized workplace campaign for state agency and higher education employees throughout Texas. One of the great benefits of the SECC is the wide variety of charities and causes represented – there is something for everyone.

Charities must meet stringent legal requirements, and then be scrutinized by teams of state employees to ensure:

- They are recognized by the IRS as 501(C)(3) nonprofit organizations and registered with the Secretary of State
- They are audited annually by an accountant in accordance with generally-accepted auditing standards
- They provide direct or indirect health and human services
- They spend no more than 25 percent of the funds raised on administration

Resignation of Board Member

Frederick E. “Shad” Rowe tendered his resignation on January 21, 2016. Shad was initially appointed to the Board on November 28, 2011 by Speaker of the House Joe Straus. We appreciate Shad’s service and commitment to ERS and its membership.

PUBLIC AGENDA ITEM - #13a

Review, Discussion and Consideration of the Rules of the Board of Trustees, Texas Administrative Code, Title 32, Part IV, Required Rule Reviews and Amendments to:

13a. Chapter 71 (Creditable Service)

May 17, 2016

Proposed amendments to Chapter 71, Creditable Service:

The Employees Retirement System of Texas (ERS) proposes amendments to 34 Texas Administrative Code (TAC), § 71.31 concerning Credit Purchase Option for Certain Waiting Period Service:

- **Section 71.31** is proposed to be amended to allow a member (contributing or non-contributing) to purchase the 90-day waiting period. Between 2003 and 2015, § 812.003, Texas Government Code, required a 90-day wait for new employees to become contributing members of ERS. Members were also permitted to purchase that service at actuarial cost. ERS adopted § 71.31 to govern the service purchase process. Section 71.31 requires that a person must be a contributing member to purchase waiting period service. This prevents members who have left state service but kept their account at ERS from purchasing waiting period service. ERS proposes amending § 71.31 to remove the requirement that a person must be a contributing member to purchase waiting period service.

The amendments to Chapter 71 are set forth in Exhibit A, are incorporated herein by reference and are proposed under Tex. Gov't Code § 815.102, which provides authorization for the ERS Board of Trustees to adopt rules for eligibility of membership in the system.

Notice of the proposed amendments to Chapter 71 was published April 1, 2016 in the Texas Register (41 TexReg 2464). ERS did not receive any comments on the proposed amendments to §71.31.

STAFF RECOMMENDATION:

Staff recommends that the Board of Trustees adopt the proposed amendments to § 71.31, of the Trustee Rules, 34 Tex. Admin. Code, as described in this agenda item and as presented in Exhibit A.

A proposed motion is included for this agenda item following the exhibit.

ATTACHMENTS-1

Exhibit A- Chapter 71, §71.31, concerning Credit Purchase Option for Certain Waiting Period Service.

§71.31 Credit Purchase Option for Certain Waiting Period Service

(a) An eligible [employee class](#) member may establish service credit for service performed during the waiting period as authorized by §813.514, Texas Government Code, and as provided in this section. The provisions of §71.14 of this title (relating to Payments to Establish or Reestablish Service Credit) do not apply to service credit established under this section.

(b) [An employee class \[A\]](#) member is eligible to establish service credit under this section if the member:

~~(1) holds a position in the employee class;~~

(1) ~~(2)~~ has completed the waiting period;

(2) ~~(3)~~ has made a retirement contribution in accordance with §813.201, Texas Government Code; and

(3) ~~(4)~~ makes application for the establishment of service credit and payment of the required contributions in accordance with procedures developed by ERS.

(c) An eligible member shall deposit with the system in a lump sum a contribution in the amount determined by the system to be the actuarial present value of the benefit attributable to the service credit established under this section. The tables recommended by the system's actuary and adopted by the board shall be used to determine the actuarial present value. The waiting period service credit tables are adopted by reference and made a part of this rule for all purposes. The 2009 waiting period service credit tables apply to service purchase calculations performed on or after September 1, 2009, and are those tables adopted by the board on February 24, 2009, based on assumptions adopted by the board on May 13, 2008. The 2010 waiting period service credit tables apply only to those employees hired by the state of Texas on or after September 1, 2009, as defined in §73.2(c) of this title (relating to Determination of Date of Hire for Retirement Benefit Eligibility). The 2010 waiting period service credit tables apply to service purchase calculations performed on or after September 1, 2010, and are those tables adopted by the board on February 23, 2010, based on legislative changes to the retirement plan effective September 1, 2009. The 2014 waiting period service credit tables apply to service purchase calculations performed on or after September 1, 2014, and are those tables adopted by the board on February 25, 2014, based on assumptions adopted by the board on February 26, 2013, and on legislative changes to the retirement plan effective September 1, 2013. For service purchase calculations performed prior to September 1, 2014, the previously adopted tables apply. Copies of these tables are available from the System's executive director, Employees Retirement System of Texas at 200 E. 18th Street, P.O. Box 13207, Austin, Texas 78711-3207.

(d) Actuarial present value shall be based on:

(1) the member's age on the date of the deposit required by this subsection;

(2) the earliest date on which the member will become eligible to retire and receive a service retirement annuity after establishing service credit under this section; and

(3) the future employment, compensation, investment and retirement benefit assumptions recommended by the system's actuary and adopted by the board.

(e) Waiting period service credit shall be established in increments of one month.

(f) This section does not apply to service credit transferred as authorized by Texas Government Code, Chapter 805.

(g) A member who withdraws contributions and cancels service credit established under this section may not reestablish such credit under §813.102, Texas Government Code, but may again establish credit only as provided by this section.

(h) Credit established under this section may not be used to determine average monthly compensation for the purpose of computing an annuity.

PUBLIC AGENDA ITEM - #13b

Review, Discussion and Consideration of the Rules of the Board of Trustees, Texas Administrative Code, Title 34, Part IV, Required Rule Reviews and Amendments to:

13b. Chapter 85 (Flexible Benefits)

May 17, 2016

Background for Proposed Amendments to Chapter 85

Under the Texas Employees Group Benefits Program (GBP), the Employees Retirement System of Texas (ERS) provides the State of Texas Employees Flexible Benefit Program (TexFlex) to active employees as a means to help budget and pay for health and day care expenses. As a flexible spending arrangement (FSA), TexFlex is a form of a cafeteria plan benefit that is funded by pre-tax salary contributions that are used to reimburse participants for expenses incurred on certain qualified benefits. The TexFlex program is comprised of a health care reimbursement plan and a dependent care reimbursement plan.

ERS expanded the voluntary benefits available to active employees to include a Qualified Transportation Fringe Benefits (QTFB) plan. Through a QTFB plan, employees can use pre-tax dollars to pay for qualified expenses associated with their daily commute such as mass transportation or parking fees. According to the 2014 Qualified Commuter Benefits governed under §132 of the Code, deferral contributions to the QTFB plan would be made with pre-tax dollars. In February 2016, the ERS Board of Trustees (Board) adopted amendments to 34 Texas Administrative Code, Part IV, Chapter 85 which allowed for the administration of both the FSA and QTFB under the governance of Chapter 85 and the TexFlex brand.

A further expansion of Chapter 85 is necessary in response to the legislative charge of HB966 from the 84th Texas Legislature. The Legislature added Subchapter J to Chapter 1551, Texas Insurance Code requiring ERS to offer employees the option to enroll in a consumer directed health plan (CDHP) within the HealthSelectSM of Texas managed care plan. Effective September 1, 2016, ERS will offer the Consumer Directed HealthSelectSM, the voluntary High Deductible Health Plan (HDHP) and Health Savings Account (HSA) benefit option.

The HSA is an account described by §223, Internal Revenue Code, as amended. An HSA is a different type of pre-tax health account than a health care FSA, although both are used to reimburse certain qualifying medical expenses. Under the Internal Revenue Code, an employee may contribute to both the HSA and the FSA under the provision that the FSA must limit reimbursements to qualifying dental, vision and orthodontia expenses incurred during the benefit plan year. This is considered a limited purpose FSA or LFSA. The LFSA works the same way as the general purpose health care reimbursement account: contributions are made on a qualified, pre-tax basis; the "use it or lose it" provision is enforced so that any funds in excess of the \$500 carryover limit are forfeited to the plan; and expenses must occur within the plan year.

By providing the LFSA to limit FSA reimbursements, participants remain eligible to participate in both the limited purpose FSA and the HSA. Participating in both plans allows participants to maximize potential savings and tax benefits.

Proposed Amendments to Chapter 85

The proposed amendments for Chapter 85 will expand the program offerings applicable to Chapter 85 to include a LFSA plan. ERS has determined that the proposed amendments to §§ 85.1, 85.3, and 85.5 would benefit TexFlex program participants in a manner permitted by the Internal Revenue Code (the

Code). The proposed amendments would also implement the LFSA as contemplated by statute, and provide for a plan document for the LFSA benefit.

Proposed Amendment to Chapter 85.1, Introduction and Definitions

- **Section 85.1 (Introduction and Definitions)** is proposed to be amended to add a definition for a general purpose health care reimbursement account and for a limited purpose health care reimbursement account.

Proposed Amendment to Chapter 85.3, Eligibility and Participation

- **Section 85.3 (Eligibility and Participation)** is proposed to be amended to allow participants in the CDHP to participate only in the limited purpose FSA program, in conformance with the Internal Revenue Code. Currently, unexpended balances up to \$500 in the FSA are automatically carried over into an employee's general purpose FSA for the following plan year. An employee with any monetary balance in a general purpose FSA, or who attempts to contribute to both an HSA and a general purpose FSA simultaneously would violate the Internal Revenue Code, as the employee would be ineligible to contribute to an HSA. The proposed amendment provides that any monetary balance remaining in an FSA account on August 31 of a plan year or any carryover that might otherwise be permitted for an employee who chooses to enroll in the CDHP for the following plan year would go into a limited purpose FSA, subject to IRS maximums or be forfeited.

Proposed Amendment to Chapter 85.5 Benefits

- **Section 85.5 (Benefits)** is proposed to be amended to clarify that only qualifying dental and vision expenses may be reimbursed through a limited purpose FSA.

The amendments to Chapter 85 presented in Exhibit B, are incorporated herein by reference and are proposed under the Texas Insurance Code, § 1551.052 and §1551.206, which provide authorization for the ERS Board of Trustees to develop, implement, and administer a cafeteria plan, and to adopt necessary rules.

Notice of the proposed amendments to Chapter 85 was published in the April 1, 2016 issue of the *Texas Register* (41 TexReg 2465). The deadline for receiving comments was Monday, May 2, 2016. ERS did not receive any comments on the proposed amendments to §§ 85.1, 85.3 and 85.5.

STAFF RECOMMENDATION:

Staff recommends that the Board of Trustees of the Employees Retirement System of Texas take the following actions with regard to the Rules of the Board of Trustees, promulgated in 34 Texas Administrative Code, Part IV, as set forth in Exhibit A, which is attached to and incorporated by reference into this Agenda Item:

- Adopt the proposed amendments to Chapter 85, concerning Introduction and Definitions; Eligibility and Participation; and Benefits as reflected in Exhibit A and this agenda item.

A proposed motion is included with this agenda item on the following page.

ATTACHMENTS – 1

Exhibit A – Chapter 85, concerning Introduction and Definitions; Eligibility and Participation; and Benefits.

CHAPTER 85. FLEXIBLE BENEFITS

§85.1 Introduction and Definitions

(a) Summary. The purpose of these rules is to govern the flexible benefits program. These rules constitute the Plan document for the State of Texas Employees Flexible Benefit Program (TexFlex). The flexible benefits plan (the plan) includes reimbursement account arrangements with optional benefits available for selection by participants as described in the plan and these rules. The plan is intended to be qualified under the Internal Revenue Code (the Code), §125, as amended from time to time, and is intended to continue as long as it qualifies under §125 and is advantageous to the state and institutions of higher education employees. Optional benefits offered under the plan for individual selection consist only of a choice between cash and certain statutory nontaxable fringe benefits as defined in the Code, §125, and regulations promulgated under the Code, §125. The plan may also include separate benefits as defined in the Code, §132, and regulations promulgated under the Code, §132, separate from the cafeteria plan, and governed by individual plan documents.

(b) Applicability of rules.

(1) These rules are applicable only to employees as defined in these rules, and terminated employees, as described in §85.3(b)(1)(B) and (C) of this title (relating to Eligibility and Participation).

(2) An employee who retired or separated from employment prior to September 1, 1988, shall not be entitled to benefits under the provisions of the plan and these rules, unless the employee is rehired and then becomes eligible for benefits.

(c) Definitions. The following words and terms when used in this chapter, shall have the following meanings, unless the context clearly indicates otherwise, and wherever appropriate, the singular includes the plural, the plural includes the singular, and the use of any gender includes the other gender.

(1) Act--The state law that authorized the establishment of a flexible benefits plan and is designated in the Texas Insurance Code, Chapter 1551, as amended.

(2) Account--A record keeping account established by the Employees Retirement System of Texas or its designee in the name of each participant for the purpose of accounting for contributions made to the account and benefits paid to a participant.

(3) Active duty--The expenditure of time and energy in the service of an employer as defined in these rules. An employee will be considered to be on active duty on each day of a regular paid vacation or on a non-work day, on which the employee is not disabled, if the employee was on active duty on the last preceding work day.

(4) Board of trustees--The board of trustees of the Employees Retirement System of Texas (ERS).

(5) Code--The Internal Revenue Code, as amended from time to time.

(6) Compensation--A participant's base salary, including amounts that would otherwise qualify as compensation but are not received directly by the participant pursuant to a

good faith, voluntary, written or electronic salary reduction agreement in order to finance payments to a deferred compensation or tax sheltered annuity program specifically authorized by state law or to finance benefit options under this plan, plus longevity and hazardous duty pay and including non-monetary compensation, the value of which is determined by the Employees Retirement System of Texas, but excluding overtime pay.

(7) Debit Card--A bank issued convenience card or similar technology approved by the plan administrator and permitted to be used by participants as an optional method to pay for eligible transactions. Use of the card is governed by the plan administrator and issuing financial institution. The card is referred to as the Flex Debit Card.

(8) Dependent--An individual who qualifies as a dependent under the Code, §152, and when applicable taking into account the Code, §105, or any individual who is:

(A) a dependent of the participant who is under the age of 13 and with respect to whom the participant is entitled to an exemption under the Code, §151, or, is otherwise, a qualifying individual as provided in the Code, §21; or

(B) a dependent or spouse of the participant who is physically or mentally incapable of caring for himself or herself.

(9) Dependent care reimbursement account--The bookkeeping account maintained by the plan administrator or its designee used for crediting contributions to the account and accounting for benefit payments from the account.

(10) Dependent care reimbursement plan--A separate plan under the Code, §129, adopted by the board of trustees, and designed to provide payment or reimbursement for dependent care expenses as described in §85.5(c) of this title (relating to Benefits).

(11) Dependent care expenses--Expenses incurred by a participant which:

(A) are incurred for the care of a dependent of the participant;

(B) are paid or payable to a dependent care service provider or to the participant as reimbursement for such expenses; and

(C) are incurred to enable the participant to be gainfully employed for any period for which there are one or more dependents with respect to the participant. Dependent care expenses shall not include expenses incurred for the services outside the participant's household for the care of a dependent, unless such dependent is a dependent under the age of 13 with respect to when the participant is entitled to a tax deduction under the Code, §151, or a dependent who is physically or mentally incapable of self support. In the event that the expenses are incurred outside the dependent's household, the dependent must spend at least eight hours each day in the participant's household. Dependent care expenses shall be deemed to be incurred at the time the services to which the expenses relate are rendered.

(12) Dependent care service provider--A person or a dependent care center (as defined in the Code, §21) who provides care or other services described in the definition of "dependent care expenses" in this section, but shall not include:

(A) a related individual described in the Code, §129; or

(B) a dependent care center which does not meet the requirements of the Code, §21.

(13) Effective date of the plan--September 1, 1988.

(14) Election form--A paper or electronic form provided by the Employees Retirement System of Texas that is an agreement by and between the employer and the participant, entered into prior to an applicable period of coverage, in which the participant agrees to a reduction in compensation for purposes of purchasing benefits under the plan.

(15) Eligible employee--An employee who has satisfied the conditions for eligibility to participate in the plan in accordance with the plan and §85.3(a)(1), and (b)(1) of this title (relating to Eligibility and Participation), and, to the extent necessary, a retired or terminated employee who is entitled to benefit payments under the plan.

(16) Employee--A person who is eligible to participate in the Texas Employees Group Benefits Program as an employee.

(17) Employer--The State of Texas, its agencies, commissions, institutions of higher education, and departments, or other governmental entity whose employees are authorized to participate in the Texas Employees Group Benefits Program.

(18) Expenses incurred--Expenses for services received or performed and for which the participant is legally responsible.

(19) Executive director--The executive director of the Employees Retirement System of Texas.

(20) Flexible benefit dollars--The dollars available to a participant which may be used for purposes of purchasing benefits under the plan.

(21) General purpose health care reimbursement account--The account described in §85.5(b)(1).

(22) [(21)] Grace period--A two (2) month and 15 day period, adopted by the TexFlex plan pursuant to IRS Notice 2005-42, immediately following the end of the plan year during which participants may continue to incur expenses for reimbursement from the prior year account balance. The grace period does not apply to a health care reimbursement plan year that begins on or after September 1, 2014, but does apply to the dependent care reimbursement plan.

(23) [(22)] Health care expenses--Any expenses incurred by a participant, or by a spouse or dependent of such participant, for health care as described in or authorized in accordance with the Code, §105 and §213, but only to the extent that the participant or other person incurring the expense is not reimbursed for the expense by insurance or other means. The types of expenses include, but are not limited to, amounts paid for hospital bills, doctor bills, prescription drugs, hearing exams, vision exams, and eye exams.

(24) [(23)] Health care reimbursement account--The bookkeeping account maintained by the plan administrator or its designee used for crediting contributions to the account and accounting for benefit payments from the account.

[\(25\)](#) ~~[(24)]~~ Health care reimbursement plan--A separate plan, under the Code, §105, adopted by the board of trustees, and designed to provide health care expense reimbursement as described in §85.5(b) of this title (relating to Benefits).

[\(26\)](#) ~~[(25)]~~ Institution of higher education--All public community/junior colleges, senior colleges or universities, or any other agency of higher education within the meaning and jurisdiction of the Education Code, Chapter 61, except the University of Texas System and the Texas A&M University System.

[\(27\)](#) ~~[(26)]~~ Leave of absence without pay--The status of an employee who is certified monthly by an agency or institution of higher education administrator to be absent from duty for an entire calendar month, and who does not receive any compensation for that month.

[\(28\)](#) Limited purpose health care reimbursement account--The account described in §85.5(b)(3).

[\(29\)](#) ~~[(27)]~~ Option--Any specific benefit offering under the plan.

[\(30\)](#) ~~[(28)]~~ Participant--An eligible employee who has elected to participate in the plan for a period of coverage.

[\(31\)](#) ~~[(29)]~~ Period of coverage--The plan year during which coverage of benefits under the plan is available to and elected by a participant; however, an employee who becomes eligible to participate during the plan year may elect to participate for a period lasting until the end of the current plan year. In such case, the interval commencing on such employee's entry date and ending as of the last day of the current period of coverage shall be deemed to be such participant's period of coverage.

[\(32\)](#) ~~[(30)]~~ Plan--The flexible benefits plan established and adopted by the board of trustees pursuant to the laws of the state of Texas and any amendments which may be made to the plan from time to time. The plan is referred to herein as TexFlex, and is comprised of a dependent care reimbursement plan, a health care reimbursement plan, an insurance premium conversion plan, and a qualified transportation benefit plan.

[\(33\)](#) ~~[(31)]~~ Plan administrator--The board of trustees of the Employees Retirement System of Texas or its designee.

[\(34\)](#) ~~[(32)]~~ Plan year--A 12-month period beginning September 1 and ending August 31.

[\(35\)](#) ~~[(33)]~~ Run-out period--The period following the end of the plan year between September 1 and December 31, during which participants may file claims for reimbursement of expenses incurred during the plan year.

[\(36\)](#) ~~[(34)]~~ Statutory nontaxable benefit--A benefit provided to a participant under the plan, which is not includable in the participant's taxable income by reason of a specific provision in the Code and is permissible under the plan in accordance with the Code, §125.

[\(37\)](#) ~~[(35)]~~ Spouse--The person to whom the participant is married. Spouse does not include a person separated from the participant under a decree of divorce, or annulment.

~~(38)~~ [(36)] TexFlex--The flexible benefits plan adopted by the board of trustees.

~~(39)~~ [(37)] Texas Employees Group Benefits Program--The employee insurance benefits program administered by the Employees Retirement System of Texas, pursuant to the Texas Insurance Code, Chapter 1551. The program consists of health, voluntary accidental death and dismemberment, optional term life, dependent term life, short and long term disability, and dental insurance coverages.

~~(40)~~ [(38)] Third Party Administrator or TPA--The vendor, administrator or firm selected by the plan administrator to perform the day-to-day administrative responsibilities of the TexFlex program for participants of the Texas Employees Group Benefits Program who enroll in either the health care reimbursement plan, dependent care reimbursement plan or both.

§85.3 Eligibility and Participation

(a) Dependent care reimbursement plan.

(1) Eligibility. Any employee eligible to participate in the Texas Employees Group Benefits Program may elect to participate in the dependent care reimbursement account.

(2) Participation.

(A) An employee who is eligible under paragraph (1) of this subsection may elect to participate by completing and submitting an election form either in writing or electronically on, or within 30 days after, the date on which the employee begins active duty. An employee, upon executing an election form for participation, either in writing or electronically, shall be deemed to have consented to and be bound by all the terms, conditions, and limitations of the plan, any and all amendments hereto, any administrative rules adopted by the plan administrator, and any decision or determinations made by the plan administrator with respect to the participant's eligibility, obligations, rights and benefits available under the plan. An election made on the date on which the employee begins active duty becomes effective on that date. An election made after the date on which the employee begins active duty becomes effective on the first day of the month following the date on which the employee begins active duty.

(B) An employee who is otherwise eligible to participate in the Texas Employees Group Benefits Program but who declined participation in the dependent care reimbursement account prior to the beginning of a plan year, and who, after the beginning of a plan year, has a qualifying life event, as defined in §85.7(c) of this title (relating to Enrollment), may elect to participate in the dependent care reimbursement account as provided in §85.7(c).

(C) A qualifying life event as defined in §85.7(c) of this title (relating to Enrollment) will permit a change or revocation of participation during the plan year as provided in §85.7(c).

(D) An eligible employee shall have an opportunity to enroll or change benefit options during the annual enrollment period. The annual enrollment period shall be prior to the beginning of a new plan year. Elections and changes in elections made during the annual enrollment period become effective on the first day of the plan year.

(E) The plan administrator shall maintain and update the participant

enrollment records. Any and all changes will be communicated to the TPA via weekly file transfer protocol (FTP), tapes or other selected media.

(3) Duration of participation.

(A) An employee's election to participate or to waive participation in the dependent care reimbursement plan shall be irrevocable for the plan year unless there is a qualifying life event as defined in §85.7(c) of this title (relating to Enrollment).

(B) An employee returning to active duty following termination of employment, or following a period of approved leave without pay, during the same plan year shall reinstate the election in effect on the employee's last previous active duty date. Reinstatement becomes effective on the date on which the employee resumes active duty, unless the employee requests a change in election as provided in §85.7(c) of this title (relating to Enrollment).

(b) Health care reimbursement plan.

(1) Eligibility.

(A) Any employee eligible to participate in the Texas Employees Group Benefits Program may elect to participate in a health care reimbursement account, except that an employee participating in a consumer directed health plan with a health savings account, as permitted under Subchapter J, Chapter 1551, Insurance Code, may only participate in the limited purpose health care reimbursement account described by §85.5(b)(3), of this title (relating to Benefits). Only participants in a consumer directed health plan are eligible to elect to participate in the limited purpose health care reimbursement account described by §85.5(b)(3).

(B) Prior to September 1, 2014, an employee whose employment has been terminated, voluntarily or involuntarily, and who had a health care reimbursement account at the time of termination, shall retain the health care reimbursement account for the applicable period of election. The terminated employee must pre-pay, on a monthly basis, the elected amount and any administrative fee for the plan year. Payments are due on the first day of each month and must be received no later than the 30th day of the month. Failure to pay will automatically cancel enrollment.

(C) On and after September 1, 2014, the employee's period of coverage ends on the date of termination of employment.

(2) Participation.

(A) An employee who is eligible under paragraph (1) of this subsection may elect to participate by completing and submitting an election form either in writing or electronically on, or within 30 days after, the date on which the employee begins active duty. An employee, upon executing an election form for participation, either in writing or electronically, shall be deemed to have consented to and be bound by all the terms, conditions, and limitations of the plan, any and all amendments hereto, any administrative rules adopted by the plan administrator, and any decision or determinations made by the plan administrator with respect to the participant's eligibility, obligations, rights and benefits available under the plan. An election made on the date on which the employee begins active duty becomes effective on that date. An election made after the date on which the employee begins active duty becomes

effective on the first day of the month following the date on which the employee begins active duty.

(B) An employee who is eligible but who declined participation in the health care reimbursement account prior to the beginning of a plan year, and who, after the beginning of a plan year, has a qualifying life event, as defined in §85.7(c) of this title (relating to Enrollment), may elect to participate in a health care reimbursement account as provided in §85.7(c).

(C) A qualifying life event as defined in §85.7(c) of this title (relating to Enrollment) will permit the following changes in election during the plan year, as provided in §85.7(c):

(i) an increase in the election amount, if the increase is consistent with the qualifying life event; or

(ii) a decrease in the election or election amount, if the decrease is consistent with the qualifying life event.

(D) An eligible employee shall have an opportunity to enroll or to change benefit options during the annual enrollment period. The annual enrollment period shall be prior to the beginning of a new plan year. Elections and changes in elections made during the annual enrollment period become effective on the first day of the plan year.

(E) The plan administrator shall maintain and update the participant enrollment records. Any and all changes will be communicated to the TPA via weekly file transfer protocol (FTP), tapes or other selected media.

(F) If an eligible employee elects to enroll in a consumer directed health plan with a health savings account, any unspent flexible benefit plan dollars in the employee's health care reimbursement account at the end of the previous plan year shall automatically be transferred to and carryover into a limited purpose account as described by §85.5(b)(3) of this title, up to the maximum carryover permitted by the IRS. Such carryover shall comply with §85.7(g) of this title. Any flexible benefit plan dollars remaining that exceed the maximum carryover permitted by the IRS will be forfeited by the employee.

(3) Duration of participation.

(A) Except as otherwise provided in subparagraph (C)(ii) of paragraph (2), or subparagraph (D) of this paragraph, an employee's election to or not to participate in a health care reimbursement account shall be irrevocable for the plan year.

(B) An employee returning to active duty following termination of employment, or following a period of leave without pay, during the same plan year shall reinstate the election in effect on the employee's last previous active duty date. Reinstatement becomes effective on the date on which the employee resumes active duty, unless the employee requests a change in election as provided in §85.7(c) of this title (relating to Enrollment) or a different requirement is imposed by the Family and Medical Leave Act of 1993 (FMLA).

(C) For plan years beginning before September 1, 2014, an employee

who is enrolled in a health care reimbursement account who terminates employment during the plan year must retain the health care account for the remainder of the plan year and prepay premiums or make monthly premium payments due for the remainder of the plan year, as described in paragraph (1)(B) of this subsection.

(D) For plan years beginning on and after September 1, 2014, an employee who is enrolled in a health care reimbursement account who terminates employment during the plan year does not retain the health care account for the remainder of the plan year. The employee's period of coverage ends on the date of termination. An employee may only file a claim for reimbursement for expenses incurred before the date of termination.

(E) Notwithstanding any provision to the contrary in this Plan, if an employee goes on a qualifying unpaid leave under the Family Medical Leave Act (FMLA), to the extent required by the FMLA, the plan administrator will continue to maintain the employee's health care reimbursement account on the same terms and conditions as though he were still an active employee (i.e., the plan administrator or its designee will continue to provide benefits to the extent the employee opts to continue his coverage). If the employee opts to continue his coverage, the employee shall pay his or her contribution in the same manner as a participant on the non-FMLA leave, including payment with after-tax dollars while on leave. The employee may also be given the option to pre-fund all or a portion of the contribution for the expected duration of the leave on a pre-tax salary reduction basis out of his pre-leave compensation by making a special election to that effect prior to the date such compensation would normally be made available to him (provided, however, that pre-tax dollars may not be utilized to fund coverage during the next plan year).

§85.5 Benefits

(a) Benefits available for selection by participants. A participant may elect, in accordance with the procedures set forth in this section, one or both of the following benefits, subject to all the requirements and conditions contained in these rules:

- (1) health care reimbursement plan;
- (2) dependent care reimbursement plan.

(b) Health care reimbursement plan.

(1) [General purpose health care reimbursement account](#). Pursuant to the health care reimbursement plan, a participant may elect to receive reimbursements of certain health care expenses which are excludable from the participant's taxable income. The [general purpose health care reimbursement account \[plan\]](#) is intended to be qualified under the Code, §105, is an optional benefit under the flexible benefits plan, and constitutes a separate written employee benefit plan as contemplated by the Code, §105, and Treasury Regulation 1.105-11.

(2) Maximum benefit available. Subject to the limitations set forth in these rules, hereafter referred to as the plan, to avoid discrimination, the maximum amount of flexible benefit dollars that an employee may receive in any plan year for health care expenses under the health care reimbursement plan is the amount permitted under the Code, §105. Even if permitted under the Code, in no event shall the amount available exceed \$5,000 in a plan year. An employee may prepay the health care election amounts for the remainder of the plan year in anticipation of termination, retirement, or a period of leave without pay.

(3) Limited purpose health care reimbursement account. An employee who elects to participate in a consumer directed health plan with a health savings account as permitted by Subchapter J, Chapter 1551, Insurance Code, may elect to participate in a limited purpose health care reimbursement account. This limited purpose health care reimbursement account may only be used to reimburse eligible dental and vision care expenses incurred during the benefit plan year or permitted carryover period. The limited purpose health care reimbursement account is intended to be qualified under the Code, §105, is an optional benefit under the flexible benefits plan, and constitutes a separate written employee benefit plan as contemplated by the Code, §105, and Treasury Regulation 1.105-11.

(c) Dependent care reimbursement plan.

(1) Pursuant to the dependent care reimbursement plan, a participant may elect to have payments made or receive reimbursement for dependent care expenses. The dependent care reimbursement plan is intended to be qualified under the Code, §129, is an optional benefit under the flexible benefits plan, and constitutes a separate written employee benefit plan as contemplated by the Code, §129.

(2) Maximum benefit available.

(A) Subject to any limitations imposed by these rules, hereafter referred to as the plan, to avoid discrimination, the maximum amount that an employee may receive in any plan year in the form of payment of or reimbursement for dependent care expenses under the dependent care reimbursement plan is the lesser of:

(i) the employee's earned income for the plan year (after all reductions in compensation including the reduction related to dependent care expenses);

(ii) the earned income of the employee's spouse for the plan year;

or

(iii) the amount permitted under the Code, §129. Even if permitted under the Code, in no event shall the amount available exceed \$5,000 in a plan year.

(B) In the case of a participant's spouse who is a full-time student at an educational institution or who is physically or mentally incapable of caring for himself, such spouse shall be deemed to have earned income of not less than \$200 per month if the participant has one dependent and \$400 per month if the participant has two or more dependents in accordance with the Code, §21.

PUBLIC AGENDA ITEM - #14a

Review, Discussion and Consideration of the Texas Employees Group Benefits Program:

14a. Selection of the Pharmacy Benefit Managers for the HealthSelectSM of Texas Prescription Drug Plan and the HealthSelectSM of Texas Medicare Pharmacy Plan
Beginning January 1, 2017

May 17, 2016

BACKGROUND:

Under the Texas Employees Group Benefits Program (GBP), the Employees Retirement System of Texas (ERS) provides Texas state employees with prescription drug benefits through services provided by pharmacy benefit managers (PBM). ERS' current contract for PBM services for the HealthSelectSM of Texas Medicare Pharmacy Plan Prescription Drug Program (Medicare Rx PDP) terminates on December 31, 2016. ERS' current contract for PBM services for the HealthSelectSM of Texas Prescription Drug Program (HealthSelect PDP) terminates on August 31, 2017. For purposes of the Board agenda item, the Medicare Rx PDP and HealthSelect PDP may sometimes be referred to as "the PDPs."

Medicare Rx PDP and HealthSelect PDP Governance

Texas Administrative Code Title 34, Part IV, Chapter 81 provides the rules that govern the PDPs.

Request for Proposal (RFP)

ERS entered into a four (4) year contract with Caremark Rx, L.L.C. (Caremark) for a period from September 1, 2008 through August 31, 2012, to provide PBM services for the HealthSelect PDP. ERS extended the Contract with Caremark twice: first for an additional two (2) year period that ended on August 31, 2014, and then for an additional three (3) year period that will end on August 31, 2017.

ERS entered into a three (3) year contract with SilverScript Insurance Company (SilverScript) for the period January 1, 2013 through December 31, 2016, to provide services for the Medicare Rx PDP. Since the SilverScript contract terminates on December 31, 2016, a new contract for Medicare Rx PDP PBM services will need to be in place prior to January 1, 2017.

Request for Proposal (RFP)

On December 11, 2015, ERS issued a RFP seeking qualified vendors to provide PBM services. Each contract has an initial term of approximately six (6) years.

Prospective Vendors Request Access to the RFP

Interested vendors were instructed to contact ERS to obtain a password that would allow them access to the RFP. As a result of these notifications, eighteen (18) companies requested access to the RFP.

By the noon deadline on January 27, 2016, ERS received four (4) proposals for HealthSelect PDP PBM services and four (4) proposals for Medicare Rx PDP PBM services as follows:

Vendor Name HealthSelect PDP	Vendor Name Medicare Rx PDP
Caremark Rx, L.L.C., providing services by and through its subsidiary CaremarkPCS Health, L.L.C. (collectively, CVS Health)	SilverScript Insurance Company (SilverScript)
Express Scripts, Inc. (ESI)	Express Scripts, Inc. (ESI)
MedImpact Healthcare Systems, Inc. (MedImpact)	Transamerica Life Insurance (Transamerica)
United HealthCare Services, Inc. (UHC)	United HealthCare Services, Inc. (UHC)

Please note that each of the HealthSelect PDP vendors submitted proposals that also included a Medicare Rx PDP proposal as noted above.

Each of the vendors submitted a proposal (Proposal) that included required pricing and other financial information, responses to RFP interrogatories, and other materials the vendors considered necessary to explain their Proposals.

Proposal Evaluation
January 2016 – May 2016

Article II of the RFP disclosed the general evaluation criteria that would be the basis for evaluating responses submitted by the vendors. The evaluation was conducted in three (3) phases as follows:

1. Phase One Evaluation

The Phase One evaluation included evaluation of the minimum requirements (as discussed further below), compliance with the RFP, the vendor's performance as reported in the Texas Comptroller's Vendor Performance Tracking System in accordance with Section 2262.055, Tex. Gov't Code, and vendor's performance with ERS if vendor had a current contract with ERS or if vendor had a contract with ERS in the past six (6) years.

Minimum Requirements. The RFP required the vendors to provide evidence that it satisfied the following minimum requirements:

a. HealthSelect PDP PBM Minimum Requirements

- o Authorization to do business in Texas. The vendor is required to meet all legal requirements for doing business in Texas. If the vendor was not authorized to do business in Texas at the time of Proposal submission, it is required to obtain such authorization prior to the contract's effective date.
- o Professional Licensure and Certifications. The vendor is required to hold all necessary and appropriate business and professional licenses and/or certifications necessary to provide PBM services.
- o Demonstrated experience in administrative duties. The vendor is required to have experience providing PBM services for a single organization with member participation of no less than 250,000 or manage a book of business with an aggregate of 5,000,000 covered lives for a minimum of three (3) years at time of Proposal submission.
- o Demonstrated Pharmacy Network. At the time of Proposal submission, the vendor was required to have a pharmacy network capable of effectively servicing the HealthSelect PDP membership (approximately 450,000 lives) without member access disruption.
- o Net Worth. The vendor is required to have a current net worth of \$50 million. In addition, since the vendor may be required to advance up to two (2) weeks of claim payments totaling approximately \$30 million before being reimbursed by ERS, the vendor is required to have at least \$30 million in cash and cash equivalents available (on average).
- o Demonstrated Financial Stability. The vendor shall be in good financial standing, not in any form of bankruptcy, and current in the payment of all taxes and fees.

b. Medicare Rx PDP PBM Minimum Requirements

- o Authorization to do business in Texas. The vendor is required to meet all legal requirements for doing business in Texas. If the vendor was not authorized to do business in Texas at the time of Proposal submission, it is required to obtain such authorization prior to the contract's effective date.
- o Professional Licensure and Certifications. The vendor is required to hold all necessary and appropriate business and professional licenses and/or certifications necessary to provide PBM services.

- Demonstrated experience in administrative duties. The vendor is required to have experience providing PBM services for a single organization with member participation of no less than 20,000 or manage a book of business with an aggregate of 100,000 covered lives for a minimum of three (3) years at time of Proposal submission.
- Demonstrated Pharmacy Network. At the time of Proposal submission, the vendor was required to have a pharmacy network capable of effectively servicing the Medicare Rx PDP membership (approximately 74,000 lives) without member access disruption.
- Net Worth. The vendor is required to have a current net worth of \$50 million. In addition, since the vendor may be required to advance up to two (2) weeks of claim payments totaling approximately \$30 million before being reimbursed by ERS, the vendor is required to have at least \$30 million in cash and cash equivalents available (on average).
- Demonstrated Financial Stability. The vendor shall be in good financial standing, not in any form of bankruptcy, and current in the payment of all taxes and fees.

Phase One was evaluated on a Pass/Fail basis. All eight (8) responses for the PDPs passed the Phase One evaluation.

2. Phase Two Evaluation

Once the Proposals had been reviewed against the Phase One criteria and deemed to be responsive, the qualified responses were vetted through a comprehensive review by the RFP evaluation team which was comprised of subject matter experts (SMEs) throughout the agency. The SMEs were assigned only those sections in the areas related to their subject matter expertise.

In recent years, ERS has become more active in the management of its programs. As a result, the agency has raised its expectations of the service level required from its vendors. The evaluation process has included considerable attention to the various types of service required of the vendor under the proposed contract. The evaluation process is a means to help the evaluation team develop a better understanding of the levels of service to be expected from the vendors under the proposed contract.

The Phase Two evaluation included review of the vendor's financial considerations/price proposal and operational capabilities and services. It included review of each vendor's original Proposal and its clarification responses. The Phase Two evaluation included the following elements:

Financial Considerations/Price Proposal. ERS staff in conjunction with Rudd and Wisdom, ERS' consulting actuaries for insurance, performed a review of vendor's financial considerations/price proposal. This included a review of vendor's administrative fee; retail, mail service, and specialty prescription reimbursements; rebates and other subsidies; and the impact of a vendor's formulary. The Financial Considerations/Price Proposal accounted for fifty percent (50%) of the total score.

Operational Capabilities and Services. The vendors would be evaluated based on their ability to provide quality operational services. The review of vendor's operational capabilities and services included the following:

- Legal Requirements. The vendors were required to submit extensive disclosure regarding such issues as litigation, regulatory proceedings, investigations, mergers, acquisitions, and reorganizations. The vendors would be required to disclose any arrangements concerning the sale of data.
- HealthSelect PDP and Medicare Rx PDP Plan Design, Eligibility, Network and Program Requirements. The vendors were evaluated based on their ability to provide PBM services within the provisions and specifications outlined in the RFP. This included providing and management of a robust retail pharmacy network (including retail, mail service and specialty pharmacies); capability of providing an extended day supply of drugs; utilization management and drug utilization review; condition management and prior authorization programs; and ability to assist ERS in initiatives to control costs. It also included the ability to actively engage in annual enrollment fairs; providing claims administration; support for the grievance procedure; coordination of benefits; and other administrative requirements (including account management and administration services, enrollment and eligibility services, communications, customer support and reporting services).

- **Communication Requirements.** The RFP stated that ERS would give consideration to vendors that had demonstrated experience in executing an effective communication strategy that promotes participant education and engagement. These communication services extend, but are not limited to, website portals; communication materials; ability to actively engage in annual enrollment fairs; capability to support customized communication materials; and development of a Master Benefit Plan Document, Benefit Books, and Evidence of Coverage.
- **Operational Specifications.** ERS strongly believes that the account service relationship is the critical link in developing and maintaining a strong working relationship dedicated toward the achievement of plan objectives. As such, the vendors are required to provide ERS with a service attention that is at the highest levels in the industry and fully consistent with ERS' expectations. The vendors were evaluated based on their ability to provide quality operational services throughout implementation and on a post-implementation basis. The operational services extend to the vendors' account management staff, call center, customer service unit, quality assurance reviews, and program reporting.
- **Information Systems Requirements.** The technological capabilities included, but were not limited to, data and information services, securely receiving and transmitting data, fault tolerance methodology and practices, quality control, business analysis and development processes, data interfaces, and information security and data security practices.
- **Financial Specifications and Requirements.** The vendors would be evaluated based on their claims reimbursement and payment methodologies, and the ability to provide quality and efficient financial reporting.
- **Administrative Benefit.** ERS recognizes an administrative benefit in awarding both contracts to one vendor. To account for this benefit, the Proposals offering both services received up to 5% of the allotted 40% under the Operational Capabilities and Services criteria for each Proposal.

Deviations. The RFP stated that deviations are not grounds for the dismissal of a vendor's Proposal with the exception of any deviations to the stated minimum requirements. Proposed deviations would be evaluated in the best interests of ERS, the GBP, its participants, and the state of Texas. When applicable, vendors were instructed to specifically identify deviations to the contract and/or RFP provisions and include the proposed language within its response for ERS' consideration.

Clarifications. As part of the evaluation process, the SMEs identified areas of the Proposals that required further clarification. The primary objective of this process is to ensure mutual understanding of the vendor's Proposal. This process is facilitated in writing to the vendor and is directed to an individual authorized to legally bind the company. Failure to comply with these clarification requests may result in rejection of the Proposal. Clarification questions were issued to the vendors with specified response due dates. The evaluation team assessed the clarification responses upon receipt.

The Operational Capabilities and Services accounted for forty percent (40%) of the total score.

3. Phase Three Evaluation

Based on the Phase Two evaluation, the scores of MedImpact (for the HealthSelect PDP) and Transamerica (for the Medicare Rx PDP) resulted in the companies being ranked fourth primarily due to their projected total cost of prescription drugs and services. The remaining three (3) entities for each program (CVS Health, ESI and UHC for the HealthSelect PDP; and SilverScript, ESI and UHC for the Medicare Rx PDP) became finalists and moved to the Phase Three evaluation. The Phase Three evaluation included Vendor Service Verification, which was ten percent (10%) of the total score.

The Vendor Service Verification processes are part of the due-diligence strategy that ERS staff performs. These verification processes are performed only for the selected finalists and are comprised of (a) face-to-face finalist interviews, (b) reference checks, and (c) site visits.

Face-to-Face Finalist Interviews (Oral Presentations/Discussions). The finalist interviews were held on April 25th, 26th, and 27th, 2016, in Austin, Texas at ERS' location. Each session included a presentation by the respective vendor, discussion of key issues, and extensive questioning of the vendor's representatives by ERS staff.

Oral presentations and discussions during the interview provide an opportunity for finalists to highlight the strengths and unique aspects of their Proposals and to provide answers to questions that ERS staff may have regarding the Proposal. Topics discussed at these sessions included contractual and performance expectations; organizational information; administrative, account management and customer service considerations; claims, billing, and reimbursement processing; information technology capabilities; and project management/implementation methodologies. The time allowed and the format were the same for all finalist presenters; a prepared agenda ensured consistency in this process.

Best and Final Offer. The finalists were formally requested to prepare a Best and Final Offer (BAFO) and to provide this BAFO at the beginning of the face-to-face interviews. The BAFO responses were provided to the appropriate SMEs for consideration and scoring.

Reference checks. Vendors are required to provide client references to be used for reference checks. ERS staff conducted reference checks to those public and private entities for which the finalists serve as the PBM. All reference checks were documented in writing. The same format of questions was used when conducting each of the reference checks so that the results were consistent and fair to all finalists. The reference check process assists in the evaluation of the Proposal and is another avenue to verify information provided by the vendor within its Proposal. While some references for each vendor declined to provide any additional information in the comments portion of the reference verification, those responding were complimentary of the performance of each vendor involved.

Site Visits. As part of the Vendor Service Verification, ERS reserves the right to perform site visits at ERS' expense to the vendors' operational center, call center, and/or data center facilities. The site visits took place as follows:

- (a) CVS Health/SilverScript Site Visits
 - o Data Center: The Data Center site visit to CVS Health/SilverScript's facility located in Scottsdale, Arizona was conducted in May.
 - o Call Center: The Call Center site visit to CVS Health/SilverScript's facility located in San Antonio, Texas was conducted in May.
- (b) ESI Site Visits
 - o Data Center: The Data Center site visit to ESI's facility located in Piscataway, New Jersey was conducted in May. The Data Center site visit to ESI's facility located in Elk Grove Village, Illinois was conducted in May.
 - o Call Center: The Call Center site visit to ESI's facility located in Corpus Christi, Texas was conducted in May.
- (c) UHC Site Visit
 - o Data Center: No site visit was performed of UHC's data center since ERS' SMEs had inspected the facility in January 2016 in conjunction with the Health Savings Account Administrator Request for Proposal.
 - o Call Center. No site visit was performed of UHC's call center since ERS' SMEs had conducted site visits of this call center in January 2016 in conjunction with the Health Savings Account Administrator Request for Proposal and also in April 2016 in conjunction with the Vision Health Care Services Request for Proposal.

Members of the evaluation team provided scores based on information provided by the finalists during the face-to-face interviews. Additionally, those members of the evaluation team that performed the due diligence site visits would include their observations from the site visits in their scores for the finalist

vendors. The Members of the evaluation team assigned to score references also provided scores for the reference checks based on their analysis.

Contractibility was also evaluated in the Phase Three evaluation process. Finalists were required to sign a contract acceptable to ERS.

Final Evaluation and Recommendation. Based on the scoring provided throughout the extensive evaluation process, all three (3) finalists for the HealthSelect PDP and all three (3) finalists for the Medicare Rx PDP were considered to have the capabilities to provide PBM services in accordance with the RFP. The evaluation team determined that factors were evident that differentiated the finalists.

Benefit Contracts leadership met with ERS' Executive Office and the Director of Procurement to review the findings of the cross-divisional evaluation team and discuss the recommendation that would be prepared by staff based on the scores provided by the evaluation team.

STAFF RECOMMENDATION:

Based on the scoring of the submitted Proposals, clarifications, reference checks, face-to-face meetings, site visits, and the financial analysis discussed in this agenda item, the Director of Procurement was able to determine the vendor that provides best value to the state of Texas for PBM services for the HealthSelect PDP and the Medicare Rx PDP for the GBP.

ERS staff will present a recommendation to the Board for the qualified vendor to provide PBM services for the HealthSelect PDP under the Texas Employees Group Benefits Program for the initial six-year term beginning January 1, 2017 and ending August 31, 2022, and the Medicare Rx PDP under the Texas Employees Group Benefits Program for the initial six-year term beginning January 1, 2017 and ending December 31, 2022.

The proposed motions are included with this agenda item.

PUBLIC AGENDA ITEM - #14b

Review, Discussion and Consideration of the Texas Employees Group Benefits Program:

14b. Selection and Contract Award Recommendation for Group Vision Care Services Administration
Beginning September 1, 2016

May 17, 2016

BACKGROUND:

The Texas Employees Group Benefits Program (GBP) offers a number of health insurance plans to State employees and retirees (Members) in accordance with Chapter 1551 of the Texas Insurance Code. Although some of the medical plans within the GBP offer basic vision benefits (which may include a routine eye exam and discounted vision care services), the GBP currently does not offer a comprehensive group vision care plan. A survey conducted in 2014 to solicit member opinions indicated a strong desire by Members for vision care to be an offered benefit. Therefore, ERS issued a request for proposal seeking a qualified vendor to provide group vision care services (RFP).

Group Vision Care Plan

A group vision care plan is not statutorily required by Chapter 1551 of the Texas Insurance Code. It will be an optional benefit for Members who choose vision care services at their own expense. Although enrollment in group vision care is not known since ERS does not currently offer a group vision care plan, ERS believes that approximately fifty percent (50%) of Members will choose to enroll in the plan during its initial year. The plan presented within the RFP includes coverage for routine eye exams, contact lens fittings (both standard and specialty), and various products associated with glasses and contact lens.

Request for Proposal (RFP)

On December 22, 2015, ERS issued an RFP seeking a qualified vendor to provide administrative services for the self-funded group vision care plan for a four (4) year period beginning September 1, 2016 through an initial term of August 31, 2020.

Prospective Vendors Request Access to the RFP

Interested vendors were instructed to contact ERS to obtain a password that would allow them access to the RFP. As a result of these notifications, eight (8) companies requested access to the RFP. The benefit was requested to be on a self-insured basis. Prospective vendors were instructed to email any questions related to the RFP to ERS' Purchasing Department.

By the noon deadline on January 26, 2016, ERS received four (4) proposals for the administration of vision care services as follows:

Vendor Name
Davis Vision, Inc. (Davis Vision)
EyeMed Vision Care, LLC (EyeMed)
Superior Vision Services, Inc. (Superior Vision)
United HealthCare Services, Inc. (UHC)

Each of the vendors submitted a proposal (Proposal) that included required pricing and other financial information, responses to RFP interrogatories, and other materials the vendors considered necessary to explain their Proposals.

Proposal Evaluation
January 2016 – April 2016

Article II of the RFP disclosed the general evaluation criteria that would be the basis for evaluating responses submitted by the vendors. The evaluation was conducted in three (3) phases as follows:

1. Phase One Evaluation

The Phase One evaluation included evaluation of the minimum requirements (as discussed further below), compliance with the RFP, the vendor's performance as reported in the Texas Comptroller's Vendor Performance Tracking System in accordance with Section 2262.055, Tex. Gov't Code, and vendor's performance with ERS if vendor had a current contract with ERS or if vendor had a contract with ERS in the past two (2) years.

Minimum Requirements. The RFP required the vendors to provide evidence that it satisfied the following minimum requirements:

- Authorization to do business in Texas. The vendor is required to meet all legal requirements for doing business in Texas. If the vendor was not authorized to do business in Texas at the time of Proposal submission, it is required to obtain such authorization prior to the contract's effective date.
- Professional Licensure and Certifications. The vendor is required to hold all necessary and appropriate business and professional licenses and/or certifications necessary to provide vision care services.
- Demonstrated experience in administrative duties. The vendor is required to have experience providing group vision care services to at least one client account with no less than 50,000 enrolled participants at the time of Proposal submission for a period of no less than five (5) years. Additionally, vendor's total eligible participants across all of its client accounts (i.e., vendor's group vision care services "book of business") was required to be, in aggregate, at least 1,000,000 participants at the time of Proposal submission.
- Demonstrated Provider Network. At the time of Proposal submission, the vendor was required to have a provider network throughout Texas that provided vision care for at least 250,000 participants and maintained a minimum of 2,500 vision care providers.
- Net Worth. The vendor is required to have a current net worth of \$10 million. In addition, since the vendor may be required to advance up to two (2) weeks of claim payments totaling approximately \$1.5 million before being reimbursed by ERS, the vendor is required to have at least \$1.5 million in cash and cash equivalents available (on average).
- Demonstrated Financial Stability. The vendor shall be in good financial standing, not in any form of bankruptcy, and current in the payment of all taxes and fees.

Phase One was evaluated on a Pass/Fail basis. All four (4) vendors submitting Proposals passed the Phase One evaluation.

2. Phase Two Evaluation

Once the Proposals had been reviewed against the Phase One criteria and deemed to be responsive, the qualified responses were vetted through a comprehensive review by the RFP evaluation team which was comprised of subject matter experts (SMEs) throughout the agency. The SMEs were assigned only those sections in the areas related to their subject matter expertise.

Over the last several years, ERS has become more active in the management of its programs. As a result, the agency has raised its expectations of the service level required from its vendors. The evaluation process has included considerable attention to the various types of service

required of the vendor under the proposed contract. The evaluation process is a means to help the evaluation team develop a better understanding of the levels of service to be expected from the vendors under the proposed contract.

The Phase Two evaluation included review of the vendor's financial considerations/price proposal and operational capabilities and services. It included review of each vendor's original Proposal and its clarification responses. The Phase Two evaluation included the following elements:

Financial Considerations/Price Proposal. ERS staff in conjunction with Rudd and Wisdom, ERS's consulting actuaries for insurance, performed a review of the vendors' financial considerations/price proposal. This included a review of each vendor's administrative fee and network reimbursement rates, and its claims funding and payment methodologies. The Financial Considerations/Price Proposal accounted for forty percent (40%) of the total score.

Operational Capabilities and Services. The vendors would be evaluated based on their ability to provide quality operational services. The review of vendor's operational capabilities and services included the following:

- Legal Requirements. As part of the Legal Requirements, vendors were evaluated on information they provided pertaining to compliance with the Health Insurance Portability and Accountability Act of 1996 (HIPAA), the Privacy Act and information security standards, its terms of use, and its ability to provide legal services and litigation support. An evaluation was also performed to determine if the vendor had any conflicts of interest.
- Group Vision Care Plan Provisions and Eligibility. The vendors were evaluated based on their ability to administer the vision care plan within the provisions and specifications outlined in the RFP. This included providing coverage for routine eye exams, contact lens fittings (both standard and specialty), frames (including bifocals, trifocals, progressives, polycarbonate, scratch coat, ultraviolet coat, tint, and standard anti-reflective materials), and contact lens (both conventional and disposable). It also included the ability to actively engage in annual enrollment fairs, provide claims administration, publication of a master benefit plan document and/or member handbook, support for the grievance procedure, coordination of benefits, and other administrative requirements (including account management and administration services, enrollment and eligibility services, communications, customer support and reporting services).
- Provider Network Requirements. The vendors were evaluated based on their ability to provide the broadest possible vision provider service area with adequate numbers of vision providers and locations across Texas. The vendors are required to offer complete flexibility in the Members' selection of a vision care provider within the selected network. In addition, the vendors are required to guarantee that the number of provider locations under contract at the beginning of each fiscal year will not decrease by more than 10% in any 3-digit zip code area on an annualized basis.

As part of the provider network requirements, the vendors are required to provide ongoing recruitment, credentialing and contracting with a sufficient number of qualified and duly licensed vision care providers; ongoing provider education to ensure that the providers are familiar with and knowledgeable about the benefits and other plan provisions; ongoing review of the fees paid to providers; quality assurance review to be monitored by periodic Member surveys and other reporting mechanisms; utilization management, including monitoring and enforcement of compliance with vision care protocol and ongoing administration of Member and provider complaints; and communication with ERS about utilization management, appeals, and complaints.

- Operational Specifications. ERS strongly believes that the account service relationship is the critical link in developing and maintaining a strong working relationship dedicated toward the achievement of plan objectives. As such, the vendors are required to provide ERS with a service attention that is at the highest levels in the industry and fully consistent with ERS' expectations. The vendors were evaluated based on their ability to provide quality operational services throughout implementation and on a post-implementation basis. The operational services extend to the vendors' account management staff, call center, customer service unit, quality assurance reviews, and program reporting.
- Communication Requirements. Vendors were evaluated with regard to the RFP's communication requirements. These communication requirements consist of, but are not limited to, capability to support customized communication materials as well as website portals.
- Information Systems Requirements. The technological capabilities included, but were not limited to, data and information services, HIPAA compliance, securely receiving and transmitting data, fault tolerance methodology and practices, quality control, business analysis and development processes, data interfaces, and information security and data security practices.

Deviations. The RFP stated that deviations are not grounds for the dismissal of a vendor's Proposal with the exception of any deviations to the stated minimum requirements. Proposed deviations would be evaluated in the best interests of ERS, the GBP, its participants, and the state of Texas. When applicable, vendors were instructed to specifically identify deviations to the contract and/or RFP provisions and include the proposed language within its response for ERS' consideration.

Clarifications. As part of the evaluation process, the SMEs identified areas of the Proposals that required further clarification. The primary objective of this process is to ensure mutual understanding of the vendor's Proposal. This process is facilitated in writing to the vendor and is directed to an individual authorized to legally bind the company. Failure to comply with these clarification requests may result in rejection of the Proposal. Clarification questions were issued to the vendors with specified response due dates. The evaluation team assessed the clarification responses upon receipt.

The Operational Capabilities and Services accounted for fifty percent (50%) of the total score. At the end of this phase of the evaluation process, the scores of Davis Vision resulted in the company being ranked fourth. The remaining three (3) entities, EyeMed, Superior Vision and UHC, were identified as finalists.

3. Phase Three Evaluation

Based on the Phase Two evaluation, the top ranked Vendors (EyeMed, Superior Vision and UHC) became finalists and moved to the Phase Three evaluation. The Phase Three evaluation included Vendor Service Verification, which was ten percent (10%) of the total score.

The Vendor Service Verification processes are part of the due-diligence strategy that ERS staff performs. These verification processes are performed only for the selected finalists and are comprised of (a) face-to-face finalist interviews, (b) reference checks, and (c) site visits.

Face-to-Face Finalist Interviews (Oral Presentations/Discussions). The finalist interviews were held on April 4th, 6th, and 7th, 2016, in Austin, Texas at ERS' location. Each session included a presentation by the respective vendor, discussion of key issues, and extensive questioning of the vendor's representatives by ERS staff.

Oral presentations and discussions during the interview provide an opportunity for finalists to highlight the strengths and unique aspects of their Proposals and to provide answers to questions

that ERS staff may have regarding the Proposal. Topics discussed at these sessions included contractual and performance expectations; organizational information; administrative, account management and customer service considerations; claims, billing, and reimbursement processing; information technology capabilities; provider network; and project management/implementation methodologies. The time allowed and the format were the same for all finalist presenters; a prepared agenda ensured consistency in this process.

Best and Final Offer. The three finalists were formally requested to prepare a Best and Final Offer (BAFO) and to provide this BAFO at the beginning of the face-to-face interviews. The BAFO responses were provided to the appropriate SMEs for consideration and scoring.

Reference checks. As part of the finalist interview, the vendors are required to provide client references to be used for reference checks. ERS staff conducted reference checks to those public and private entities for which EyeMed, Superior Vision, or UHC serve as the administrator for group vision care services. All reference checks were documented in writing. The same format of questions was used when conducting each of the reference checks so that the results were consistent and fair to all finalists. The reference check process assists in the evaluation of the Proposal and is another avenue to verify information provided by the vendor within its Proposal. While some references for each vendor declined to provide any additional information in the comments portion of the reference verification, those responding were complimentary of the performance of each vendor involved.

Site Visits. As part of the Vendor Service Verification, ERS reserves the right to perform site visits at ERS' expense to the vendors' operational center, call center, and/or data center facilities. The site visits took place as follows:

- (a) EyeMed Site Visits
 - o Data Center: The Data Center site visit to EyeMed's facility located in Suwanee, Georgia was conducted on April 12, 2016.
 - o Operations Center: The Operational/Customer Service site visit to EyeMed's facility located in Mason, Ohio was conducted on April 12, 2016.
- (b) Superior Vision Site Visits
 - o Data Center: The Data Center site visit to Superior Vision's facility located in Owings Mill, Maryland was conducted on April 11, 2016.
 - o Operations Center: The Operational/Customer Service site visit to Superior Vision's facility located in Rancho Cordova, California was conducted on April 13, 2016.
- (c) UHC Site Visit
 - o Data Center: No site visit was performed of UHC's data center since ERS' SMEs had inspected the facility in January 2016 in conjunction with the Health Savings Account Administrator Request for Proposal.
 - o Operations Center. The Operational/Customer Service site visit to UHC's facility located in San Antonio, Texas was conducted on April 15, 2016.

Members of the evaluation team would update their evaluation scores based on the information provided by the finalists during the face-to-face interviews. Additionally, those members of the evaluation team that performed the due diligence site visits would include their observations from the site visits in their scores for the finalist vendors. The Member of the evaluation team assigned to score references also provided scores for the reference checks based on her analysis.

Contractibility was also evaluated in the Phase Three evaluation process. Finalists were required to sign a contract acceptable to ERS.

Final Evaluation and Recommendation. Based on the scoring provided throughout the extensive evaluation process, all three (3) finalists were considered to have the capabilities to provide the group vision care services in accordance with the RFP. The evaluation team determined that factors were evident that differentiated the three (3) finalists.

Benefit Contracts leadership met with ERS' Executive Office and the Director of Procurement to review the findings of the cross-divisional evaluation team and discuss the recommendation that would be prepared by staff based on the scores provided by the evaluation team.

STAFF RECOMMENDATION:

Based on the scoring of the submitted Proposals, clarifications, reference checks, face-to-face meetings, site visits, and the financial analysis discussed in this agenda item, the Director of Procurement was able to determine the vendor that provides best value to the State of Texas for group vision care services for the GBP.

ERS staff will present a recommendation to the Board for the qualified vendor to provide group vision care services under the Texas Employees Group Benefits Program for the initial four-year term beginning September 1, 2016 and ending August 31, 2020.

The proposed motions are included with this agenda item.

PUBLIC AGENDA ITEM - #15a

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2017:

15a. Basic and Optional Term Life, Accidental Death and Dismemberment Proposed Rates

May 17, 2016

BACKGROUND:

The Employees Retirement System of Texas (ERS) offers Basic and Optional Term Life, Accidental Death and Dismemberment (AD&D) and Voluntary AD&D insurance coverages under the Texas Employees Group Benefits Program (GBP). The benefits provided under the optional life, voluntary AD&D, and dependent life plans are funded solely by the contributions from individuals participating in the plans based on contribution rates adopted annually by the ERS Board of Trustees (Board). The contributions to fund employee and retiree basic term life and AD&D benefits are also adopted by the Board, but paid for by the State of Texas through the State's biennial appropriation for the GBP.

On August 23, 2011, the Board approved the selection of Minnesota Life Insurance Company (Minnesota Life) to underwrite and administer the life insurance and AD&D coverages for an initial term beginning January 1, 2012 and extending through August 31, 2016. In accordance with the terms of the contract, the staff negotiated an extension for the period September 1, 2016 through August 31, 2018.

Coverage Options

The coverage options for Basic and Optional Term Life, as well as voluntary AD&D programs for actives and retirees are provided below.

Basic Group Term Life Insurance with AD&D coverage

<i>Actives:</i>	Each participating employee who elects GBP health coverage is automatically enrolled in \$5,000 Basic Group Term Life Insurance and \$5,000 Basic AD&D coverage.
<i>Retirees:</i>	Each participating retired employee in the GBP is automatically enrolled in \$2,500 Basic Group Term Life Insurance. AD&D coverage is not available to retired employees.

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Optional Group Term Life Insurance with Basic AD&D coverage

<p><i>Actives:</i></p>	<p>The amount of Optional Group Term Life Insurance and AD&D coverage is based on the employee's salary. Upon being hired, an employee may apply for Optional Term Life Insurance at one or two times annual salary without Evidence of Insurability (EOI). An election of Optional Term Life Insurance at three or four times of annual salary requires EOI. The combined amount of Optional Group Term Life Insurance may not exceed \$400,000 with a corresponding amount of AD&D coverage.</p>												
<p><i>Retirees:</i></p>	<p>Optional Group Term Life Insurance is available to retirees. However, specific rules governing the maximum amounts available are dependent on date of retirement.</p> <p style="text-align: center;"><i>continued on next page</i></p> <table border="1" data-bbox="597 709 1068 1031"> <thead> <tr> <th data-bbox="597 709 906 793">Age</th> <th data-bbox="914 709 1068 793">Benefit Coverage</th> </tr> </thead> <tbody> <tr> <td data-bbox="597 793 906 846">70-74</td> <td data-bbox="914 793 1068 846">65%</td> </tr> <tr> <td data-bbox="597 846 906 898">75-79</td> <td data-bbox="914 846 1068 898">40%</td> </tr> <tr> <td data-bbox="597 898 906 951">80-84</td> <td data-bbox="914 898 1068 951">25%</td> </tr> <tr> <td data-bbox="597 951 906 1003">85-89</td> <td data-bbox="914 951 1068 1003">15%</td> </tr> <tr> <td data-bbox="597 1003 906 1031">90 and over</td> <td data-bbox="914 1003 1068 1031">10%</td> </tr> </tbody> </table>	Age	Benefit Coverage	70-74	65%	75-79	40%	80-84	25%	85-89	15%	90 and over	10%
Age	Benefit Coverage												
70-74	65%												
75-79	40%												
80-84	25%												
85-89	15%												
90 and over	10%												

Dependent Term Life Insurance coverage with AD&D coverage

<p><i>Actives:</i></p>	<p>Each participating employee may purchase \$5,000 of Dependent Group Term Life Insurance and \$5,000 of AD&D for each listed eligible dependent.</p>
<p><i>Retirees:</i></p>	<p>Each participating retired employee may retain \$2,500 of Dependent Group Term Life Insurance if held as an active employee. The AD&D coverage is not available for dependents of retired employees.</p>

Voluntary AD&D coverage

<p><i>Actives:</i></p>	<p>Voluntary Accidental Death and Dismemberment is a separate insurance program. Voluntary AD&D, sometimes referred to as Voluntary Accident Insurance (VAI), is offered to employees for an additional premium unrelated to the Group Term Life premium. An employee is not required to carry Optional Group Term Life Insurance coverage in order to carry Voluntary AD&D coverage and no EOI is required for Voluntary AD&D. The amount of Voluntary AD&D coverage is a maximum of \$200,000, but available in lesser incremental amounts.</p>
<p><i>Retirees:</i></p>	<p>Not available to retirees.</p>

Enrollment

The following table lists enrollment and volume for the life and AD&D plans as of March 31, 2015.

GBP Life and AD&D Coverage as of March 31, 2016

Plan	Funding	Enrolled Members	Volume of Insurance
Basic Life	Fully Insured	319,399	\$ 1,338,425,000
Optional Life & AD&D	Fully Insured	212,673	20,307,087,650
Voluntary AD&D	Fully Insured	133,201	18,500,016,750
Dependent Life & AD&D	Fully Insured	112,040	489,007,500

Basic and Dependent Optional Life Insurance Funding

The life insurance plans are funded through a fully insured minimum premium arrangement with Minnesota Life (the insurer). Under this funding arrangement, ERS pays the insurer the contractual administrative fees on a monthly basis. Each week, ERS pays the insurer the amount required to provide for the actual life insurance claims paid by the insurer during the previous week. The minimum premium arrangement includes maximum premium rates for each coverage that are guaranteed for the term of the contract. In no event will payments to the insurer over the term of the contract exceed the amount calculated based on the guaranteed maximum premium rates. The administrative fees are guaranteed for the term of the contract. Recently, Benefit Contracts agreed to a contract extension through August 31, 2018. As part of the extension, ERS agreed to increase the maximum premium rate by approximately 6%.

The AD&D plan is also fully insured by Minnesota Life; ERS pays each month's premium in full. The AD&D premium is based on premium rates that are also guaranteed for the term of the contract.

Basic and Optional Life Contribution Rates

The Underwriting, Data Analysis and Reporting (UDAR) unit of ERS' Benefit Contracts division works in cooperation with Rudd and Wisdom, the consulting actuary for insurance, to develop recommended member contribution rates for the life and AD&D Plans. We developed member contribution rates for the Life Plan based on (a) reasonable expectations of future claims determined through a review of the plan experience over the last five years, (b) anticipated claim payment patterns, (c) expected investment income earned on funds held by ERS and (d) the maximum claims rates and administrative fees included in the Minnesota Life contract.

Based on this analysis, we concluded that the member contribution rates currently in effect for FY 2016 for all Life coverages are appropriate for continued use for FY 2017. The experience for the life insurance and optional life coverage outline the data for fiscal years 2012 through 2016 (YTD through February 2016). The life of the current contract is included in this agenda item as Exhibit A but does not reflect the full five years used in the final rate setting process.

The contribution rates for basic life insurance have remained unchanged following reductions effective September 1, 2007. The contribution rates for optional life insurance were reduced by an average of 10% effective September 1, 2012. Staff and Rudd and Wisdom believe that the current member contribution rates for basic life coverage and optional life coverage will remain adequate and should be continued through Fiscal Year 2017 (FY 2017).

AD&D Contribution Rates

AD&D member contribution rates, which are based on the guaranteed premium rates, have been stable since September 1, 2007. Consequently, all AD&D premium rates will remain at the current levels under the Minnesota Life contract, the staff and Rudd and Wisdom recommend that the current AD&D member contribution rates be continued through FY 2017.

STAFF RECOMMENDATION:

Based on the analysis described above, staff and Rudd and Wisdom recommend that the Board adopt member contribution rates for the life, and AD&D plans as presented in the following table, and as described in Rudd and Wisdom's analysis included with the agenda item as Exhibit B, effective September 1, 2016.

GBP Life and AD&D Coverage Proposed Monthly Member Contribution Rates for FY 2017 Effective September 1, 2016

Plan	Proposed FY 2017	Change from current rate
Active and Retiree Basic Term Life and AD&D⁽¹⁾	\$ 2.22	No change
Active and Retiree Optional Life and AD&D⁽²⁾		
Under Age 25	\$ 0.05	No change
25-29	0.05	No change
30-34	0.06	No change
35-39	0.06	No change
40-44	0.08	No change
45-49	0.12	No change
50-54	0.19	No change
55-59	0.33	No change
60-64	0.57	No change
65-69	0.93	No change
70-74	1.48	No change
75-79	2.41	No change
80-84	3.92	No change
85-89	6.79	No change
90 & Over	10.57	No change
Active Dependent Life and AD&D⁽¹⁾	\$ 1.38	No change
Retiree Minimum Optional Life⁽²⁾	\$ 2.34	No change
Retiree Dependent Life⁽¹⁾	\$ 3.05	No change
Voluntary AD&D		
Employee Only⁽²⁾	\$ 0.02	No change
Employee & Family⁽²⁾	0.04	No change

⁽¹⁾ Rates are per unit of coverage. \$5,000 of coverage for active employees and their dependents; \$2,500 of coverage for retired employees and their dependents.

⁽²⁾ Rates are per \$1,000 of coverage which is based on individual salary and coverage level, e.g., Elections I – IV. Retiree Optional Life does not include AD&D.

A proposed motion is included with this agenda item following the exhibits.

ATTACHMENTS – 2

Exhibit A – Financial Experience of Group Life Coverage for Fiscal Year 2015 and Fiscal YTD 2016

Exhibit B – Recommended Member Contribution Rates for the Life and AD&D Plans under the Texas Employees Group Benefits Program for Fiscal Year 2016, Rudd and Wisdom, Inc.

Financial Experience of Group Life Coverage for FY 2013 through March 2016

Group Life Insurance and Optional Coverages

Experience Summary through March 31, 2016

Life Coverages (Flexible Funding Basis)

Coverages	Average Volume (000)	Total Premium	Incurred Claims	Loss ratio
Basic Life	\$1,303,188	\$28,887,633	\$27,173,321	94.1%
Optional Life	\$18,707,438	\$216,093,486	\$211,862,741	98.0%
Dependent Life	\$499,139	\$8,026,813	\$8,160,955	101.7%
Life Total	\$20,509,765	\$253,007,932	\$247,197,017	97.7%

Rudd and Wisdom, Inc.

CONSULTING ACTUARIES

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Raymond W. Tilotta
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David G. Wilkes, F.S.A.

April 29, 2016

Mr. Porter Wilson
Executive Director
Employees Retirement System
of Texas
Post Office Box 13207
Austin, Texas 78711-3207

Re: Recommended Member Contribution Rates for
the Life and AD&D Plans under the Texas
Employees Group Benefits Program for Fiscal
Year 2017

Dear Mr. Wilson:

The purpose of this correspondence is to present recommendations for member contribution rates for the Life and AD&D Plans under the Texas Employees Group Benefits Program (GBP) for Fiscal Year 2017 (FY17).

Background

On August 23, 2011, the Board of Trustees of the Employees Retirement System (ERS) approved a contract with Minnesota Life Insurance Company (Minnesota Life) to provide a fully insured minimum premium arrangement for the Life Plan and a fully insured AD&D Plan for an initial term from January 1, 2012 through August 31, 2016. In accordance with the terms of the contract, the staff has negotiated an extension for the period September 1, 2016 through August 31, 2018.

Under the terms of the minimum premium arrangement for the Life Plan, Minnesota Life provides administrative services in return for contractual administrative fees and fully insures the life insurance risk in return for claims premiums which are limited to the lesser of (a) the actual claims incurred under the Life Plan or (b) premiums based on actual participation and the maximum claims rates included in the contract.

Mr. Porter Wilson
Page Two
April 29, 2016

The AD&D Plan is fully insured under a traditional insurance contract under which Minnesota Life accepts full risk in return for payment of premiums based on contractual premium rates. The maximum claims rates and administrative fees for the Life Plan and the AD&D premium rates are guaranteed for the term of the contract.

FY17 Rate Analysis

We developed member contribution rates for the Life Plan based on (a) reasonable expectations of future claims determined through a review of the plan experience over the last five years, (b) anticipated claim payment patterns, (c) expected investment income earned on funds held by ERS and (d) the maximum claims rates and administrative fees included in the Minnesota Life contract. Based on this analysis, we concluded that the member contribution rates currently in effect for FY16 for all Life coverages are appropriate for continued use for FY17.

We concluded that the current member contribution rates for the AD&D Plan are sufficient to produce adequate revenue to provide for the FY17 AD&D premium rates included in the Minnesota Life contract.

We and the staff plan to complete a detailed study of historical experience and the impact of evolving trends in Life Plan enrollment for use in setting rates for FY17.

Conclusion and Recommendation

Based on our analysis, we recommend that the contribution rates for the AD&D Plan and all Life coverages remain at the FY16 levels for FY17.

It is our opinion that, collectively, the recommended Life and AD&D member contribution rates will provide revenues sufficient to meet the expected obligations under these plans. The recommended rates are presented in the attachment.

Please let us know if you have questions or if you need additional information.

Sincerely,



Philip S. Dial

PSD:nlg

Enclosure

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GROUP BENEFITS PROGRAM

Life and AD&D Plans

Recommended Monthly Member Contribution Rates for FY 2017

Plan	FY 2016	Recommended FY 2017
Active and Retiree Basic Term Life and AD&D (1)	\$ 2.22	\$ 2.22
Active and Retiree Optional Life and AD&D (2)		
Under Age 25	\$ 0.05	\$ 0.05
25-29	0.05	0.05
30-34	0.06	0.06
35-39	0.06	0.06
40-44	0.08	0.08
45-49	0.12	0.12
50-54	0.19	0.19
55-59	0.33	0.33
60-64	0.57	0.57
65-69	0.93	0.93
70-74	1.48	1.48
75-79	2.41	2.41
80-84	3.92	3.92
85-89	6.79	6.79
90 & Over	10.57	10.57
Active Dependent Life and AD&D (3)	\$ 1.38	\$ 1.38
Retiree Minimum Optional Life (2)	2.34	2.34
Retiree Dependent Life (3)	3.05	3.05
Voluntary AD&D		
Employee Only (4)	\$ 0.02	\$ 0.02
Employee & Family (4)	0.04	0.04

(1) Rates are per unit of coverage. \$5,000 of coverage for active employees. \$2,500 of coverage for retired employees. Basic Term Life for retirees does not include AD&D.

(2) Rates are per \$1,000 of coverage. Optional Life for retirees does not include AD&D.

(3) Rates are per unit of coverage. \$5,000 of coverage for dependents of active employees. \$2,500 of coverage for dependents of retired employees. Dependent Life for retirees does not include AD&D.

(4) Rates are per \$1,000 of coverage.

PUBLIC AGENDA ITEM - #15b

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2017:

15b. Texas Income Protection Plan Proposed Rates

May 17, 2016

BACKGROUND:

Under the Texas Employees Group Benefits Program (GBP), the Employees Retirement System of Texas (ERS) provides short and long-term disability coverage through the Texas Income Protection PlanSM (TIPP). Disability coverage provides benefits for disabilities resulting from occupational and non-occupational illness or injury. These types of coverage can be beneficial to a covered employee and his/her family by replacing a percentage of earnings if a covered employee is unable to work due to injury or illness. Overall, the disability coverages available within TIPP are available to active employees as an optional benefit and offered under a self-funded arrangement.

Disability Coverages

Short-term disability	This coverage provides a maximum benefit of 66% of an enrolled employee's monthly salary up to a maximum of \$10,000 in covered payroll or \$6,600 in benefits for a period no longer than five months
Long-term disability	This coverage provides a maximum benefit of 60% of an enrolled employee's monthly salary up to a maximum of \$10,000 in covered payroll or \$6,000 in benefits for a period ranging from 12 months up to age 65, depending on the employee's age at the time of disability.

ERS does not receive appropriated funds from the State of Texas for the costs associated with administering TIPP benefit. Rather, the disability benefits are funded solely by contributions from employees participating in the plans based on member contribution rates adopted annually by the ERS Board of Trustees (Board). Approximately 52% of eligible GBP employees were enrolled in short-term disability coverage and 40% were enrolled in long-term disability coverage as of March 31, 2016.

Overall, member enrollment in TIPP benefit has been relatively stable year over year. The following table summarizes the enrollment and covered monthly payroll by type of disability coverage for the period ending March 31, 2016.

**GBP Disability Plans
as of March 31, 2016**

Coverage	Plan Type	Funding	Enrolled Members	Covered Monthly Payroll
Disability	Short Term	Self Funded	117,075	\$ 460,038,734
Disability	Long Term	Self Funded	90,196	\$ 377,318,192

Note: The GBP retains the risk under the self-funded plans.

Aon Hewitt Absence Management, LLC (Aon Hewitt) was awarded the contract to provide all administrative services for TIPP benefit at the February 2013 board meeting. The initial four-year term began September 1, 2013 and goes through August 31, 2017. On January 5, 2016, Reed Group, Ltd., a wholly owned subsidiary of The Guardian Life Insurance Company of America®, announced its acquisition of the absence management administration business of Aon Hewitt and will serve as the TIPP administrator through the duration of the contract period.

Fiscal Year 2016 Member Contribution Rate Analysis

The Underwriting, Data Analysis, and Reporting (UDAR) unit of Benefit Contracts works in cooperation with Rudd and Wisdom, Inc, the consulting actuary for insurance, to develop recommended member contribution rates for the disability plans based on reasonable expectations of future claims, anticipated claim payment patterns, expected investment income on funds held by ERS, and the administrative fees associated with the TIPP benefit administration.

The experience for the short disability plan for Fiscal Years 2015 and 2016 YTD (experience through March 31, 2015) and the cumulative experience for long term disability for Fiscal Years 2004-2015 is listed in Exhibit A of this agenda item.

In establishing contribution rates for FY 2017, the consulting actuary and UDAR staff evaluate prior experience for each coverage using different rating techniques for the short and long-term disability plans. Important distinctions between the plans are considered. For instance, under the short-term disability plan, benefits last approximately 5 months. As a result, in analyzing experience, it is necessary to focus on the previous year's results to project future costs. However, under the long-term disability plan, benefits can last many years. In order to provide for future benefits, claims reserves are established at the time of the initial claim. Over time, as disabled individuals stop receiving benefits for any reason, these reserves are reduced. As a result, significant gains/losses can occur year over year. In setting the long-term rates, ten years of experience is considered to allow for these fluctuations.

Based on the analysis, UDAR and Rudd and Wisdom have determined that the current member contribution rates associated with the TIPP benefit are adequate to provide for the cost of coverage and should be continued through FY 2017.

STAFF RECOMMENDATION:

Staff recommends that the Board approve the member contribution rates listed below and described in Staff's and Rudd and Wisdom's analysis included as Exhibit B of this agenda item, effective September 1, 2016.

**GBP Disability Plans
Proposed Monthly Member Contribution Rates for FY 2017
(effective September 1, 2016)**

Plan Description	FY 2017	Change from current rate
Short Term Disability*	\$0.30	No Change
Long Term Disability*	\$0.63	No Change

* Rates are per \$100 of monthly covered salary

A proposed motion is included with this agenda item following the exhibits.

ATTACHMENTS – 2

Exhibit A – Financial Experience of Short-Term and Long-Term Disability Plans for Fiscal Year 2015 and Fiscal Year 2016 YTD

Exhibit B – Recommended Member Contribution Rates for the Disability Plans under the Texas Employees Group Benefits Program for Fiscal Year 2017, Rudd and Wisdom, Inc.

**Financial Experience of
Short-Term and Long-Term Disability Coverage**

Short Term Disability Experience		
	FY 2015	FY 2016 YTD <i>as of March 2016</i>
Member Contributions	\$15,623,840	\$9,599,007
Incurred Claims	\$11,263,401	\$6,141,612
Administrative Fees	\$3,330,708	\$1,949,610
Total Expense	\$14,594,109	\$8,091,222
Contribution Gain/(Loss)	\$1,029,731	\$1,507,785

Long Term Disability Experience	
	FY 2006 – FY 2015 Cumulative
Actual Member Contributions	\$262,579,995
Incurred Claims with Discounted Reserves	\$242,065,159
Administrative Fees	\$14,581,724
Total Expense	\$256,646,882
Contribution Gain/(Loss)	\$5,933,113

Rudd and Wisdom, Inc.

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April 29, 2016

Mr. Porter Wilson
 Executive Director
 Employees Retirement System
 of Texas
 Post Office Box 13207
 Austin, Texas 78711-3207

Re: Recommended Member Contribution Rates for
 the Disability Plans under the Texas Employees
 Group Benefits Program for Fiscal Year 2017

Dear Mr. Wilson:

The purpose of this correspondence is to present recommendations for member contribution rates for the Disability Plans under the Texas Employees Group Benefits Program (GBP) for Fiscal Year 2017 (FY17).

Background

The GBP provides Short Term Disability (STD) and Long Term Disability (LTD) coverages (collectively referred to herein as the GBP Disability Plans) under a self-funded arrangement administered by a third party administrator. Participation in the GBP Disability Plans is voluntary. The plans are funded exclusively by member contributions; i.e., employers do not contribute toward the cost of the plans.

At its February 2013 meeting, the Board of Trustees approved a recommendation to award the contract to provide administrative services for the GBP Disability Plans to Aon Hewitt Absence Management LLC (Aon Hewitt) for an initial four-year term beginning September 1, 2013 through August 31, 2017. Effective September 1, 2013, all administrative services for the GBP Disability Plans were transitioned from Dearborn National to Aon Hewitt. The administrative fees under the Aon Hewitt contract are guaranteed for the term of the contract. On January 5, 2016, Reed Group, Ltd. (Reed) announced its acquisition of the absence management administration business of Aon Hewitt. As a result, Reed will be responsible for administration of the GBP Disability Plans for the remainder of the contract period.

Mr. Porter Wilson
Page Two
April 29, 2016

FY17 Rate Analysis

Since the GBP Disability Plans are funded exclusively by member contributions, those contributions must be adequate to provide for all costs under the plans.

In order to develop recommended member contribution rates for the Disability Plans, we have projected the expected cost of coverage for FY17 based on (a) reasonable expectations of future claims determined through a review of plan experience, (b) anticipated claim payment patterns, (c) investment income expected to be earned on funds held by ERS in support of the plans and (d) administrative fees included in the Aon Hewitt/Reed contract.

Based on this analysis we determined that the member contribution rates currently in effect for the STD and LTD plans will be adequate to support the expected cost of coverage in FY17.

Recommendation

Based on our analysis, we recommend the following:

- Maintain the member contribution rate for the STD plan at \$0.30 per \$100 of monthly covered salary.
- Maintain the member contribution rate for the LTD plan at \$0.63 per \$100 of monthly covered salary.

It is our opinion that the member contribution rates recommended above will provide revenues sufficient to meet the expected obligations under the GBP Disability Plans. The recommended rates are presented in the attachment.

Please let us know if you have questions or if you need additional information.

Sincerely,



Philip S. Dial

PSD:nlg

Enclosure

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GROUP BENEFITS PROGRAM

Disability Plans

Recommended Monthly Member Contribution Rates for FY 2017

<u>Plan</u>	<u>FY 2016</u>	<u>Recommended FY 2017</u>
Short Term Disability	\$ 0.30	\$ 0.30
Long Term Disability	0.63	0.63

Rates are per \$100 of monthly covered salary.

PUBLIC AGENDA ITEM - #15c

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2017:

15c. State of Texas Dental Discount Plan, Dental Choice and Dental Health Maintenance Organization Proposed Rates

May 17, 2016

BACKGROUND:

Beginning in Fiscal Year 2015, the Employees Retirement System of Texas (ERS) had expanded the dental care options available to Group Benefits Program (GBP) participants to include a non-insurance discount plan. The table below summarizes the insurance and non-insurance offerings available to participants and the administrator of each of the dental choice options.

Dental Care Options

State of Texas Dental Choice PlanSM (Dental Choice)	Self-funded dental preferred provider organization (PPO) plan	HumanaDental Insurance Company (HumanaDental) serves as the Third Party Administrator (TPA) for the Dental Choice plan
Dental Health Maintenance Organization (DHMO) plan	Fully-insured DHMO plan	DentiCare, Inc., a wholly owned subsidiary of Humana, Inc., underwrites the DHMO plan
State of Texas Dental Discount PlanSM	Non-insurance discount plan	Careington International (Careington) is the administrator for the dental discount plan

State of Texas Dental Choice PlanSM

HumanaDental Insurance Company (HumanaDental) administers the self-funded dental preferred provider organization (PPO) plan, branded as the State of Texas Dental Choice PlanSM (Dental Choice). HumanaDental was awarded the contract by the Board after a competitive bid process in December 2013; the corresponding contract period began on September 1, 2014 and expires on August 31, 2018. HumanaDental has been the administrator of the Dental Choice since Fiscal Year (FY) 2009.

HumanaDental is reimbursed based on an administrative fee that is guaranteed for the four-year term of the contract.

Membership in Dental Choice has steadily increased each year since FY 2010. The following table provides Dental Choice enrollment as of March 31, 2016 and the year-over-year change in enrollment for each coverage category.

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**State of Texas Dental ChoiceSM
Member Enrollment
as of March 31, 2016**

	Employees	Retirees	Survivors	COBRA	Total	Year Over Year Change FY2015 – FY2016
Member Only	65,108	23,094	1,781	816	90,799	6.52%
Member & Spouse	15,318	14,808	0	245	30,371	6.03%
Member & Children	21,339	1,259	37	87	22,722	6.78%
Member & Family	18,788	1,597	0	105	20,490	5.10%
Total	120,553	40,758	1,818	1,253	164,382	6.28%

Since Dental Choice is a self-funded plan, the GBP assumes all risk for claims and administrative expenses in excess of member contributions. Therefore, it is critical that member contributions are sufficient to support the anticipated costs for the upcoming year. To determine the proposed member contribution rates for Dental Choice, staff and Rudd and Wisdom, Inc., ERS' consulting actuary for insurance, reviewed and analyzed the following:

- Claims experience through March 31, 2016;
- Estimated trends in per capita benefit costs;
- Projected provider reimbursement;
- Historical enrollment patterns; and
- Contractually guaranteed administrative fees.

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Dental Health Maintenance Organization

In December 2013, the Board also approved the selection of DentiCare, Inc., a wholly owned subsidiary of Humana, Inc., to underwrite the fully-insured Dental Health Maintenance Organization plan (DHMO) for the contract period beginning September 1, 2014 and ending August 31, 2018. Since the DHMO is a fully-insured program, DentiCare, Inc. provides all services for the insurance plan, assuming the risk for claims and administrative expenses in excess of contractual premiums.

The following table provides DHMO enrollment as of March 31, 2016, as well as the year-over-year change in enrollment for each coverage category.

Dental Health Maintenance Organization (DHMO) Member Enrollment as of March 31, 2016

	Employees	Retirees	Survivors	COBRA	Total	Year Over Year Change FY2015 – FY2016
Member Only	34,432	10,302	607	296	45,637	1.72%
Member & Spouse	5,939	6,161	0	84	12,184	-1.19%
Member & Children	9,065	762	14	26	9,867	-4.75%
Member & Family	7,636	963	0	39	8,638	-6.07%
Total	57,072	18,188	621	445	76,326	-0.55%

The staff negotiated a 3.8% reduction in the DHMO rates effective September 1, 2015. The revised rates are guaranteed through the end of the contract period, August 31, 2018.

The DHMO premiums are paid in full by member contributions. Therefore the member contribution rates for FY17 should be set equal to the contractual premium rates.

State of Texas Dental Discount PlanSM

Effective September 1, 2014, Careington International (Careington) was awarded the contract to administer the State of Texas Dental Discount PlanSM (Dental Discount) for GBP participants; this plan is not an insurance program. Participating dentists agree to accept a discounted rate for payment-in-full at the time services are rendered. There are no dental claims to file with Careington and participants do not receive an Explanation of Benefits (EOB).

The administrative fee for the Dental Discount plan is paid entirely by the participants through their contributed fees. The rate is dependent upon the number of participants enrolled in the program at the close out of Annual Enrollment every summer. Every August, ERS will evaluate the number of participants in this program and the administrative rate is adjusted accordingly.

**State of Texas Dental Discount PlanSM
Member Enrollment
as of March 31, 2016**

	Employees	Retirees	Survivors	COBRA	Total	Year Over Year Change FY2015 – FY2016
Member Only	2,904	422	11	22	3,359	45.92%
Member & Spouse	576	377	0	13	966	16.95%
Member & Children	673	23	0	2	698	11.15%
Member & Family	723	48	0	6	777	11.16%
Total	4,876	870	11	43	5,800	30.19%

STAFF RECOMMENDATION:

State of Texas Dental Choice PlanSM

Based on the analysis listed above, the current member contribution rates represent a 10% increase for Fiscal Year 2017.

State of Texas Dental Choice Plan SM			
Coverage Category	Proposed Member Contribution Rates		
	Proposed FY 2017	Proposed FY2017	Change from current
Member Only	\$ 24.28	\$26.61	\$ 2.33
Member and Spouse	48.56	53.22	4.66
Member and Children	58.28	63.86	5.58
Member and Family	82.56	90.47	7.91
Spouse Only	24.28	26.61	2.33
Spouse and Child(ren)	58.28	63.86	5.58
Child(ren)	34.00	37.25	3.25

The consulting actuary's analysis of the Dental Choice contribution rates is included in this agenda item as Exhibit A.

Dental Health Maintenance Organization

Staff and Rudd and Wisdom recommend that DHMO member contribution rates for FY 2017 remain the same in accordance with the guaranteed the premium rates offered by DentiCare. The recommended DHMO member contribution rates are presented in the following table:

Dental Health Maintenance Organization			
Coverage Category	Proposed Member Contribution Rates		
	Current FY16	Proposed FY17	Change from current
Member Only	\$ 9.59	\$ 9.59	No Change
Member and Spouse	19.17	19.17	No Change
Member and Children	23.01	23.01	No Change
Member and Family	32.59	32.59	No Change
Spouse Only	9.59	9.59	No Change
Spouse and Child(ren)	23.01	23.01	No Change
Child(ren)	13.42	13.42	No Change

Member contribution rates for the DHMO are lower than those for Dental Choice; however, participants must obtain services through a dentist contracting with the DHMO. The consulting actuary's analysis for the DHMO is included in this agenda item as Exhibit B.

State of Texas Dental Discount PlanSM

ERS staff does not anticipate significant enrollment growth. Therefore, the Dental Discount Program is not expected to breach the necessary 25,000 enrolled participant size to allow a decrease in rates. As a result, the rates for FY 2017 is expected to remain the same as FY 2016 which are as follows:

State of Texas Dental Discount PlanSM			
Coverage Category	Proposed Member Contribution Rates		
	Current Rates FY16	Proposed Rates FY17	Change
Member Only	\$ 2.25	\$ 2.25	No Change
Member and Spouse	4.50	4.50	No Change
Member and Children	5.40	5.40	No Change
Member and Family	7.65	7.65	No Change
Spouse Only	2.25	2.25	No Change
Spouse and Child(ren)	5.40	5.40	No Change
Child(ren)	3.15	3.15	No Change

A proposed motion is included with this agenda item following the exhibits.
ATTACHMENTS - 2

Exhibit A – Recommended Member Contribution Rates for the Texas Employees Group Benefits Program Self-Funded Dental PPO Plan for FY 2017, Rudd & Wisdom, Inc.

Exhibit B – Recommended Member Contribution Rates for the Texas Employees Group Benefits Program Fully Insured Dental Health Maintenance Organization Plan for FY 2017, Rudd & Wisdom, Inc.

Rudd and Wisdom, Inc.

CONSULTING ACTUARIES

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Evan L. Dial, F.S.A.
Philip S. Dial, F.S.A.
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Raymond W. Tilotta
Ronald W. Tobleman, F.S.A.
David G. Wilkes, F.S.A.

April 29, 2016

Mr. Porter Wilson
Executive Director
Employees Retirement System
of Texas
Post Office Box 13207
Austin, Texas 78711-3207

Re: Recommended Member Contribution Rates for the
Texas Employees Group Benefits Program Self-
Funded Dental PPO Plan for Fiscal Year 2017

Dear Mr. Wilson:

The purpose of this correspondence is to present recommendations for member contribution rates for the Texas Employees Group Benefits Program (GBP) self-funded dental preferred provider organization (PPO) plan, the State of Texas Dental Choice Plansm (Dental Choice), for Fiscal Year 2017 (FY17). Our analysis and recommendations are presented below.

Analysis

At its meeting on December 7, 2013, the Board of Trustees accepted the proposal of HumanaDental Insurance Company to administer Dental Choice on a self-funded basis in return for an administrative fee guaranteed for the four-year period beginning September 1, 2014.

We have projected costs for Dental Choice for FY16 and FY17 based on an analysis of historical experience, estimated trends in per capita claims, anticipated enrollment patterns and the contractual administrative fee.

1. Our analysis indicates that the per capita costs (claims and administrative expenses) are expected to exceed per capita contributions by about 7.8% for FY16.
2. The analysis also indicates that per capita costs are increasing at a rate of about 1.8% per year due to increases in the price and utilization of dental services.

Mr. Porter Wilson
Page Two
April 29, 2016

3. Based on this analysis, we project that it would be necessary to increase FY16 contribution rates by 9.6% in order to cover claims and administrative expenses in FY17.

Recommendation

Based on the analysis described above and consultation with the staff, we recommend that member contribution rates for FY17 be established at levels which are 9.6% greater than those in effect for FY16. The current and recommended rates are shown on the attachment to this letter.

Please let us know if you have any questions or need additional information.

Sincerely,

A handwritten signature in black ink, appearing to read "Philip S. Dial". The signature is fluid and cursive, with the first name "Philip" and last name "Dial" clearly distinguishable.

Philip S. Dial

PSD:nlg

Enclosure

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GROUP BENEFITS PROGRAM

Dental Choice

Recommended Monthly Member Contribution Rates for FY 2017

Coverage Category	Monthly Member Contribution Rates	
	Current FY16	Recommended FY17
Member Only	\$24.28	\$26.61
Member and Spouse	48.56	53.22
Member and Children	58.28	63.86
Member and Family	82.56	90.47
Spouse Only	24.28	26.61
Child(ren)	34.00	37.25
Spouse and Child(ren)	58.28	63.86

Rudd and Wisdom, Inc.

CONSULTING ACTUARIES

Mitchell L. Bilbe, F.S.A.
Evan L. Dial, F.S.A.
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April 29, 2016

Mr. Porter Wilson
Executive Director
Employees Retirement System
of Texas
Post Office Box 13207
Austin, Texas 78711-3207

Re: Recommended Member Contribution Rates for
the Texas Employees Group Benefits Program
Fully Insured Dental Health Maintenance
Organization Plan for Fiscal Year 2017

Dear Mr. Wilson:

The purpose of this correspondence is to present recommendations for member contribution rates for the Texas Employees Group Benefits Program (GBP) Fully Insured Dental Health Maintenance Organization plan (DHMO) for Fiscal Year 2017 (FY17). Our analysis and recommendations are presented below.

Background

At its meeting on December 7, 2013, the Board of Trustees approved a contract with DentiCare, Inc., a wholly owned subsidiary of Humana, Inc., to provide all services for the fully-insured DHMO offered to all participants under the GBP beginning September 1, 2014. Under the terms of the contract, the premium rates are guaranteed for a four-year period ending August 31, 2018.

The staff negotiated a 3.8% reduction in the DHMO rates effective September 1, 2015. The revised rates are guaranteed through the end of the contract period, August 31, 2018.

The DHMO premiums are paid in full by member contributions. Therefore the member contribution rates for FY17 should be set equal to the contractual premium rates.

Mr. Porter Wilson
Page Two
April 29, 2016

Recommendation

We recommend that DHMO member contribution rates for FY17 be established at the same level as the contractual premium rates. Under this recommendation, the DHMO member contribution rates would remain at the FY16 levels for FY17. The current and recommended member contribution rates are shown on the attachment to this letter.

Please let us know if you have any questions or need additional information.

Sincerely,



Philip S. Dial

PSD:nlg

Enclosure

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GROUP BENEFITS PROGRAM

Dental Health Maintenance Organization Plan

Recommended Monthly Member Contribution Rates for FY 2017

Coverage Category	Monthly Member Contribution Rates		
	Current FY16	Recommended FY17	Change
Member Only	\$9.59	\$9.59	\$0,00
Member and Spouse	19.17	19.17	0,00
Member and Children	23.01	23.01	0,00
Member and Family	32.59	32.59	0,00
Spouse Only	9.59	9.59	0,00
Child(ren)	13.42	13.42	0,00
Spouse and Child(ren)	23.01	23.01	0.00

PUBLIC AGENDA ITEM - #15d

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2016

15d. Health Maintenance Organizations Proposed Rates

May 17, 2016

BACKGROUND:

The Texas Employees Group Benefits Program (GBP) offers health maintenance organizations (HMOs) as a comprehensive medical and prescription drug benefit options in certain Texas counties. HMOs are designed to control health care spending through the use of a closed provider panel and limitation of coverage to health care services accessed from network providers. In return for a monthly premium, a GBP-participating HMO provides fully insured health benefits. In order to be eligible to participate in the GBP, an HMO must provide network benefits that are at least as good as the benefits offered under the HealthSelect of Texas (HealthSelect)SM plan.

The benefits provided by GBP-participating HMOs are funded by the contributions paid by the enrolled members and by the State of Texas through the biennial legislative appropriation and are based on contribution rates adopted by the Employees Retirement System of Texas (ERS) Board of Trustees (Board). The State pays 100% of the contribution rate for eligible employees and retirees and 50% of the contribution rate for dependent coverage.

When determining appropriate premium rates for participating HMOs, ERS must comply with a rider in the State's appropriations act which stipulates that:

"In no event shall the total amount of state contributions allocated to fund coverage in an optional health plan exceed the actuarially determined total amount of state contributions required to fund basic health coverage for those active employees and retirees who have elected to participate in that optional health coverage."

In order to ensure compliance with the rider, ERS staff and the consulting actuary utilizes a theoretical cost index model (TCI). The TCI estimates the total cost that would be required to cover the HMO's participants if they were enrolled in HealthSelect. In order to be eligible to participate in the GBP, the HMO must agree to charge premium rates that are no greater than 95% of the TCI. The TCI requirement is designed to produce a minimum savings of 5% as compared to HealthSelect.

Federal Health Care Reform

The HMOs had to apply an out-of-pocket maximum to all member cost sharing beginning in 2015 since these programs provide both medical and prescription drug coverage under the same contract. The cost associated with this requirement, as well as any additional cost(s) attributable to the various ACA fees, were recognized in the determination of HMO premium rates for FY 2017.

Available HMO Coverages within the GBP

The table below provides the coverage areas and enrollment for current GBP participating HMOs: Community First Health Plans, Inc. (Community First or CFHP), Scott and White Health Plan (Scott & White or SWHP), and KelseyCare powered by Community Health Choice, Inc. (KelseyCare powered by CHC).

Texas Employees Group Benefits Program Participating HMOs Fiscal Year 2016 as of March 31, 2016

HMO	Areas of Coverage	Enrolled Members	Enrolled Dependents	Total
Community First	8-county service area: San Antonio region	2,676	2,301	4,977
Scott & White	45-county service area: Austin, San Angelo, Temple and Waco regions	11,482	7,099	18,581
KelseyCare powered by CHC	5-county service area: Houston region	923	966	1,889

For Fiscal Year 2017, staff did not publish a HMO RFA. Incumbent carriers were provided a renewal option whereby the carriers were to provide renewal rates that met the TCI requirement, service area expansion notifications (if applicable), evidence that disaster recovery and/or business resumption process had been successfully tested, and updated liability insurance coverages. None of the incumbent Carriers submitted a request to expand their respective coverage areas with their renewal options.

- Exhibit A-1 illustrates the Community First HMO service area for FY 2017, reflecting no changes to the Carrier's service areas.
- Exhibit A-2 illustrates the Scott & White HMO service area for FY 2017, reflecting no changes to the Carrier's service areas.
- Exhibit A-3 illustrates the KelseyCare powered by CHC service area for FY 2017, reflecting no changes to the Carrier's service areas.

The analyses performed by ERS' Underwriting, Data Analysis and Reporting (UDAR) staff and Rudd and Wisdom, Inc., the consulting actuary for insurance, confirmed that the proposed rates for all three meet the TCI rating criteria.

STAFF RECOMMENDATION:

With respect to the incumbent HMO Carriers described herein, ERS staff and the consulting actuary recommend that the following HMOs be approved for continued participation in the GBP for FY 2017 beginning September 1, 2016:

- **Community First:** San Antonio Region (8 Counties)
- **Scott & White:** Austin/San Angelo/Temple/Waco Region (45 Counties)
- **KelseyCare powered by CHC:** Houston Region (5 Counties)

Based on the submitted renewal information, and the consulting actuary's rate analysis discussed in this agenda item and detailed in Exhibit B, the ERS staff and consulting actuary recommend the following monthly HMO contribution rates for FY 2017 for Community First, Scott & White and KelseyCare powered by CHC, respectively.

Texas Employees Group Benefits Program

Community First Health Plans, Inc.
Proposed Monthly HMO Rates
Fiscal Year 2017

Coverage Category	Total Contribution Rate (Monthly)	State Contribution Amount (Monthly)	Member Contribution Amount (Monthly)	Change in Member Contribution	
				Amount	Percentage
Member Only	\$ 509.28	\$ 509.28	\$ 0.00	\$ 0.00	0.0%
Member & Spouse	1,094.96	802.12	292.84	8.66	3.0%
Member & Child(ren)	901.44	705.36	196.08	5.80	3.0%
Member & Family	1,487.12	998.20	488.92	14.46	3.0%

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Scott and White Health Plan
Proposed Monthly HMO Rates
Fiscal Year 2017

Coverage Category	Total Contribution Rate (Monthly)	State Contribution Amount (Monthly)	Member Contribution Amount (Monthly)	Change in Member Contribution	
				Amount	Percentage
Member Only	\$ 607.96	\$ 607.96	\$ 0.00	\$ 0.00	0.0%
Member & Spouse	1,307.12	957.54	349.58	21.62	6.6%
Member & Child(ren)	1,076.08	842.02	234.06	14.48	6.6%
Member & Family	1,775.24	1,191.60	583.64	36.10	6.6%

KelseyCare powered by CHC
Proposed Monthly HMO Rates
Fiscal Year 2017

Coverage Category	Total Contribution Rate (Monthly)	State Contribution Amount (Monthly)	Member Contribution Amount (Monthly)	Change in Member Contribution	
				Amount	Percentage
Member Only	\$ 481.76	\$ 481.76	\$ 0.00	No Change	No Change
Member & Spouse	1,035.80	758.78	277.02	No Change	No Change
Member & Child(ren)	852.72	667.24	185.48	No Change	No Change
Member & Family	1,406.76	944.26	462.50	No Change	No Change

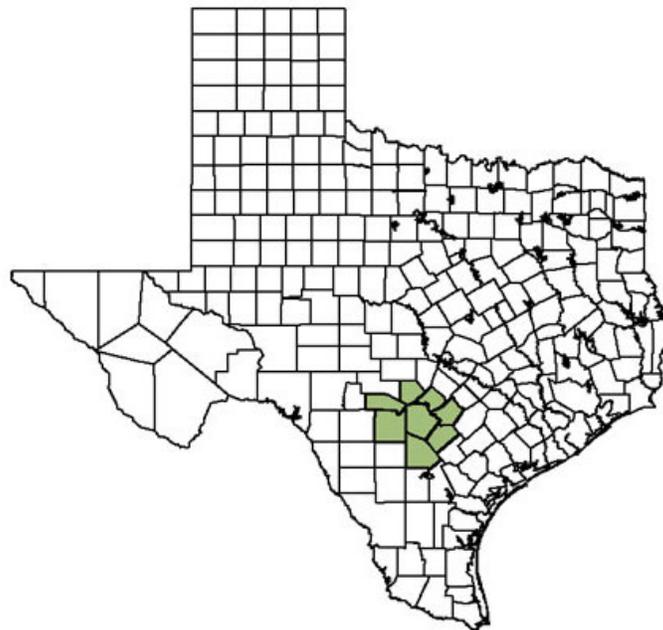
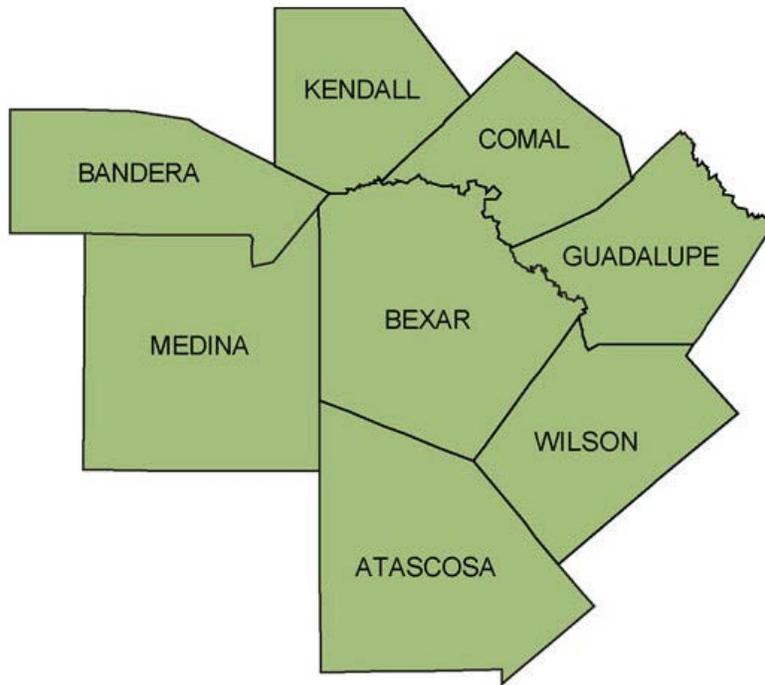
A proposed motion is included with this agenda item following the exhibits.

ATTACHMENTS – 2

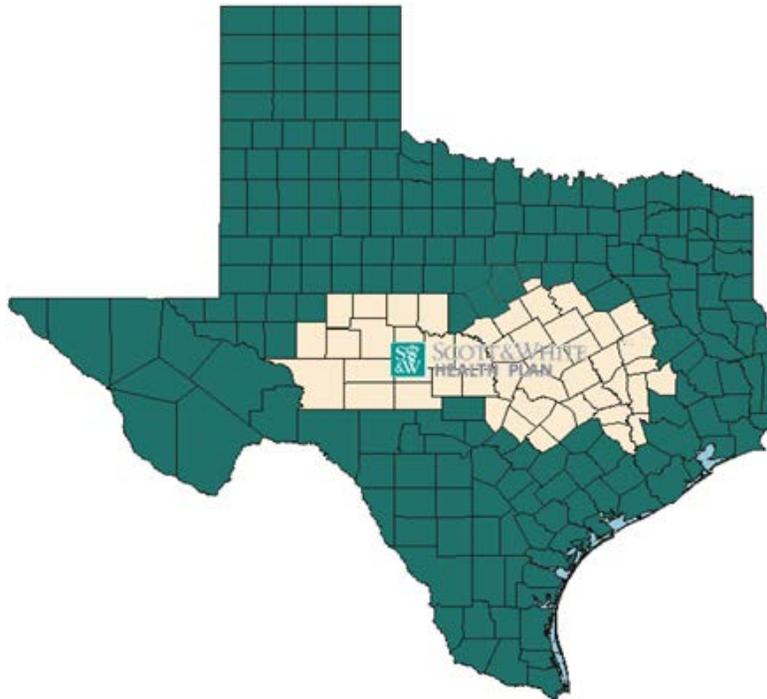
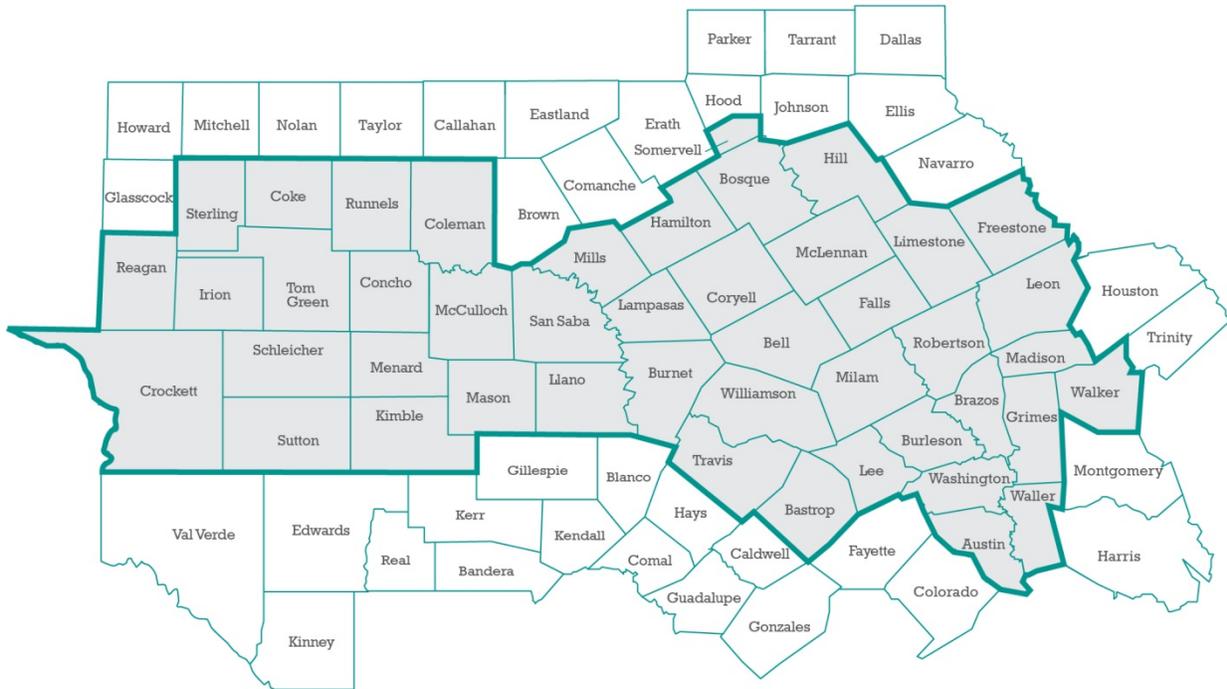
Exhibit A – Coverage Area Maps of Recommended HMOs

Exhibit B – Recommended HMO Contribution Rates for FY 2017, Rudd & Wisdom, Inc.

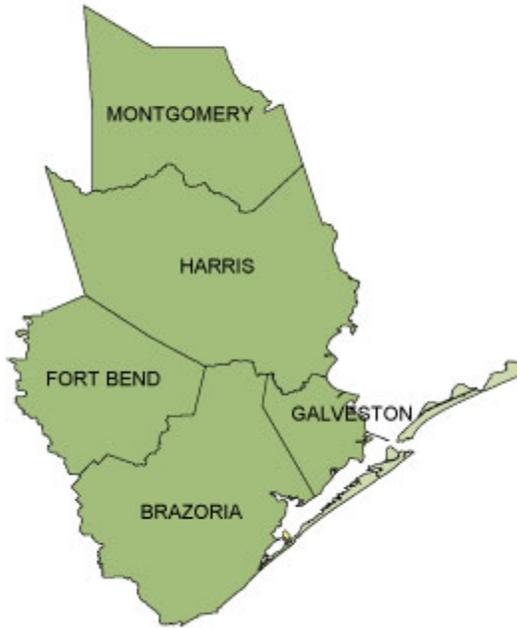
Community First Health Plans, Inc. (CFHP) HMO
Proposed GBP FY2017 Service Area



Scott & White Health Plan (SWHP) HMO
Proposed GBP FY2017 Service Area



KelseyCare powered by CHC HMO
Proposed GBP FY2017 Service Area



5 Counties



Rudd and Wisdom, Inc.

CONSULTING ACTUARIES

Mitchell L. Bilbe, F.S.A.
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May 2, 2016

Mr. Porter Wilson
 Executive Director
 Employees Retirement System
 of Texas
 Post Office Box 13207
 Austin, Texas 78711-3207

Re: Recommended HMO Contribution Rates for
 Fiscal Year 2017

Dear Mr. Wilson:

Historically, ERS has used a variety of processes to select HMOs for participation in the Texas Employees Group Benefits Program (GBP). Since FY14, ERS has provided a contract renewal option when appropriate. Under the renewal process, each year the HMO is required to provide certain critical information including renewal rates that meet ERS rating requirements and notification of proposed service area expansions, if any.

Rate Analysis

ERS requires each HMO to submit rates based on Adjusted Community Rating (ACR) a methodology which determines rates based on the HMO's anticipated revenue requirements for providing services specifically for GBP participants. To demonstrate compliance with this requirement, the HMO must submit GBP experience rated premiums with supporting utilization and experience data. The ACR methodology has been quite successful for ERS in the development of cost effective HMO rates for the GBP. As we have previously discussed with the Board, ACR produces HMO premium rates that are appropriate for the GBP, provided the methodology is diligently applied.

Renewal Proposals

The renewal rate analysis for HMOs that currently participate in the GBP focuses on confirmation that (a) ACR was utilized, (b) the ACR methodology reflected actual GBP experience, and (c) the documentation was adequate to allow an independent confirmation of the appropriateness of the rates proposed for the GBP for FY17. In our analysis of the FY17 renewal rates, we have carefully

reviewed the basis for the proposed rates. We have worked with the HMOs to assure the utilization of realistic assumptions in order to avoid overly conservative rating.

For a number of years, the General Appropriations Act has included a Rider applicable to the appropriation to ERS for the GBP that specifies the following:

“In no event shall the total amount of state contributions allocated to fund coverage in an optional health plan exceed the actuarially determined total amount of state contributions required to fund basic health coverage for those active employees and retirees who have elected to participate in that optional health coverage.”

In order to confirm compliance with the Rider, we utilize a theoretical cost model designed to provide an estimate of the total cost of providing HealthSelect coverage (i.e., under the basic health plan) to HMO participants. The theoretical cost model develops for each HMO a theoretical cost under HealthSelect based on the age/sex/dependent makeup of that HMO’s enrollment. The theoretical cost also reflects the differing cost patterns attributable to the geographic location of the HMO.

The theoretical cost for the HMO is compared to the total cost based on the HMO’s proposed rates. If the theoretical cost is lower, the HMO is deemed to be in compliance with the Rider and eligible for further consideration for approval. If the theoretical cost is higher, the HMO is not in compliance with the Rider and cannot be recommended for approval.

While the theoretical cost model is not intended to be used in the determination of the appropriateness of an HMO’s premium rates (since it does not reflect actual HMO cost levels), it can be used to determine whether the participation of a given HMO raises or lowers the cost of the overall program, as required by the Rider. An HMO with premium rates that exceed the theoretical cost for the HMO may increase total program cost (as prohibited by the Rider), while an HMO with premium rates below the theoretical cost has the potential to reduce the overall cost of the program. For FY17, ERS requires the HMOs to provide rates that do not exceed 95% of the theoretical cost.

Each of the currently participating HMOs [Community First Health Plan (CFHP), Kelsey Care powered by Community Health Choice (CHC) and Scott and White Health Plan (SWHP)] submitted proposed renewal rates for continued GBP participation for FY17 through the contract renewal process. We and the ERS staff analyzed the rate submissions and engaged in negotiations that ultimately produced proposed renewal rates for each of the HMOs that are in full compliance with the ERS rating requirements and the Rider.

Recommendation

We recommend the Board approve FY17 contract extensions for CFHP, CHC and SWHP. The attachment presents the contribution rates recommended for approval for FY17. The attachment

Mr. Porter Wilson
Page 3
May 2, 2016

also provides a comparison of the contribution rates in effect for FY16 with those recommended for approval for FY17 as well as the changes in member contribution rates.

The recommended contribution rates will result in the same proportionate increases in the state's contribution rates and the member's share of the dependent contribution rates. For example, in the case of CFHP, there will be a 3.0% increase in the state's contribution rates and 3.0% increase in the member's share of the dependent contribution rates.

The recommended contribution rates are expected to produce a 5.6% average increase in per capita contributions for all members presently participating in HMOs.

We will be pleased to answer any questions and provide any additional information that may be required.

Sincerely,

A handwritten signature in black ink, appearing to read "Philip S. Dial". The signature is fluid and cursive, with the first name "Philip" and last name "Dial" clearly distinguishable.

Philip S. Dial

PSD:nlg

Enclosure

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Texas Employees Group Benefits Program

Recommended Monthly HMO Contribution Rates for FY 2017

HMO	Current – FY 2016			Recommended – FY 2017			Change in Member Contribution	
	Total	State	Member	Total	State	Member	Amount	Percent
Community First								
Member Only	\$ 494.24	\$ 494.24	\$ 0.00	\$ 509.28	\$ 509.28	\$ 0.00	\$ 0.00	0.0%
Member & Spouse	1,062.60	778.42	284.18	1,094.96	802.12	292.84	8.66	3.0 %
Member & Child(ren)	874.80	684.52	190.28	901.44	705.36	196.08	5.80	3.0 %
Member & Family	1,443.16	968.70	474.46	1,487.12	998.20	488.92	14.46	3.0 %
Scott and White								
Member Only	\$ 570.36	\$ 570.36	\$ 0.00	\$ 607.96	\$ 607.96	\$ 0.00	\$ 0.00	0.0%
Member & Spouse	1,226.28	898.32	327.96	1,307.12	957.54	349.58	21.62	6.6 %
Member & Child(ren)	1,009.52	789.94	219.58	1,076.08	842.02	234.06	14.48	6.6 %
Member & Family	1,665.44	1,117.90	547.54	1,775.24	1,191.60	583.64	36.10	6.6 %
Kelsey Care powered by Community Health Choice								
Member Only	\$ 481.76	\$ 481.76	\$ 0.00	\$ 481.76	\$ 481.76	\$ 0.00	\$ 0.00	0.0%
Member & Spouse	1,035.80	758.78	277.02	1,035.80	758.78	277.02	0.00	0.0 %
Member & Child(ren)	852.72	667.24	185.48	852.72	667.24	185.48	0.00	0.0 %
Member & Family	1,406.76	944.26	462.50	1,406.76	944.26	462.50	0.00	0.0 %

Note: Contribution Rates Do Not Include Basic Life

PUBLIC AGENDA ITEM - #15e

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for Fiscal Year 2017:

15e. GBP Financial Status Update and Rate Proposals for HealthSelect of TexasSM and Consumer Directed HealthSelect

May 17, 2016

BACKGROUND:

The Group Benefits Program (GBP) provides health benefits coverage throughout Texas and the United States for more than half-a-million state and higher education employees, retirees, and their dependents. HealthSelect of TexasSM (HealthSelect) is the self-funded, point-of-service health benefit plan offered under the Texas Employees GBP. Most GBP members (approximately 83%) enroll in HealthSelect. Effective September 1, 2016, as required by state legislation, GBP members will have the option of a high-deductible health plan combined with a health savings account known as Consumer Directed HealthSelect.

**Texas Employees Group Benefits Program
HealthSelect of TexasSM
Member Enrollment
as of March 31, 2016**

	Employees	Retirees	Survivors	COBRA	Total
Member Only	126,208	36,183	708	591	163,690
Member & Spouse	17,224	9,571	0	49	26,844
Member & Children	40,032	2,848	19	32	42,931
Member & Family	21,903	1,960	0	24	23,887
Total	205,367	50,562	727	696	257,352

The administrative costs and benefits provided under HealthSelect are funded by the contributions paid by the State and Higher Education Agencies and by their enrolled members. Contribution rates are adopted annually by the Board of Trustees (Board) of the Employees Retirement System of Texas (ERS). The State currently pays 100% of the HealthSelect contribution rate for eligible employees and retirees and 50% of the contribution rates for dependent coverage.

HealthSelect participants share costs with the plan through:

- Copayments – The fixed dollar amount a participant pays for certain medical and prescription drug services.
- Deductible – The annual amount a participant pays before the plan pays any benefits. Participants pay 100% of the allowable charges for certain medical and prescription drug services until the deductible is met. Currently, prescription drugs, bariatric surgery, out-of-area participants, and out-of-network medical services are subject to a deductible.

- **Coinsurance** –A percentage of the total allowable cost of certain types of services paid by the participant. Once a participant has paid their maximum amount of coinsurance in the plan year, the plan pays 100% of allowable costs for the rest of the plan year.

The ERS Board sets the monthly contribution rates for HealthSelect based on the plan’s benefits, member cost sharing, projected expenses, provider reimbursement arrangements, and available funding from the State of Texas. The extent to which the ERS Board can increase contributions is limited by the funding appropriated by the legislature. As a self-funded plan, contributions are deposited into an ERS-administered fund and, together with investment income and revenue from various miscellaneous sources, used to pay claims and internal and external administrative expenses.

Internal administrative expenses represent slightly less than 0.5% of the total HealthSelect expenses. The plan pays external administrative fees to the HealthSelect third party administrator (TPA) and the pharmacy benefit manager (PBM). Internal and external administrative fees combined represent less than 3% of the total HealthSelect expenses.

Federal Health Care Reform

Beginning January 1, 2016, the out-of-pocket maximum established by the Affordable Care Act (ACA), which previously applied only to member cost sharing (copayments, deductibles, and coinsurance) for medical benefits, became applicable to member cost sharing attributable to both prescription drug benefits and medical benefits. Therefore, in order to align with medical benefits, the deductible for prescription drug benefits, which had previously been applicable to the plan year, became applicable to the calendar year starting January 1, 2016.

Regulations issued under the ACA specify the amount of the out-of-pocket maximum applicable to each year. Effective January 1, 2016, the maximum is \$6,450 per individual and \$12,900 for a family. Beginning January 1, 2017, the maximum will be \$6,550 per individual and \$13,100 per family.

ACA Fees - Various governmental fees required under the ACA will increase the GBP health plan cost by approximately \$37.1 million in FY 2016. The additional cost attributable to the ACA fees is expected to be \$12.5 million in FY 2017. These fees include the Patient Centered Outcomes Research Institute (PCORI) fee which will be assessed through FY 2019, the Transitional Reinsurance Program fee which will be assessed through CY 2016 and the Health Insurance Providers fee. The drop in ACA fees in FY 2017 is due to termination of the Transitional Reinsurance Program effective December 31, 2016, and a one-year moratorium on the Health Insurance Providers fee in CY 2017 as provided in the Consolidated Appropriations Act of 2016.

FY 2016 Cost Reduction Strategies

Alternative Reimbursement Program Update – ERS has established alternative reimbursement programs with certain provider groups that participate in the HealthSelect network. ERS has negotiated performance - based payment arrangements with four large, clinically-integrated, multi-specialty practice groups that have agreed to operate as Patient-Centered Medical Homes (PCMH). These groups have agreed to provide care for their HealthSelect patients using quality-of-care standards and evidence-based best practices.

PCMH Clinic	Area	No. of GBP Participants As of March 31, 2016
Austin Regional Clinic	Austin	23,860 participants
Kelsey-Seybold Clinic	Houston	9,694 participants
Covenant Health	Lubbock	7,828 participants
Austin Diagnostic Clinic	Austin	5,394 participants
Trinity Mother Frances	Tyler	3,928 participants

For FY 2015, the GBP saved approximately \$11 million with the PCMHs currently in place. Under the APM arrangements, ERS shared \$1.6 million of the savings with these clinics. Together with UnitedHealthcare, ERS staff are working to identify and implement PCMHs with additional provider groups that are suited for the GBP population.

Employer Group Waiver Plan + Commercial Wrap (EGWP + Wrap) Update - The GBP EGWP + Wrap, branded as HealthSelect Medicare Rx, was implemented effective January 1, 2013, and is administered by SilverScript Insurance Company. This program saved the GBP approximately \$40 million in calendar year 2013 versus the Retiree Drug Subsidy (RDS), exceeding the initial projection of \$27 million. In subsequent calendar years the program has saved approximately \$50 million in 2014 and approximately \$70 in 2015. The projected calendar year 2016 savings are \$65 million. These savings are attributable to increased subsidies from the federal government, coverage gap discounts from pharmaceutical manufacturers for brand drugs that fall in the “donut hole”, as required under the ACA, and federal government reinsurance reimbursements for members who incur large prescription drug costs.

The GBP continues to receive funds through the Medicare Part D Retiree Drug Subsidy (RDS) program on behalf of Medicare-primary HMO participants and a few Medicare–primary participants who remain under the HealthSelect prescription drug plan administered by Caremark.

Plan Design Changes – Every year, ERS staff reviews the HealthSelect plan to ensure benefits are in line with industry standards and maintaining financial obligations. Staff believes HealthSelect benefits meet these requirements and no changes are needed for FY 2017 other than the changes mentioned above due to ACA requirements.

The largest change to the GBP offerings for FY 2017 is the addition of the state mandated high deductible health plan with a health savings account passed in the 84th Legislative Session. Benefits for this plan were approved by the Board of Trustees in February 2016. Known as “Consumer Directed HealthSelect”, this plan features a \$2,100 in-network individual deductible and \$4,200 in-network family deductible. The high deductible includes claims for medical and pharmacy benefits. Once the deductible is met, the plan will pay 80% of in-network services. Preventive services are not subject to the deductible and are covered at 100% by the plan. A detailed benefit description for Consumer Directed HealthSelect will be made available during open enrollment periods and on the ERS website.

The Consumer Directed HealthSelect plan will require the coordination of three vendors for the separate pieces: medical claims will be administered by UnitedHealthcare, Caremark will be the pharmacy benefits manager, and health savings accounts will be administered by OptumBank, a subsidiary of United Healthcare Services, Inc.

Fiscal Year 2017 HealthSelect Contribution Rate Analysis

In determining the recommended contribution rates for FY 2017, Rudd and Wisdom, Inc., ERS' consulting actuary for insurance, and the Underwriting, Data Analysis, and Reporting (UDAR) unit of Benefit Contracts analyzed the following critical factors:

- Revenue requirements
- Expected state funding
- Historical enrollment
- Claims experience
- Projected contingency fund balance
- Cost containment practices
- Anticipated increases in plan costs attributable to the ACA
- Impact of participating HMOs and funding for basic life and AD&D coverages

Other considerations include the projected health plan benefit cost trend, which is the projected increase in the per capita cost as a result of anticipated increases in the price and utilization of health care services and member cost share leveraging, and the medical and prescription drug benefit costs expected under the administrative services and pharmacy benefit management contracts in effect for FY 2017.

It is anticipated that the medical benefit cost trend will continue at an annual rate of about 6.5% through FY 2017; however, the prescription drug benefit cost trend is currently projected at 16.0% which will drive the total health plan benefit cost trend into the 9% range.

House Bill 1, the legislative appropriations bill for FY 2017-18 provides funding for increases in per capita contributions for the GBP health plan at 7% for FY 2017, under the expectation that ERS would maintain benefits at the current level and use the contingency fund to supplement employer and member contributions during the biennium, as necessary.

The Consumer Directed HealthSelect plan is required by statute to be revenue neutral. In order to satisfy this requirement, the ERS consulting actuary and UDAR considered the following items with specific regard to the implementation of a Consumer Directed Health Plan (CDHP).

- Profile of Members who would select a CDHP
- Savings due to reduced cultivation
- Adverse selection due to additional plan offerings
- Savings due to benefit reduction

It was determined that a plan design with an individual deductible of \$2,100/\$4,200 (individual/family), 80% coinsurance after the deductible, \$45/\$90 (individual/family) HSA contribution, member contribution rates for dependent coverage that are 90% of the HealthSelect member contribution rates, and state contribution rates that are the same as the HealthSelect state contribution rates would satisfy the requirement for revenue neutrality.

Rudd and Wisdom's analysis is included in this agenda item as Exhibit A.

STAFF RECOMMENDATION:

The legislative appropriation for group insurance for FY 2016-17 biennium included in H.B. 1 provides for increases in per capita funding for the GBP Health Plan that would be adequate to fund a 7% increase in the average per capita state contribution for insurance for FY 2017. The legislature intends for any funding deficiency to be covered through supplements from the GBP contingency fund.

After allocating funding for the HMOs, MA Plans, and the basic life and AD&D coverages, staff and the consulting actuary determined that the remaining appropriation for FY 2017 would be sufficient to fund a HealthSelect contribution rate increase of 7.1% effective September 1, 2016.

The 7.1% increase is expected to provide sufficient funding to maintain current benefits through FY 2017. Therefore ERS staff and the consulting actuary recommend adoption of the contribution rates for HealthSelect for FY 2017 as presented in the following table and Exhibit A. The contribution rates are based on continuation of current HealthSelect benefits, revised as required by the ACA, and the current contribution strategy in which the state pays 100% of the contribution rate for member coverage and 50% of the contribution rates for dependent coverage.

HealthSelect of Texas
Proposed Monthly Contribution Rates for FY 2017
 Effective September 1, 2016

Membership Category	Total Contribution	State Pays	Member Pays	Change in Member's Monthly Contribution
Member Only	\$ 615.08	\$ 615.08	\$ 0.00	\$ 0.00
Member & Spouse	1,322.44	968.76	353.68	23.44
Member & Children	1,088.68	851.88	236.80	15.68
Member & Family	1,796.05	1,205.56	590.48	39.12

Consumer Directed HealthSelect
Proposed Monthly Contribution Rates for FY 2017
 Effective September 1, 2016

Membership Category	Total Contribution	State Pays	Member Pays	Savings vs. HealthSelect
Member Only	\$ 615.08	\$ 615.08	\$ 0.00	\$ 0.00
Member & Spouse	1,287.08	968.76	318.32	35.36
Member & Children	1,065.00	851.88	213.12	23.68
Member & Family	1,737.00	1,205.56	531.44	59.04

A recommended motion is included with this agenda item following the exhibit.

ATTACHMENT – 1

Exhibit A – Recommended NTE Contributions Rates for HealthSelect and Consumer Directed HealthSelect for Fiscal Year 2017, Rudd & Wisdom, Inc.

Rudd and Wisdom, Inc.

CONSULTING ACTUARIES

Mitchell L. Bilbe, F.S.A.
 Evan L. Dial, F.S.A.
 Philip S. Dial, F.S.A.
 Philip J. Ellis, A.S.A.
 Charles V. Faerber, F.S.A., A.C.A.S.
 Mark R. Fenlaw, F.S.A.

Brandon L. Fuller, A.S.A.
 Christopher S. Johnson, F.S.A.
 Oliver B. Kiel, F.S.A.
 Robert M. May, F.S.A.
 Edward A. Mire, F.S.A.
 Rebecca B. Morris, A.S.A.
 Amanda L. Murphy, F.S.A.

Michael J. Muth, F.S.A.
 Khiem Ngo, F.S.A., A.C.A.S.
 Elizabeth A. O'Brien, A.S.A.
 Raymond W. Tilotta
 Ronald W. Tobleman, F.S.A.
 David G. Wilkes, F.S.A.

May 2, 2016

Mr. Porter Wilson
 Executive Director
 Employees Retirement System
 of Texas
 Post Office Box 13207
 Austin, Texas 78711-3207

Re: Recommended Contribution Rates for HealthSelect
 for Fiscal Year 2017

Dear Mr. Wilson:

The purpose of this correspondence is to present recommended contribution rates for HealthSelect for Fiscal Year 2017 (FY17). HealthSelect is the self-funded health plan provided under the Texas Employees Group Benefits Program (GBP).

The recommendations presented herein were developed based on projections of anticipated costs for the remainder of FY16 and for FY17. Our analysis and these projections are discussed herein.

Basis for Projections

To develop recommended HealthSelect contribution rates, we have projected health plan benefit costs, administrative expenses and other revenue for FY16 and FY17 as described below:

- **Health Plan Benefit Costs** - To project health plan benefit costs, we have analyzed historical enrollment and claims experience, and we have estimated expected changes in per capita cost as a result of anticipated increases in the price and utilization of health care services and member cost share leveraging (the health plan benefit cost trend). We developed a projection based on the benefit structure currently in effect for FY16 and the medical and prescription drug benefit costs expected under the administrative services and pharmacy benefits management contracts in effect for FY17. Our projections include provision for applicable fees required under the Affordable Care Act (ACA).
- **Administrative Expense** - The administrative expense for FY17 has been projected based on the administrative fees expected to be paid to (a) the HealthSelect medical benefits administrator, and (b) the HealthSelect pharmacy benefits manager (PBM).
- **Other Revenue (Net Investment Income, Subsidies available under the Medicare Part D Retiree Drug and Employer Group Waiver Programs, and Prescription Drug Rebates)** - The revenue

expected to be generated from these sources has been projected under benefits and contracts in place for 2016. This revenue has been used to offset other plan costs.

Updated Projection for FY16

Overall, Health Plan experience for FY16 has been considerably better than expected at the time the Board adopted rates in May, 2015. The following are key observations regarding the FY16 experience.

1. FY16 per capita medical benefit costs have been almost 2% lower than expected.
2. Although the prescription drug benefit cost trend remains quite high, per capita prescription drug benefit costs have been running over 3% lower than expected; i.e., while costs continue to increase rapidly, they have not increased as much as expected, due in part to lower than expected utilization of expensive medications for treatment of Hepatitis C.
3. Prescription drug rebates and the subsidies attributable to the Medicare Part D Employer Group Waiver Plan + Wrap (EGWP) have been greater than expected.

Funding Available for HealthSelect for FY17

The legislative appropriation for the FY16-17 biennium provides for an increase in per capita funding for the GBP Health Plan of 7.0% for FY17. The legislature intends for a funding deficiency, if any, to be covered through subsidies from the GBP contingency fund.

We determined the funding available for HealthSelect for FY17 as follows.

1. We determined the amount of funding expected to be available under the legislative appropriation for FY17.
2. We and the staff completed rate negotiations with the HMOs participating in the GBP. Based on these negotiations, we determined that a 5.6% average increase in per capita contributions would be required for members presently participating in HMOs.
3. We determined that the rates for the basic life and AD&D coverage could remain unchanged.
4. We and the staff agreed that the state contribution rates for HealthSelect Medicare Advantage should be set at the same level as for HealthSelect.
5. After allocating funding for the HMOs and the basic life and AD&D coverages, we determined that the remaining FY17 funding would be sufficient to fund a HealthSelect contribution rate increase of 7.1% effective September 1, 2016.

6. Under the parameters described above, the weighted average increase in the state's per capita contribution for the basic life, AD&D and health coverage for all GBP participants (HealthSelect and HMOs combined) is expected to be 7.0% for FY17 as provided in the appropriation.

Projection for FY17

We then projected financial results for HealthSelect in FY17 in order analyze the adequacy of the available funding. Our projection is based on the following important assumptions.

1. HealthSelect benefits will be maintained at current levels during FY17, except for the update to maximum member cost sharing as required under the ACA.
2. The health plan benefit cost trend is projected to be about 9.0% for FY17. The continued rapid increase in the cost of prescription drug benefits is a key factor in the rising cost.
3. Interest rates are projected to remain at the current low levels. Therefore, investment income is expected to be low, but the plan is not expected to experience unrealized losses as a result of increasing interest rates.
4. The GBP is expected to incur about \$12.5 million in ACA fees in FY17.
5. The cost for fully insured HealthSelect Medicare Advantage medical coverage for Medicare-primary participants will be reduced about 8% for CY17, since the FY17 moratorium on the Health Insurance Providers Fee is expected to more than offset the expected increase in the cost of medical coverage.
6. Prescription drug rebates and Part D subsidies will continue to increase along with increases in prescription drug plan costs.
7. HealthSelect contribution rates will be increased 7.1% effective September 1, 2016.
8. As discussed at the February, 2016 Board meeting, the state contribution rates for Consumer Directed HealthSelect will be set equal to the HealthSelect state contribution rates. The member contribution rates for Consumer Directed HealthSelect will be set at 90% of the HealthSelect member contribution rates.

Based on these assumptions, our projection for FY17 indicates that HealthSelect will operate in a breakeven range in FY17. The better than expected results for FY16 and FY17 will maintain the GBP's favorable financial condition through the current biennium.

Proposed Rates

Based on this analysis, we recommend that the FY17 state and member contribution rates for HealthSelect be established at a level that is 7.1% greater than the FY16 rates.

The following information is included in the attachments:

- The recommended HealthSelect and Consumer Directed HealthSelect contribution rates for FY17 are presented in Attachment 1.
- The recommended HealthSelect and Consumer Directed HealthSelect contribution rates for FY17 for the state and the members are presented in Attachment 2.
- A comparison of the FY16 and the recommended FY17 member contribution rates is presented in Attachment 3.

Conclusion

It is our best estimate at this time that the contribution rates recommended herein, together with other revenue sources will provide adequate funding to support the current benefits through FY17. It is important to note, however, that HealthSelect is operating in a volatile environment in which both the cost and utilization of health care services continue to rise. This volatility creates the potential for actual experience to vary from that which has been anticipated in developing the projections upon which these rate recommendations are based.

Please let us know if you have questions or if you need additional information.

Sincerely,



Philip S. Dial

PSD:nlg

Enclosures

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Attachment 1

TEXAS EMPLOYEES GROUP BENEFITS PROGRAM

Recommended Monthly Contribution Rates for HealthSelect for FY 2017

Coverage Category	HealthSelect	Consumer Directed HealthSelect
<i>Active Employees</i>		
Employee Only	\$615.08	\$615.08
Employee & Spouse	1,322.44	1,287.08
Employee & Children	1,088.68	1,065.00
Employee & Family	1,796.04	1,737.00
<i>Retirees</i>		
Retiree Only	\$615.08	\$615.08
Retiree & Spouse	1,322.44	1,287.08
Retiree & Children	1,088.68	1,065.00
Retiree & Family	1,796.04	1,737.00
<i>Retirees with Interim Insurance Coverage</i>		
Retiree Only	\$1,722.22	\$1,641.22
Retiree & Spouse	3,702.83	3,441.82
Retiree & Children	3,048.30	2,820.00
Retiree & Family	5,028.91	4,701.60
<i>Surviving Dependents</i>		
Spouse Only	\$707.36	\$672.00
Children Only	473.60	449.92
Spouse & Children	1,180.96	1,121.92
<i>COBRA (Including Former Employee)</i>		
Employee Only	\$627.38	\$581.48
Employee & Spouse	1,348.89	1,221.02
Employee & Children	1,110.45	994.50
Employee & Family	1,831.96	1,679.94
<i>COBRA (Without Employee)</i>		
Spouse or Child Only	\$627.38	\$581.48
Spouse & Children	1,110.45	994.50

NOTE: Contribution rates do not include basic term life or AD&D.

Attachment 2

TEXAS EMPLOYEES GROUP BENEFITS PROGRAM

**Recommended FY 2017
Monthly State and Member Contribution Rates**

HealthSelect			
Coverage Category	Total	State	Member
Member Only	\$615.08	\$615.08	\$0.00
Member & Spouse	1,322.44	968.76	353.68
Member & Children	1,088.68	851.88	236.80
Member & Family	1,796.04	1,205.56	590.48

Consumer Directed HealthSelect			
Coverage Category	Total	State	Member
Member Only	\$615.08	\$615.08	\$0.00
Member & Spouse	1,287.08	968.76	318.32
Member & Children	1,065.00	851.88	213.12
Member & Family	1,737.00	1,205.56	531.44

Note: Contribution rates do not include Basic Life.

Attachment 3

TEXAS EMPLOYEES GROUP BENEFITS PROGRAM

**Comparison of FY16 and FY17
Monthly Member Contribution Rates**

HealthSelect			
Coverage Category	FY16	FY17	Change
Member Only	\$0.00	\$0.00	\$0.00
Member & Spouse	\$330.24	353.68	23.44
Member & Children	\$221.12	236.80	15.68
Member & Family	\$551.36	590.48	39.12

Consumer Directed HealthSelect			
Coverage Category	FY16	FY17	Change
Member Only	NA	\$0.00	NA
Member & Spouse	NA	318.32	NA
Member & Children	NA	213.12	NA
Member & Family	NA	531.44	NA

PUBLIC AGENDA ITEM - #15f

Review, Discussion and Consideration of the Texas Employees Group Benefits Program for
Fiscal Year 2017:

15f. TexFlex Program Proposed Fees and Rates

May 17, 2016

BACKGROUND:

The Employees Retirement System of Texas (ERS) provides the State of Texas Employees Flexible Benefit Program (TexFlex), a voluntary benefit program, to active employees under the Texas Employees Group Benefits Program (GBP). Funded by pre-tax salary contributions from participants, the TexFlex program offers the following benefit options which are used to reimburse participants for qualified expenses according to the rules of the corresponding benefit plan.

- ***Flexible Spending: Health Care Reimbursement***

The health care reimbursement plan is a plan under the Internal Revenue Code (the Code) §125, adopted by the ERS board of trustees (Board), and designed to provide payment or reimbursement for health care expense. The maximum tax-deferred contribution amount is determined by the Internal Revenue Service (IRS) and is currently set at \$2,550 annually.

Under the TexFlex health care reimbursement plan, the pre-taxed member contributions are credited into a participant-specific bookkeeping account, herein called health care reimbursement account (HCRA), and maintained by the plan administrator. A participant is then able to use the contributions from his/her specific HCRA to fund health care expenses not covered by insurance such as prescription copays, dental expenses, eyeglasses/Lasik/contacts, medical supplies, and some over-the-counter (OTC) products when prescribed by a doctor. The entire annual contribution is available to the participant at the beginning of each fiscal year.

- ***Flexible Spending: Dependent Care Reimbursement***

The dependent care reimbursement plan, also provided under the Code §125, is adopted by the Board, and designed to provide payment or reimbursement for dependent care expenses. The maximum tax-deferred contribution amount is determined by IRS and is currently set at \$5,000 annually.

The TexFlex dependent care reimbursement plan provides a participant with the means to contribute pre-tax dollars into a participant-specific bookkeeping account, herein called dependent care reimbursement account (DCRA), that is maintained by the plan administrator. A participant is then able to use the contributions from his/her specific DCRA for day care expense for qualifying adults or children under the age of 13.

- ***Commuter Spending Account Plan***

At its February 24, 2015 public meeting, the ERS Board of Trustees (Board) approved the addition of the Commuter Spending Account (CSA), a Qualified Transportation Fringe Benefit, as an optional benefit available to active employees. Through the CSA, employees can use pre-tax dollars to pay for qualified expenses associated with their daily commute such as mass transportation or parking fees. According to the 2014 Qualified Commuter Benefits governed under §132 of the Code, deferral contributions to the CSA are made with pre-tax dollars. While not part of a §125 FSA cafeteria plan, the CSA is included under the TexFlex program brand.

The maximum contribution limits for Qualified Transportation Fringe Benefit, like CSA, are set by the IRS. The monthly limit for qualified parking is \$250 and the combined monthly limit for transit passes and vanpooling is \$130. Participants could elect to contribute to both the parking plan and the transit pass/vanpooling plan for a maximum monthly contribution of \$380. If the participant does not use the full

amount before the end of the plan year, the left over amount is carried forward. As a §132 QTFB plan, the CSA does not have a “use it or lose it” forfeiture provision.

TexFlex Program Governance

Texas Administrative Code Title 34, Part IV, Chapter 85 (Chapter 85) provides the rules that govern the TexFlex program. These rules constitute the Plan document. Chapter 85 stipulates the following: the TexFlex program is intended to be qualified under the Code §125; and will continue as long as it qualifies under §125 and is advantageous to the state and institutions of higher education employees. Optional benefits offered under the TexFlex program for individual selection consist only of a choice between cash and certain statutory nontaxable fringe benefits as defined in the Code §125, and regulations promulgated under the Code §125.

Additionally Chapter 85 provide the rules that govern the TexFlex CSA program which will align with the requisites provided under §132.

Health Care Reimbursement and Dependent Care Reimbursement Plans

• **Enrollment and Contributions**

Participation in the TexFlex plan is voluntary and enrollment is available during the annual enrollment period. The following table illustrates the changes in enrollment and contribution elections specific to the Health Care Reimbursement and Dependent Care Reimbursement Plans available under the §125 Flexible Spending Plans for FY2016 as compared with the same period in FY2015.

**TexFlex §125 Flexible Spending Program
Health Care Reimbursement and Dependent Care Reimbursement Plans
Enrollment and Contribution Elections**
Fiscal Years Beginning 2015 and 2016

Account Type	Enrollment (#)			Contribution Elections (\$)		
	FY 2015 Enrollment	FY 2016 Enrollment	Change in Enrollment (%)	FY 2015 Contribution Elections**	FY 2016 Contribution Elections**	Change in Elections** (%)
Health Care Reimbursement Plan	51,760	49,372	-4.6%	\$66,047,108	\$65,531,978	-0.8%
Dependent Care Reimbursement Plan	4,404	3,902	-11.4%	\$15,178,206	\$14,504,241	-4.4%
Participation in Both Plans	-2,822	-2,618	-7.2%			
TOTAL* <i>(Participants)</i>	53,342	50,656	-5.0%	\$81,225,314	\$80,037,219	-1.5%

*Total enrollment is not equal to the sum of health care and dependent care enrollment because some members are enrolled in both plans.

** Contribution Elections are pledges into the program and are reported commitments for the applicable fiscal year.

• **Plan Rates and Fees**

In previous years, the direct per employee cost of participation in the Health Care Reimbursement or Dependent Care Reimbursement Plan was nominal at \$1.00 per account per month. For plan year 2016, ERS enacted an administrative fee holiday during which the \$1.00 fee was waived for participants. The cost of administration for the TexFlex program is covered by the previous year’s forfeited account balances.

Also, beginning in plan year 2016, the TexFlex branded debit cards were available to participants at no additional costs. The program’s prior administrator had assessed an annual convenience fee of \$15.00 to each participant who elected the optional debit card feature.

- **Premium conversion**

Pre-tax payments, or “premium conversion,” for dependent health insurance contributions is also part of the TexFlex program. Premium conversion is automatic for every state employee covering dependents on their health insurance coverage under the Texas Employees Group Benefits Plan. Together, TexFlex and the premium conversion programs generated approximately \$40 million in FICA tax savings to the state of Texas in Fiscal Year 2015. State employees realized even greater savings through reductions in their federal taxable income.

- **Plan Forfeitures**

One important consideration to using the TexFlex Health care and Dependent Care Reimbursement benefits is the forfeiture feature that is characteristic of a §125 cafeteria plan. Any contributed funds that are not used by the end of the plan year or by the end of the Dependent Care Reimbursement grace period are forfeited to the TexFlex Program. Forfeited funds are applied to future plan administrative costs and are no longer available for use by the program participant. This forfeiture feature is commonly referred to as the “use it or lose it” rule.

The total accumulated forfeitures since the plan’s inception is just over \$9 million through Plan Year 2014; Plan Year 2015 will be finalized in June 2016 to allow for residual claims exceptions following the conclusion of the run-out period. It is important to note that since 2008, the account forfeitures have been declining. With the change to the \$500 carryover specific to the Health Care Reimbursement plan that went into effect on September 1, 2014, ERS staff anticipates a continuing decline in the amount of forfeitures.

Commuter Spending Account (CSA)

- **Enrollment and Contributions**

Participation in the TexFlex CSA program is voluntary. Since this is a month-to-month benefit, participants can enroll, change election, or disenroll in the parking and transit accounts on a monthly basis. Enrollment in the CSA program became available in February 2016. Unlike the §125 Flexible Spending plans, the CSA program does not have a mandatory “use it or lose it” rule. So, unused balances are rolled over to the next month; however, any balances less than \$3.00 will be forfeited.

Participants can use their TexFlex branded debit card to pay for parking and transit expenses. However, if a participant does not use the debit card option for qualified parking expenses, then the participant can submit a paper claim to the program administrator for reimbursement. IRS does not permit paper claim filings for the reimbursement of transit expenses.

As of March 2016, 19 participants have elected to participate in the parking benefit and 128 participants have elected to participate in the transit benefit.

- **Administration Fee**

The CSA program does have a \$3.00 monthly administrative fee that is deducted from the balance of one of the participant’s CSA accounts.

STAFF RECOMMENDATION:

In consideration of the TexFlex participation and plan forfeitures, ERS maintains a balance of funds that is more than adequate to cover the TexFlex programs administrative costs. Therefore, staff recommends the Board approve an administrative fee holiday for TexFlex participants for FY 2017.

A proposed motion is included with this agenda item on the following page.

PUBLIC AGENDA ITEM - #16

16. Review, Discussion and Selection of Contract Award Recommendation for Actuarial Services for Insurance

May 17, 2016

Background

The Group Benefits Program (“GBP”) provides insurance benefits to state employees, retirees of state agencies, certain higher education institutions, other employers and the dependents of these groups. The insurance benefits provided through the GBP include (among other benefits) health, life, dental and disability plans. Section 1551.210, Texas Insurance Code, authorizes the Board of Trustees to designate a firm to provide actuarial, valuation and consulting services for these benefits.

Request for Proposal (RFP)

Effective September 1, 2009, ERS entered into a Third Restated Contract with Rudd & Wisdom, Inc. to provide actuarial services for the administration of the GBP through August 31, 2011. This contract was subsequently extended through August 31, 2013, and again through August 31, 2016.

With the contract for the actuarial services for insurance expiring on August 31, 2016, ERS staff prepared an RFP for actuarial services.

On January 8, 2016, ERS issued an RFP seeking proposals from qualified actuarial firms to provide actuarial services for the GBP for a six-year period beginning September 1, 2016 through August 31, 2022.

General Evaluation Criteria within the RFP

Article II of the RFP disclosed criteria for the basis of evaluating proposals submitted by respondents. Staff evaluated all respondent proposals for satisfaction of minimum requirements and compliance with provisions of the RFP. Once staff determined that a respondent satisfied the minimum requirements and complied with the RFP, the respondent’s proposal was moved to the next phase of the evaluation process. The subsequent evaluation criteria were grouped into six (6) categories.

- Qualifications and experience
- Price proposal
- Service verification
- Financial considerations
- Contractibility
- Legal disclosures

Qualifications and Experience

Staff evaluated a number of factors related to the qualifications and experience of the respondents, including the:

- qualifications of respondent’s proposed actuarial staff;
- respondent’s experience providing actuarial, valuation and consulting services;
- respondent’s experience presenting to administrative bodies;
- respondent’s understanding of the statement of work within the RFP and their ability to provide services; and
- respondent’s security practices and policies.

Price Proposal

Staff evaluated the respondent's fees as part of its best value consideration. The respondent's hourly fees were delineated by role, including principal actuary, supporting actuary, data analyst, clerical / administrative staff, and other professional staff.

Service Verification

The respondent service verification process is part of ERS' due diligence practice and is only performed for selected finalists. Service verification is comprised of:

- o face-to-face finalist interviews;
- o reference checks; and
- o site visits, if necessary, to the finalists' offices. (Following the face-to-face interviews with the finalists, evaluation team members deemed site visits to the finalists' offices as unnecessary)

Financial Considerations

Staff evaluated the respondent's financial considerations, including a review of the respondent's audited financial statements, operating losses, if any, and possible merger and/or acquisition disclosures, if any.

Contractibility

Respondents are provided an opportunity to present deviations to the provisions of the RFP requirements and Contractual Agreements. If a respondent submits deviations, the respondent must include specific language that certain provisions require discussion. Deviations from the RFP and Contractual Agreements may eventually affect contractibility, which is evaluated on a pass or fail basis.

Legal Disclosures

Respondents are required to submit extensive disclosure related to matters of litigation, regulatory proceedings, investigations, performance assessments and contract disputes. Legal disclosures are evaluated on a pass or fail basis.

Proposal Evaluation

February 2016 – May 2016

ERS received two (2) proposals to provide actuarial services for insurance. The respondent firms are listed below in alphabetical order.

- o Rudd & Wisdom, Inc. (Rudd)
- o The Segal Company (Southeast), Inc., Segal Consulting Division (Segal)

Both respondents submitted a proposal which included the required pricing, responses, and other materials deemed necessary to further explain their proposal for services.

Comprehensive Evaluation by Cross-Divisional Team (Benefit Contracts, Enterprise Planning, Finance, Governmental Affairs, Information Systems, Legal Services, Procurement)

Once staff determined that each respondent's proposal satisfied the minimum requirements and complied with the RFP, the proposals were vetted through a comprehensive review by the RFP evaluation team, which was comprised of subject matter experts within the agency. The evaluation team members were assigned to individually evaluate sections of the respondent's proposal that relate to their subject matter expertise.

Following the initial scoring of proposals by the evaluation team members, Rudd and Segal were selected as finalists.

In addition to reviewing each finalist's written proposal, evaluation team members further vet the finalists as noted in the RFP. Additional avenues for vetting and evaluating each finalist include:

- Clarifications
- Reference Checks
- Face-to-Face Interviews (Oral Presentations / Discussions)
- Best and Final Offer

Clarifications

Subject matter experts serving on the evaluation team identified areas of the proposals that required further clarification. The primary objective of this process is to ensure mutual understanding of the finalist's proposal. This process is facilitated in writing to the finalist and is directed to an individual authorized to legally bind the firm. Clarification questions were issued to the finalists with specified response deadlines. The evaluation team assessed clarification responses as part of its final evaluation.

Reference Checks

ERS staff conducted reference checks to those entities for which Segal provides actuarial services. (ERS decided to forgo reference checks for Rudd, as Rudd currently performs actuarial services for ERS. Thus ERS may rely on its own experience with Rudd in lieu of contacting other clients of Rudd as stipulated in the RFP.) All reference checks were documented in writing. The reference check process assists in the evaluation of the proposal and is another avenue to verify information provided by the finalist within its proposal.

Face-to-Face Interviews (Oral Presentations / Discussions)

Finalist interviews were conducted April 5 and April 6, 2016, at the ERS Building. Each session included a presentation by the finalist, discussion of key issues, and extensive questioning of the finalist's representatives by ERS staff.

Face-to-face interviews provide an opportunity for finalists to highlight strengths and unique aspects of their firms and to provide answers to questions that ERS staff may have on their proposal. The time allowed and the format was the same for both finalists.

Best and Final Offer (BAFO)

Both finalists were formally requested to provide a BAFO at the beginning of the face-to-face interviews. The BAFO responses were provided to the designated members of the evaluation team for consideration and scoring. Both finalists reduced their fees from the levels originally provided within their written proposals.

Final Evaluation by Cross-Divisional Team

A comprehensive review and analysis is made of each finalist's proposal, contractual deviations, clarifications, references, face-to-face interviews, and best and final offer submissions to affirm the qualifications and capabilities of the finalists to provide services in accordance with the RFP. Evaluation team members individually perform a final scoring assessment of each finalist based on the evaluation criteria within the RFP. Based on the scoring results from the extensive evaluation process, both Rudd and Segal are considered to have the qualifications and capabilities to provide actuarial services for insurance in accordance with the RFP. The evaluation team, however, identified factors that differentiate the two finalists.

Enterprise Planning leadership met with the ERS Executive Office to review the findings of the cross-divisional evaluation team and discuss the recommendation that would be prepared by staff based on the scores provided. The scores are in response to the information provided by the vendors throughout the evaluation process which included the reviews of the proposals, follow-up inquiries and clarifications, pricing for services, information shared during the face-to-face interviews, and reference checks.

STAFF RECOMMENDATION:

Based on the scoring of the submitted proposals, clarifications, reference checks, face-to-face interviews and financial analysis discussed in this agenda item, ERS staff will present a recommendation to the Board for the qualified vendor that provides the best value to the state for actuarial services for insurance for the GBP.

These services will be provided under a contract which will cover a six-year term beginning September 1, 2016 through August 31, 2022.

A proposed motion is included with this agenda item.

PUBLIC AGENDA ITEM - #17

Review, Discussion and Consideration of the ERS Incentive Compensation Plan

May 17, 2016

ERS INCENTIVE COMPENSATION PLAN BACKGROUND:

On December 13, 2006, the Board of Trustees (Board) approved the ERS Incentive Compensation Plan (Plan or ICP). The Board reviews the Plan annually, and it was most recently amended and approved by the Board on August 18, 2015. The plan communicates strategic performance priorities to the Investments division staff and encourages the highest level of performance in the delivery of value to ERS and the members, retirees, and beneficiaries of the retirement system. The ICP is designed to drive sustained levels of high investment performance, promote teamwork, support ERS' strategic and operational goals and attract and retain key employees. Staff is presenting the proposed changes to the ICP for the upcoming plan year (Fiscal Year 2017) to allow the Board time to review, discuss and consider as needed. Staff will present and request approval of the proposed ICP plan document at the August Board Meeting.

Staff seeks to simplify the Plan and related process while maintaining the objective to provide incentives to employees who excel in carrying out the strategic performance priorities established by the Board. Based on discussions internally among Human Resources, Investments, Legal, and the Executive Office, the following revisions to the ERS Incentive Compensation Plan are being offered for consideration and discussion:

Proposed Revisions to the ICP Plan Document

Reconsideration of Qualitative Metric

Qualitative performance goals with a 25% discretionary metric was added to all Investments Professionals in the ICP plan approved August 18, 2015. This is consistent with industry standards and best practices. However, administrative challenges associated with this metric exist because of its subjective nature. As a result, a request to either refine the methodology used to evaluate the metric or remove the qualitative performance goal metric for the Investment Professionals in the Investments Division is being considered.

Modify the Eligibility Date for New Hires

Currently the plan allows the Executive Director to authorize a New Hire for eligibility in the Plan after the beginning of the Plan Year. The Eligibility Date is the first day of the first full month after the hire date. Staff recommends to change the Eligibility Date for employees that start after the beginning of the plan year. The recommendation is to defer eligibility in the plan to the first of the month following a six month employment period. The plan may allow for the use of the Boards and/or the Executive Director's discretion after a 90 day employment period if warranted. This may be in the case of an ERS rehire.

Plan Process Improvements

As previously suggested by the Board, add HR oversight of the Incentive Compensation Award calculations and management of the Incentive Compensation Plan.

Other revisions are included in the plan document as presented in Exhibit A.

STAFF RECOMMENDATION:

This agenda item is presented for discussion and informational purposes only. No action is necessary at this time.

PUBLIC AGENDA ITEM - # 18

18. Review and Discussion of Sunset Commission Report Findings

May 17, 2016

Sunset Review Report Released

Following an extensive review of ERS, with field work beginning in early October 2015, the Sunset staff published their final report on ERS on April 29, 2016. The report has findings in five issue areas and makes six recommendations for statutory changes and ten for management action. ERS will provide a report response that will be published in addition to the report. Members of the Sunset Commission, composed of state senators and representatives and appointed public representatives, will begin to hold hearings on the report in June.

Sunset staff met with ERS in more than 60 formal meetings, and participated in countless informal discussions on ERS operations and programs. To date, ERS employees have tracked more than 3,500 work hours supporting the Sunset review process. Additionally, more than 200 unique documents were provided to Sunset staff for review, many created or developed to meet the specific needs of the review team. Although the review examined all aspects of ERS operations and programs, the issues are focused on aspects of the Group Benefits Program (Issues 2 and 3), contracting (Issue 1) and investment reporting (Issue 4). The final issue, Issue 5, deals with standard Sunset recommendations that are often included in agency reports if their governing statutes do not already include the provisions.

The report and the agency response will serve as the basis for discussion during public hearings of the Sunset Advisory Commission beginning in June. Sunset Commission members will approve and adopt management directives for implementation by ERS, as well as finalize recommended statutory changes to be considered in formal legislation during the 2017 Regular Legislative Session.

Sunset Review Report Findings and Recommendations

The Sunset staff review of ERS programs and operations identified five primary issues, with related recommendations for improvement – structured as a mix of both management directives and potential statutory changes. These issues and the related significant recommendations follow:

Issue 1: ERS Needs to Make Additional Improvements to Ensure ERS' Contracts Adhere to Best Practices and Provide Best Value to the State

Summary: Sunset believes that ERS' formerly decentralized approach to contracting operations and staffing, as well as flexible, contract-specific policies contribute to inconsistent and inefficient contracting outcomes. Sunset staff noted that this concern had not actually resulted in recurring problems, but presented the potential for poor performance.

Recommendations for Management Action:

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

ERS Response:

ERS began reviewing this issue at the beginning of fiscal year 2016 and centralized related functions on April 1 by creating the Office of Procurement and Contract Oversight. The new division consolidates many functions that had been performed by staff throughout the agency. Management is continuing to review roles and responsibilities for further centralization opportunities.

Issue 2: ERS Does Not Strategically Manage the Group Benefits Program (GBP) to Ensure Its Effectiveness and Plan for the Future

Summary: Acknowledging the importance of employee benefits to state agencies ability to recruit and retain a skilled workforce, Sunset believes ERS does not focus sufficiently on seeking member input on programs, evaluating ongoing benefit operations, and communicating plan direction to the external stakeholders and the public. Sunset staff identified the agency's strategic investment planning process – including conducting an experience study, crafting an investment policy, defining an asset allocation, and performing valuation activities – as a model for the type of strategic process they would like to see applied to the GBP.

Recommendations for Statutory Change:

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

Recommendations for Management Action

- 2.2 ERS should establish an advisory committee to obtain regular stakeholder and expert input on benefits.
- 2.3 Direct ERS to develop a process and clear criteria for evaluating changes to the GBP.

ERS Response:

ERS performs many strategic management functions related to the GBP, including detailed monthly and annual financial monitoring of all benefit programs, performing actuarial evaluations of benefit operations, and monitoring industry trends and innovations. The agency publishes an annual evaluation in the agency's *Cost Management and Fraud Report*, although the focus of the report is focused on cost containment efforts. ERS regularly seeks input from stakeholders and stakeholder groups through formal and informal methods. Better documentation of the strategic oversight of the GBP will help to formalize and expand the agency's efforts and re-establishing an advisory committee could be helpful in gathering stakeholder input, if the committee is properly structured.

Issue 3: ERS Benefit Decision Processes Lack Balanced Treatment and Full Information for Members

Summary: Sunset believes ERS communications and notifications provided to members are unclear and hinder members' understanding of the benefit processes and procedures (such as the financial implications of in-network and out-of-network services). Sunset also believes that the member appeals and review processes do not provide adequate balance and consistency and place too much burden on the member population.

Recommendations for Statutory Change:

- 3.1 Require ERS to develop and implement a process that allows members to participate directly in the insurance appeal process.
- 3.2 Require ERS to establish a precedent or other type of manual for the insurance appeal process.

Recommendations for Management Action:

- 3.3 Direct ERS to more effectively educate members about choices and decisions that can lead to unexpected health insurance charges.
- 3.4 Direct ERS to ensure balanced representation on the Grievance Review Committee of customer service and other staff.
- 3.5 Direct ERS to develop policies and procedures to govern reviews of Chapter 615 survivor benefit applications.
- 3.6 Direct ERS staff to comprehensively track and analyze benefit application decision and appeals data.

ERS Response:

ERS strives to communicate complex insurance information to participants in a simple and effective manner. This is a difficult task given the agency's diverse membership base and is accomplished with varying results. ERS can expand communications related to the grievance and appeals process, particularly related to why a medical cost may not be covered and why an appeal might not be granted. In addition, ERS can formalize related policies and procedures and make operational changes to ensure that the appeals and Chapter 615 application process is fully transparent and equitable. The agency can also modify existing processes to include an avenue for more direct member during the appeal process.

Issue 4: ERS Does Not Adequately Track or Report All Costs Associated with Alternative Investments

Summary: Sunset believes there is a public need for increased tracking and transparent reporting of profit-sharing activities within alternative investment.

Recommendation for Statutory Change:

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

ERS Response:

ERS can increase reporting to ensure that the costs and net returns of alternative investments are fully disclosed and readily available. Costs are currently reported to the Board of Trustees in public meetings and included in the Comprehensive Annual Financial Report; however, there is not ongoing reporting available to the public. Reporting these costs is somewhat complex given that they may change over the course of an investment, depending on adjustments to market valuations. The institutional investment industry is currently developing reporting standards and best practices that ERS will consider in implementing this recommendation.

Issue 5: ERS' Statute Does Not Reflect Standard Elements of Sunset Reviews

Summary: Over time, Sunset has developed a set of standardized recommendations that are applied to all agencies regardless of the findings of their operational review. These "across-the-board" recommendations or ATBs are intended to enhance "good government" standards across state agencies. This section of the report also provides comment on the continuing need for agency specific reporting requirements.

Recommendations for Statutory Change:

- 5.1 Apply standard across-the-board requirements to ERS.
 - Board Member Training
 - Alternative Dispute Resolution
- 5.2 Change the due date for the *Cost Management and Fraud Report* and continue the agency's other reports.

ERS Response:

ERS can implement these across the board requirements.

STAFF RECOMMENDATION:

This agenda item is presented for discussion and informational purposes only. No action is necessary at this time.

ATTACHMENTS – 1

Exhibit A – Sunset Advisory Commission Staff Report on Employees Retirement System of Texas

SUNSET ADVISORY COMMISSION

STAFF REPORT

Employees Retirement System of Texas



2016–2017
85TH LEGISLATURE

SUNSET ADVISORY COMMISSION

Representative Larry Gonzales

Chair

Senator Van Taylor

Vice Chair

Representative Cindy Burkett

Senator Juan “Chuy” Hinojosa

Representative Dan Flynn

Senator Robert Nichols

Representative Senfronia Thompson

Senator Charles Schwertner

Representative Richard Peña Raymond

Senator Kirk Watson

William Meadows

LTC (Ret.) Allen B. West

Ken Levine

Director

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

**SUNSET STAFF REPORT
2016-2017
85TH LEGISLATURE**

HOW TO READ SUNSET REPORTS

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

1. SUNSET STAFF EVALUATION PHASE

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

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

2. SUNSET COMMISSION DELIBERATION PHASE

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

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

3. LEGISLATIVE ACTION PHASE

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

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

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**SUMMARY OF SUNSET STAFF
RECOMMENDATIONS**

SUMMARY

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

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

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

These procurement and contracting functions support ERS' two main responsibilities — managing the retirement fund and administering the Group Benefits Program (GBP) for more than 500,000 state employees, retirees, and dependents. On the retirement side of the house, the review found ERS strategically manages its investment program with a capable staff and an engaged board. The agency works to keep investment costs low and successfully worked with the Legislature in 2015 to put the retirement fund on a path to actuarial soundness. However, even though the review found no significant problems within the investment program, the agency could improve the transparency of costs related to alternative investments.

On the other side of the house is the Group Benefits Program, which Sunset staff found does not always get the attention it needs and deserves. From this vantage point, several issues emerged. ERS' unique status as a trust fund means the agency and its board members are legally bound to perform their duties solely in the interest of retirement fund participants and beneficiaries. While the importance of controlling costs cannot be overstated, this fiduciary duty, along with the fact that the Legislature ultimately controls the eligibility and funding aspects of the GBP, has created an entrenched culture that is heavily focused on the program's financial aspects, sometimes at the expense of members' needs and expectations. The review found ERS does not strategically manage

the GBP to ensure the specific benefits within the program are meeting members' and employers' needs. As a key recruitment and retention tool, ERS should have an inclusive, forward-thinking approach for administering group benefits that is not focused solely on controlling costs. Further, ERS does not provide adequate information to help members make informed decisions about aspects of their insurance and other benefits.

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

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

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

The following material summarizes Sunset staff recommendations on ERS.

Issues and Recommendations

Issue 1

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

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

Key Recommendations

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

- Direct ERS to further centralize and consolidate its procurement and contracting staff into the new division.
- Direct ERS to implement contract term dates in agency contracts, except in limited circumstances.

Issue 2

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

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

Key Recommendations

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

Issue 3

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

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

Key Recommendations

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

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

Issue 4

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

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

Key Recommendation

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

Issue 5

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

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

Key Recommendations

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

Fiscal Implication Summary

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

ERS AT A GLANCE

ERS AT A GLANCE

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

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

What Is a Trust Fund?

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

Key Facts

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

ERS Board of Trustees

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

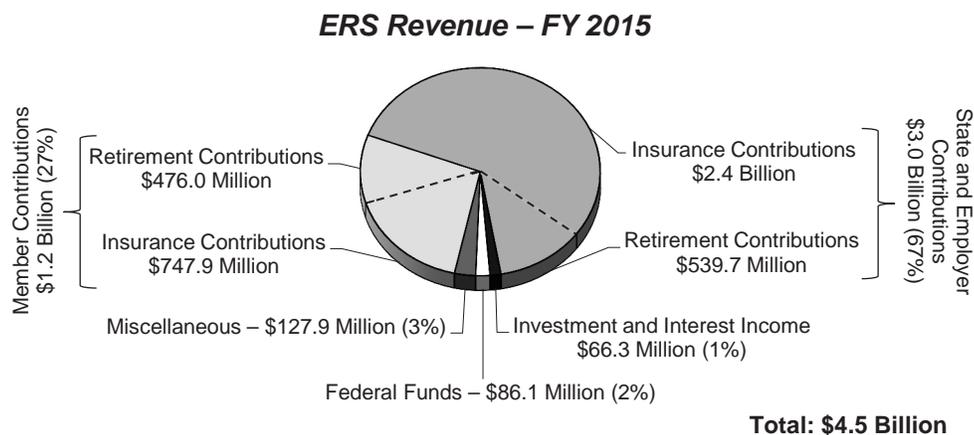
* This is an elected position, but the current trustee was appointed to the position by the board upon the resignation of the previous elected trustee.

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

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

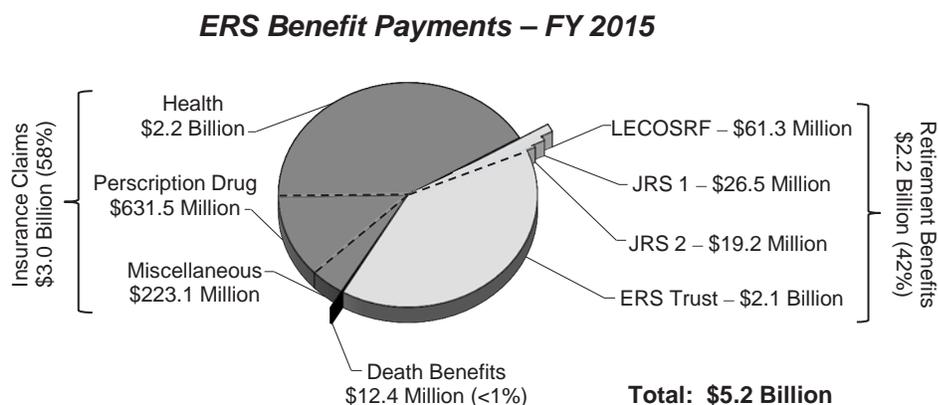
advisors to provide investment expertise and services. Appendix A, *Equal Employment Opportunity Statistics*, compares ERS' workforce composition to the percentage of minorities in the statewide civilian labor force for the past three fiscal years.

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



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

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



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

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

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

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

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

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

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

Retirement Plan Populations – FY 2015

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

* Includes LECOSRF members.

Healthcare Program Enrollment – FY 2015

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

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

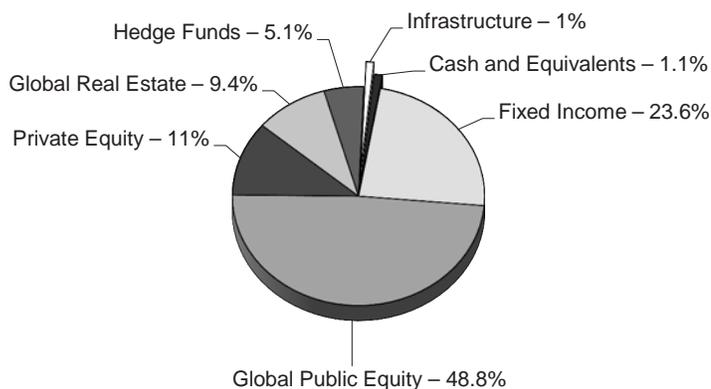
Health Insurance Plan Types – FY 2015

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

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

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

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



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

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

² Section 815.5091, Texas Government Code.

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

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

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

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

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

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

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

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

¹¹ Ibid.

ISSUES

ISSUE 1

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

Background

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

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

Contracts per Division

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

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

Select ERS Contracts

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

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

Key SAO Findings

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

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

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

Findings

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

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

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

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

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

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

ERS does not have detailed procedures for monitoring contractor performance.

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

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

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

Some performance guarantees seem impossible for vendors to meet.

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

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

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

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

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

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

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

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

Recommendations

Management Action

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

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

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

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

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

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

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

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

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

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

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

Fiscal Implication

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

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

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

ISSUE 2

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

Background

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

GBP Benefits – As of August 31, 2015

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

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

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

Findings

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

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

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

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

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

ERS does not formally request and receive feedback from its members to know whether benefits are meeting their needs, how they view the quality of existing benefits, or what benefit changes they would like to see. ERS also does not systematically get input from state agencies and other employers to know what benefits are most useful in recruiting and retaining employees. Without regular input from members and employers, ERS and the state lack a full understanding of what is and isn’t working in the GBP and what changes could be made to increase its continued effectiveness as a recruitment and retention tool.

ERS Member Surveys

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

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

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

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

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

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

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

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

Group Benefits Program Goals

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

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

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

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

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

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

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

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

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

Retirement and Investment Planning and Reporting Tools

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

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

Recommendations

Change in Statute

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

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

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

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

Management Action

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

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

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

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

Fiscal Implication

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

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

² Ibid., 3.

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

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

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

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

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

⁸ Section 1551.061, Texas Insurance Code.

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

ISSUE 3

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

Background

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

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

Insurance Appeals

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

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

Benefit Applications

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

Findings

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendations

Change in Statute

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

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

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

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

Management Action

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

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

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

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

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

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

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

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

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

Fiscal Implication

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

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

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

³ Section 1551.355, Texas Insurance Code.

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

⁵ Section 814.201, Texas Government Code.

⁶ Chapter 615, Texas Government Code.

⁷ Employees Retirement System of Texas, *Health Select Master Benefit Plan Document*, accessed March 22, 2016, <http://healthselectoftexas.welcometouhc.com/assets/pdf/HS%20In-Area%201-2016%20MBPD%20FINAL.pdf>; "Medical & Drug Policies and Coverage Determination Guidelines- Commercial," United Healthcare, last modified 2015, http://www.unitedhealthcareonline.com/b2c/CmaAction.do?channelId=016228193392b010VgnVCM100000c520720a_____.

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

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

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

ISSUE 4

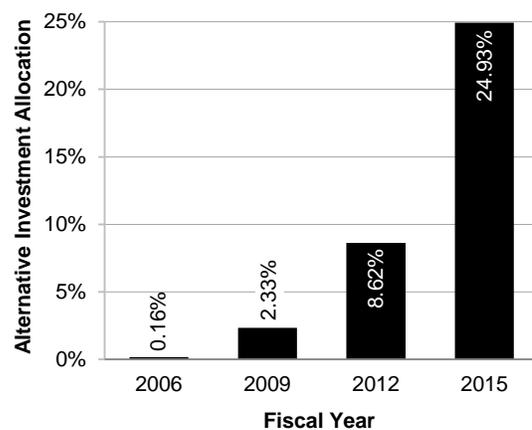
ERS Does Not Adequately Track or Report All Costs Associated With Alternative Investments.

Background

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

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

Change in Alternative Investments



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

Alternative Investment Terms

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

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

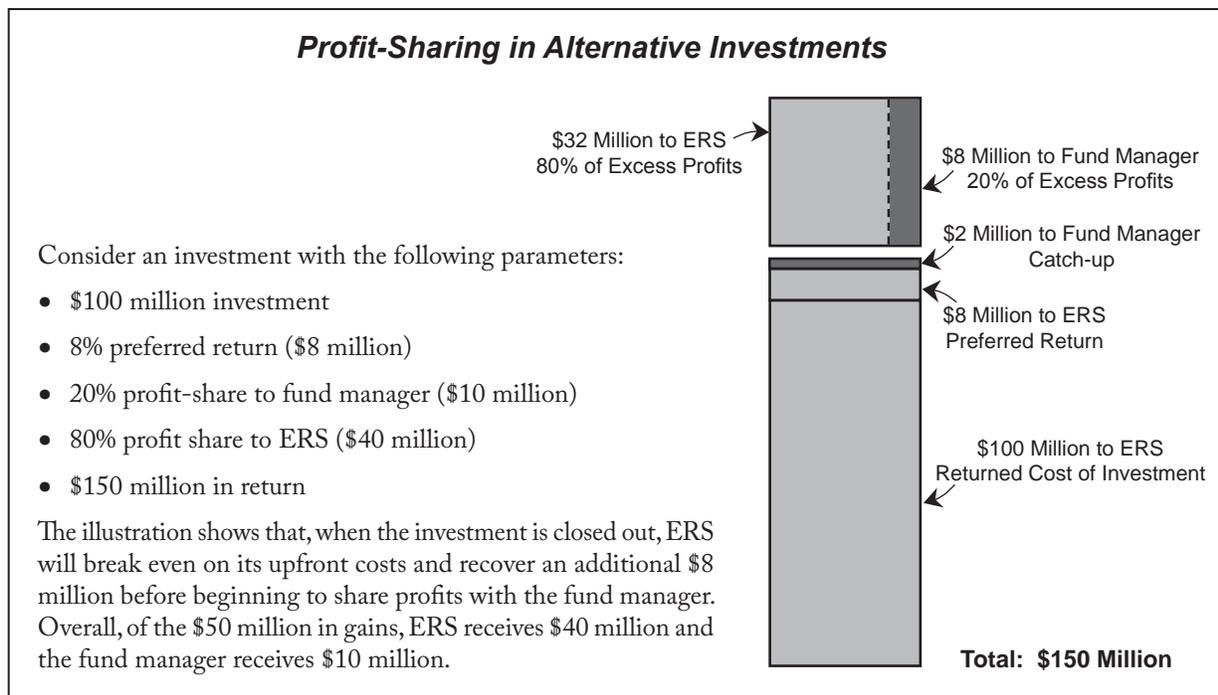
Preferred Return: A minimum investment target negotiated between an investor and the fund manager that must be paid to the investor prior to profit-sharing beginning. As an example, preferred returns in private equity are often around 8 percent of the original investment.

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

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

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

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



Findings

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

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

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

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

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

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

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

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

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

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

Recommendation

Change in Statute

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

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

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

Fiscal Implication

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

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

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

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

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

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

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

ISSUE 5

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

Background

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

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

Findings

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

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

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

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

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

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

Recommendations

Change in Statute

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

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

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

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

Fiscal Implication

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

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

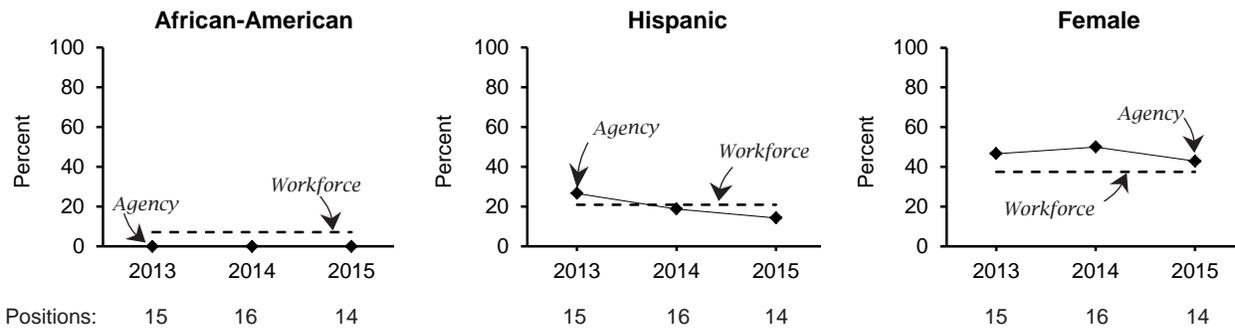
APPENDICES

APPENDIX A

Equal Employment Opportunity Statistics 2013 to 2015

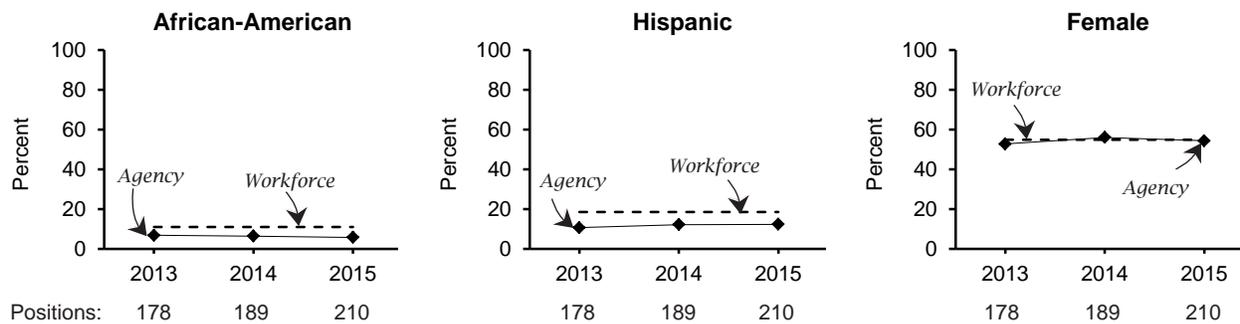
In accordance with the requirements of the Sunset Act, the following material shows trend information for the employment of minorities and females in all applicable categories by the Employees Retirement System of Texas (ERS).¹ The agency maintains and reports this information under guidelines established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

Administration



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

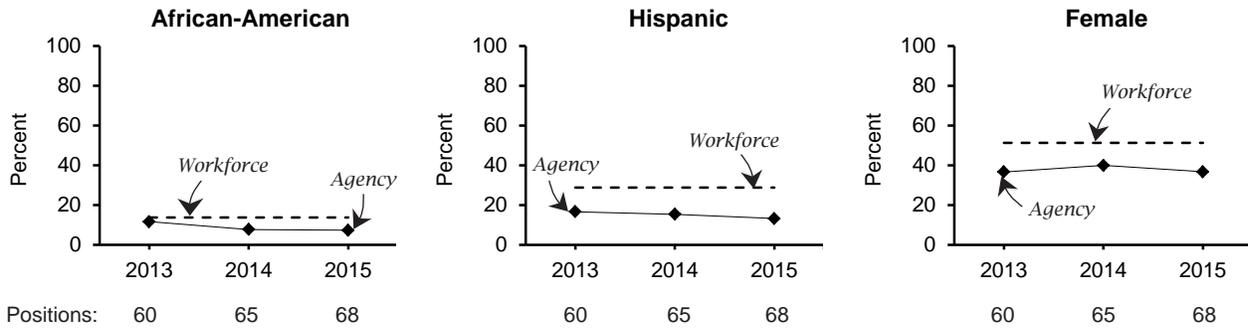
Professional



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

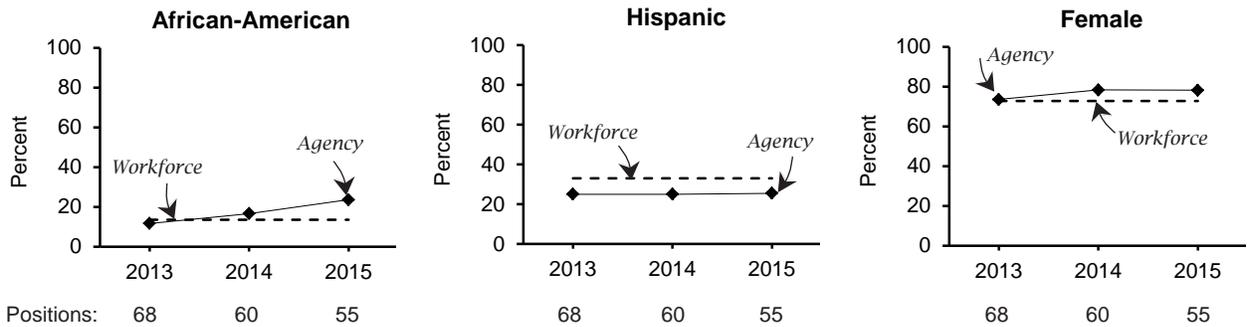
Appendix A

Technical



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

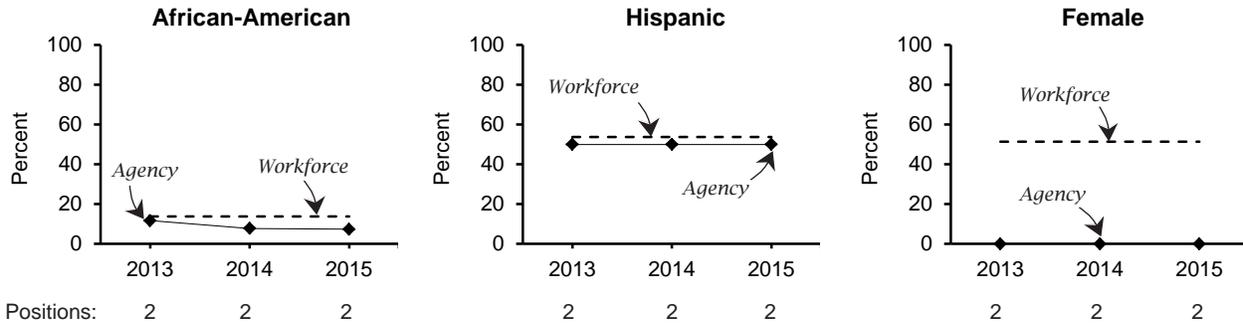
Administrative Support



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

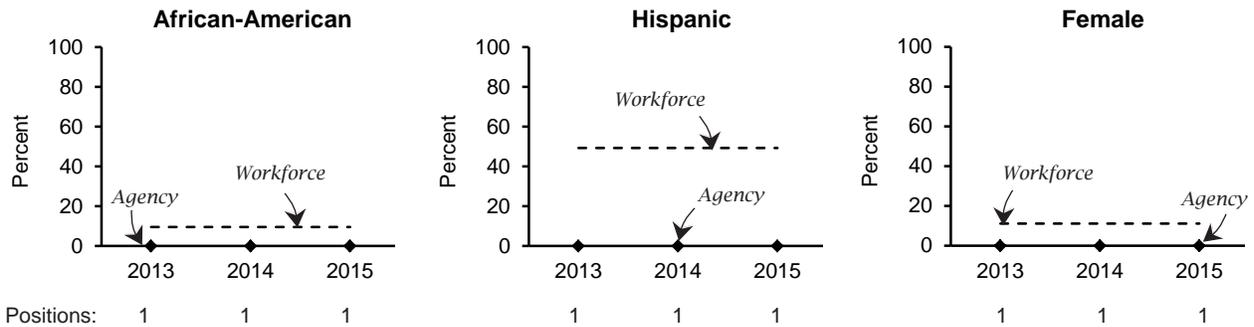
Appendix A

Service/Maintenance



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

Skilled Craft



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

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

² Section 21.501, Texas Labor Code.

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

APPENDIX B

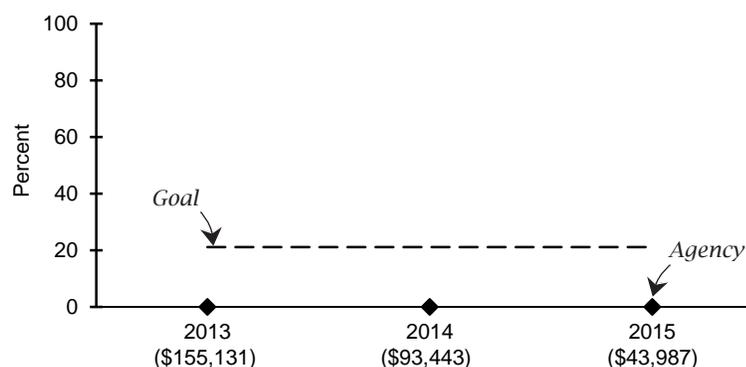
Historically Underutilized Businesses Statistics 2013 to 2015

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

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

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

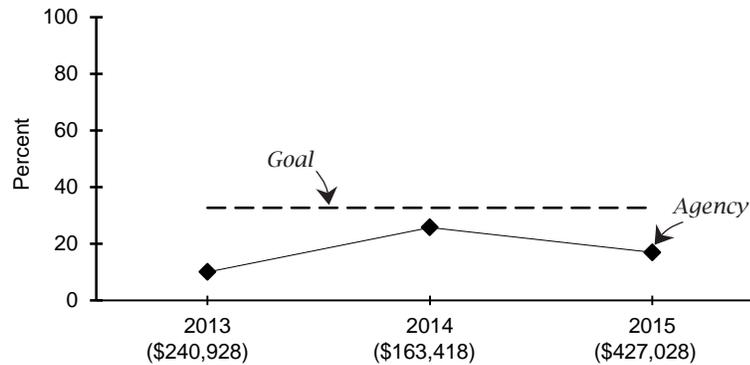
Building Construction



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

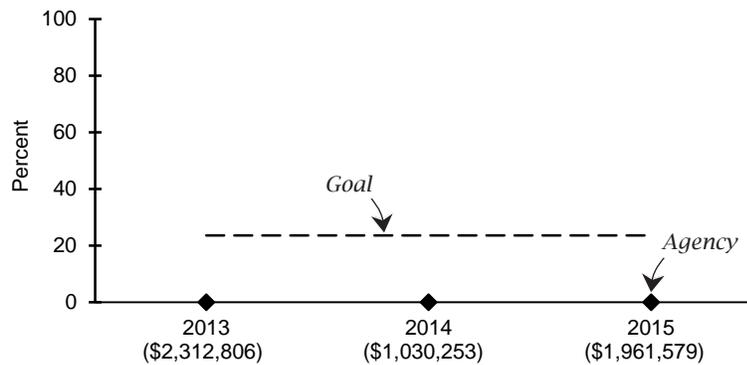
Appendix B

Special Trade



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

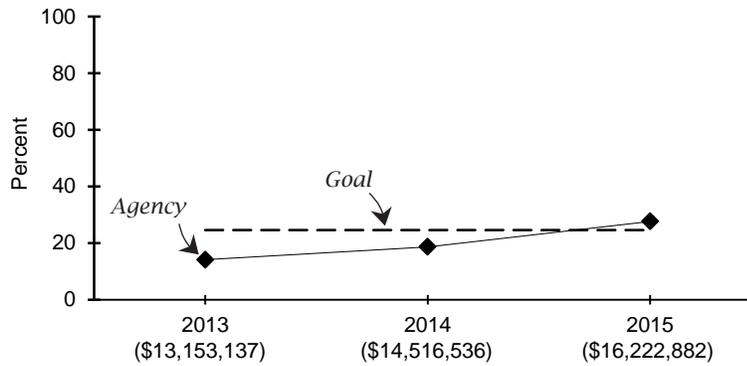
Professional Services



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

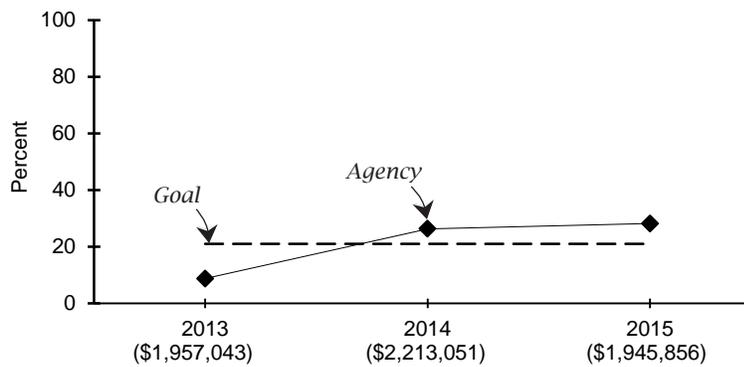
Appendix B

Other Services



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

Commodities



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

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

2 Chapter 2161, Texas Government Code.

APPENDIX C

Employees Retirement System of Texas Reporting Requirements

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

Appendix C

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

APPENDIX D

Staff Review Activities

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

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

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

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

————— *Report Prepared By* —————

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PUBLIC AGENDA ITEM - # 19*

19. Review and Discussion of Board Policy on Pension Funding Priorities and Guidelines

May 17, 2016

BACKGROUND:

As discussed at the February 23, 2016 board of trustees meeting, an internal staff workgroup at ERS has been researching the development of a formal, comprehensive pension policy for possible adoption by the board. ERS operates the retirement program within these policies and guidelines but has not previously compiled them into a centralized guidance document.

The objective of the project was to identify core elements of a comprehensive funding policy for ERS administered pension plans and craft a policy for board consideration.

The Board Policy on Pension Funding Priorities and Guidelines is a formally adopted policy that includes a systemic set of procedures used to determine the contributions needed in a specific year or over a series of years.

Funding policies have existed for a number of years but have a renewed focus due to the Governmental Accounting Standards Board (GASB) Statement 67/68 requirements that make a clear separation between accounting cost (expense) and funding cost (contributions). Prior GASB standards created the Annual Required Contribution (ARC) used as the default funding standards for many systems. ERS requests funding based on a variation of these methods. The creation of GASB 67/68 has changed that dynamic and many systems are adopting funding policies uniquely tailored to their needs and realities. Ideally, these policies address ongoing contributions to pay for benefits as well as how to finance gains/losses as experience occurs.

The three broad components of a funding policy include:

- Actuarial cost method: Allocates the total present value of benefits (TPV) between past service (actuarial accrued liability) and future service (normal cost);
- Asset smoothing: The technique used to recognize pension assets gains and losses over time so as to reduce the effects of market volatility and stabilize year-to-year contributions; and
- Amortization period: The length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded actuarial accrued liability or surplus.

In addition, funding policies can include a discussion on benefit enhancements (such as COLAs and/or 13th checks) as part of this process.

Possible Limitations of a Funding Policy

ERS contributions are set by the Legislature and have typically been based on a fixed percent of payroll. ERS has not historically been funded based on an actuarially determined need, but rather as a fixed percent of payroll. Some other systems adjust year-to-year rates based on an actuarially determined contribution.

Policy Adoption Process

- May 17, 2016 – A full policy draft is attached to this agenda item for review and discussion (Exhibit A).
- August 16, 2016 - A finalized policy document will be presented for board approval, incorporating any feedback from the May meeting.

This agenda item includes several exhibits. Exhibit A is the draft of the policy. Exhibit B is a comparison of best practices and system policies. Exhibit C is the current Texas Pension Review Board Guidelines. Exhibit D is a brief from Segal Consulting that compares the major best practice recommendations for funding policies.

** We are accredited by the State Pension Review Board (PRB) as a Minimum Educational Training (MET) sponsor for Texas public retirement systems. This accreditation does not constitute an endorsement by the PRB as to the quality of our MET program. This agenda item may be considered in-house training provided by ERS to board trustees and the system administrator for purposes of fulfilling the MET program requirements. ERS is an accredited sponsor of MET for its system administrator and trustees.*

This agenda item is provided for informational and discussion purposes only.

ATTACHMENTS – 4

Exhibit A –Draft Board Policy on Pension Funding Priorities and Guidelines

Exhibit B – Best Practices and System Comparisons

Exhibit C – Texas Pension Review Board’s Guidelines for Actuarial Soundness

EMPLOYEES RETIREMENT SYSTEM OF TEXAS
Board Policy on Pension Funding Priorities and Guidelines
(Draft Funding Policy)

Approved by the Board: Date to be determined

The Employees Retirement System of Texas (ERS) is a public trust established under the state constitution and statute to administer four defined benefit retirement plans for a diverse membership that includes judges/justices serving the district and appellate courts, district attorneys, members of the Texas Legislature, statewide elected officials, and state employees. The retirement trust funds are for the exclusive purpose of paying of retirement benefits for its members.

This document addresses the three pre-funded plans administered by the system, which include the ERS plan, the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOSRF), and the Judicial Retirement System of Texas Plan Two (JRS 2).

FUNDING OBJECTIVE

The main objective of ERS' retirement programs is to fully fund the long-term cost of benefits provided by statute, through disciplined and timely accumulation of contributions and prudent investment assets to deliver earned benefits on a continuing basis.

FUNDING GUIDELINES

This funding policy seeks to balance five main objectives:

- **Pay 100% of vested benefits** - Contributions and current plan assets must be sufficient to pay for all vested benefits expected to be paid to members and their beneficiaries when due. Protection and payment of vested retirement benefits is the Board's fundamental policy, and in the event of any conflict, that policy takes precedence over all other objectives and guidelines reflected in this policy.
- **Contribution Stability and Sound Financing of Benefits** –The Texas Constitution requires that the financing of benefits must be based on sound actuarial principles. It is the Board's desire that year-to-year contribution volatility be controlled to the extent reasonably possible while also achieving the sound actuarial financing of benefits during the appropriations process.
- **Inter-Generational Responsibility** – The costs of benefits, which are shared between the state (as the employer) and the employee, should be paid for by the generation that receives the benefits, whenever possible and in a manner consistent with the duty to pay all vested benefits when due and without reduction.
- **Workforce Parity** – Plan design, when possible, should treat the active workforce, other ERS members and annuitants equitably whenever possible.
- **Quality of Benefit** – System annuitants should receive a benefit that is sufficient to provide a foundation for retirement security.

KEY TERMS

The definitions below describe key terms used throughout the policy.

- **Actuarial Accrued liability (AAL)**: Also called accrued liability. That portion, as determined by a particular Actuarial Cost Method, of the Total Present Value of Benefits which is not provided for by future Normal Costs. It is equal to the Actuarial Present Value of Future Plan Benefits minus the actuarial present value of future Normal Costs.
- **Actuarially Sound Contribution (ASC) Rate**: The contribution rates needed to pay off any unfunded liabilities within a 31-year period per statute.
- **Board of Trustees**: The six-member governing body of ERS.
- **Defined benefit**: An employer-sponsored retirement benefit that provides workers, upon attainment of designated age and service thresholds, with a monthly benefit based on the employee's salary and length of service. The value of a benefit from a defined benefit plan is generally not affected by the return on the assets that are invested to fund the benefit.
- **Normal Cost Rate**: That portion of the Total Present Value of Benefits and administrative expenses which is allocated to a valuation year by the Actuarial Cost Method. Payment of an Unfunded Actuarial Accrued Liability is not part of Normal Cost (see Amortization Payment). Under the entry age normal cost method, the Normal Cost is intended to be the level cost (when expressed as a percentage of pay) needed to fund the benefits of a member from hire until ultimate termination, death, disability or retirement. For pension plan benefits which are provided in part by employee contributions, Normal Cost refers to the total of employee contributions and employer Normal Cost unless otherwise specifically stated.
- **Plans** (ERS, LECOSRF, JRS2):
 - ERS – DB plan that covers state employees (Regular Class and Law Enforcement and Custodial Officers) and elected officials, including statewide officials, members of the Legislature, and district attorneys.
 - LECOSRF – A DB plan providing a supplemental benefit for Law Enforcement and Custodial Officer (LECO) members; if eligible, they receive approximately 80% of their benefit from ERS and 20% from LECOSRF.
 - JRS 2 – DB plan for judges and justices serving on the district and appellate courts who began services on or after September 1, 1985.
- **Plan sponsor**: A designated party, typically the employer, that sets up a pension plan for its employees. For all pension plans administered by ERS, the plan sponsor is the state of Texas.

FUNDING METHODS

Actuarial Cost Method

For pre-funded defined benefit retirement plans, there is a Total Present Value of Benefits for all benefits expected to be paid to current plan members. Each plan must select a cost method

that allocates the Total Present Value of Benefits between past service (Actuarially Accrued Liability) and future service (normal cost).

The actuarial valuation uses the Entry Age Normal actuarial cost method. Under this method, the first step is to determine the contribution rate (level as a percentage of pay) required to provide the benefits to each member, or the normal cost rate. The normal cost rate is then split into two pieces: (i) the member's contribution rate, and (ii) the remaining portion of the normal cost rate which is the employer's normal cost rate. The total normal cost rate is based on the benefits payable to a new member and the entry age characteristics of the current active membership, which is commonly referred to as the "Ultimate" Entry Age Normal actuarial cost method.

The Unfunded Actuarial Accrued Liability (UAAL) is the liability for future benefits which is in excess of (i) the actuarial value of assets, and (ii) the present value of future normal costs. The employer contribution provided in excess of the employer normal cost is applied to amortize the UAAL.

Asset Smoothing Method

For pre-funded defined benefit retirement plans, asset smoothing reduces volatility in contribution rates by increasing the period over which gains and losses are recognized.

Currently ERS uses an adjustment method, where 20% of any remaining market gain or loss is recognized each year. This method typically results in lower year-to-year volatility, and it allows immediate offsetting gains or losses to be recognized, but it can take a longer period to reflect a specific significant gain or loss.

FUNDING PERIOD

A funding period policy is the length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded liability or surplus.

Section 811.006, Texas Government Code, in statute since 1985, includes a funding period policy of 31 years by prohibiting any benefit enhancement that would result in a funding period of more than 31 years for paying off any unfunded liabilities. Having a funding period standard in statute is a good practice.

A number of actuarial and financial groups including the Blue Ribbon Panel on Public Pension Plan Funding (commissioned by the Society of Actuaries), the Conference of Consulting Actuaries, and the Government Finance Officers Association have published recommendations for funding policies, including a well-defined funding period policy. These groups have recommendations for funding periods of 15-25 years. Within the state of Texas, the Texas Pension Review Board (PRB) is the oversight agency for all public retirement systems in the state. PRB publishes actuarial soundness guidelines. For funding period, those guidelines recommend a period of no more than 40 years, but ideally 15-25 years.

Note: Staff presents two options below but recommends option 2.

Option 1: While the Board recognizes the existing statute, it will track and report on a funding period of no more than 20 years based on a rolling amortization (where the 20 year rate is recalculated each year). In addition to the normal cost and ASC rates, the system's consulting actuaries will include a funding policy rate within each year's valuation that reflects the contribution rate need to meet this standard.

Option 2: While the Board recognizes the existing statute, it will track and report on a closed amortization period as of August 31, 2016 until a funding period of at least 20 years is reached. In addition to the normal cost and ASC rates, the system's consulting actuaries will include a funding policy rate within each year's valuation that reflects the contribution rate needed to meet this standard.

- The UAAL, (i.e., the difference between the Actuarial Accrued Liability and the Actuarial Value of Assets), as of August 31, 2016, shall be amortized over a "closed" 31-year period. In other words, the UAAL as of August 31, 2017 shall be amortized over 30 years, the UAAL as of August 31, 2018 shall be amortized over 29 years, etc.
- Beginning with the August 31, 2027 valuation, the Board shall have the discretion to continue the "closed" amortization period, or instead amortize the UAAL over another period, not to exceed 20 years.

CRITERIA FOR BENEFIT ENHANCEMENTS

The most common types of retirement benefit enhancements include

- **Cost-of-Living-Adjustment (COLA):** An adjustment to the base retirement benefit. Typically expressed as a percent. A COLA can be a set percent or tied to an index, such as the CPI.
- **Multiplier increase:** A multiplier is the percent of salary replaced for each year of service. Currently this rate is 2.3% for ERS and JRS 2, and 0.5% for LECOSRF. Over time, the multiplier was increased from 1.5% for the ERS plan to its current rate.
- **Supplemental payment:** Commonly referred to as a 13th check, a one-time supplemental payment does not result in an ongoing increase in the annuity. Annuities are paid on a monthly basis, with 12 checks per year. A 13th check is one additional annuity check per year.

These enhancements are not a designed feature of the pension plans administered by the system and therefore are not built into the cost rates and contribution rates for the plans. The Board has limited authority to grant supplemental payments (13th checks), but it typically will not do so without legislative input. The Board has no authority over granting COLAs or other benefit enhancements; these are set by the Legislature.

The Board does not generally take a formal position on whether a benefit enhancement should be granted unless the subsequent enhancement would result in a UAAL for the fund. But if the

Legislature would like to consider a benefit enhancement, the Board recommends that the following guidelines be considered:

- The plan's funding period should be no more than 20 years, before and after granting an enhancement;
- The plan's funded ratio should be at least 90%, before and after granting an enhancement;
- The enhancement should not rely on the trust balance for payment, but rather the state of Texas should make additional contributions to pay off the additional liability created by these enhancements via:
 - Annual payroll contribution (amortized over no more than 10 years) or
 - Lump sum equal to the additional amount of liability created
- Current employees should not be responsible for paying for retroactive, unfunded annuity enhancements for those members already retired.

GUIDELINES FOR FUTURE CONTRIBUTION RATE CHANGES

The state of Texas sets appropriations for a two-year period. Future budget commitments are not guaranteed beyond a two-year period. To provide an incentive to maintain contribution rates, Section 815.402, Texas Government Code, links the state and member contributions such that any future decreases in the state rate will be matched by an equal decrease in the member rate. In addition, the Texas Constitution, Article XVI, Section 67 requires ERS to be funded on actuarial principles. This constitutional provision also requires a minimum contribution of six percent of current compensation from system members, and a range of 6-10 percent of aggregate compensation from the state, unless the Governor determines that an emergency exists.

For all pension plans administered by ERS, the Texas Legislature determines the benefit design and the contribution rates. ERS does not have the authority to adjust the contribution rates. The ERS, LECOSRF and JRS 2 plans are currently, and have been historically, funded on a fixed percent of payroll, as required by the constitution. With a fixed percent of payroll funding structure, contribution rates received by the plan are not adjusted year-to-year based on actuarially determined need. This structure is in conflict with actuarial funding best practices but is not anticipated to change.

In seeking funding during the budget process, the Board directs staff to request funding based on the priorities and guidelines outlined in this document.

MEASURES FOR MONITORING PROGRESS TOWARDS GOALS

These are the key metrics the Board will monitor to measure progress, which will be included in each year's actuarial valuation.

- **Funding period:** *Also called amortization period.* The term "Funding Period" is used in two ways. In the first sense, it is the period used in calculating the Amortization Payment as a component of an actuarially determined contribution rate. For example,

the funding period of 31 years for the Actuarially Sound Contributions (ASC) rate is outlined in Section 811.006 of the Texas Government Code. Similarly, the funding period outlined earlier in this document determines the funding period for calculating the funding policy contribution rate. In the second sense, it is a calculated item: the number of years in the future that will theoretically be required to amortize (i.e., pay off or eliminate) the Unfunded Actuarial Accrued Liability, based on the statutory employer contribution rate that is not actuarially determined, and assuming no future actuarial gains or losses.

- **Funded ratio:** The ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL). Plans sometimes calculate a market funded ratio, using the market value of assets (MVA), rather than the AVA.
- **Unfunded Actuarial Accrued Liability (UAAL):** Commonly referred to as the unfunded liability, this is the excess of the Actuarial Accrued Liability over the Actuarial Value of Assets. This value may be negative in which case it may be expressed as a negative Unfunded Actuarial Accrued Liability, also called the Funding Surplus.
- **Funding Policy Rate:** The total contribution rate needed for each plan to meet the funding period policy set by the Board under the **Funding Period** section of this document.

MONITORING FUNDING PROGRESS

The Board, with input from System staff and the System's consulting actuary, will monitor the System's progress towards meeting the guidelines and objectives contained within this policy.

As needed, the Board will update this policy to reflect significant changes in funding, benefits or methodologies used to monitor funding progress.

Exhibit B – Best Practices and System Comparisons

Exhibit B will be presented during the meeting.

Item 19, Exhibit B – Pension Funding Policy Best Practices and System Comparisons

Table 1. Best Practices Recommendations’ Objectives for Retirement System Funding Policies

Objective	Conference of Consulting Actuaries	American Academy of Actuaries	Blue Ribbon Panel/Society of Actuaries	Government Finance Officers Association Best Practice	ERS Status?
Fund the expected cost of all promised benefits	X	X	X	X	Making progress with finite funding period for ERS; LECOSRF and JRS 2 still on path to depletion.
Match annual contributions to fund the cost of benefits to years of service	X	X	X	X	Current contributions for all plans cover the full normal cost, plus an amount towards the unfunded liabilities.
Manage contribution volatility	X	X	X	X	Yes. ERS is funded based on smoothed value of assets.
Balance competing objectives	X	X	X	X	Identified in draft policy, but paying vested benefits is the identified priority over other objectives.
Identify risks/barriers to achieving funding objectives	X	X	X		Several identified in draft policy (ie, the Legislature controls contribution rates and benefit design; budget limited to two year windows).
Communicate how the funding policy objectives will be achieved by the contribution allocation procedure	X	X		X	Typically, actuaries allocate member’s contribution to normal cost first. Any remaining normal cost is paid by the state contribution. Any balance on state rate goes towards unfunded liabilities.
Establish an enforcement mechanism for making contributions on a consistent actuarially determined basis	X	X	X	X	ERS does not have the authority to set contribution rates. Its plans are funded on a fixed percent of payroll rather than an actuarially determined need.

Source: Segal Consulting and ERS.

Item 19, Exhibit B – Pension Funding Policy Best Practices and System Comparisons

Table 2. Retirement System Funding Policies and Actuarial Methods

System/Group	Actuarial Cost Method	Asset Smoothing	Amortization Policy	Benefit Enhancements Policy	Funded based on Actuarially Determined Need
Best Practices and Where Texas ERS stands					
Best Practices	Varies Entry Age Normal Cost is the most common.	Varies 3-year fixed is model practice. 5-year fixed is acceptable.	Unfunded liabilities should be paid off in no more than 10-25 years. Some groups prefer closed amortization periods, which force the amortization period down by one year at each valuation.	Enhancements should be pre-funded and built into the normal cost rates. If it is an ad-hoc enhancement, full liability for the enhancement should be paid at time granted or paid off within a time limited period.	Plans should be funded based on an actuarially determined need and rates adjusted from year to year.
Texas ERS	Entry Age Normal Cost (Ultimate)	20% gain/loss recognized each year. The smoothing method may be revisited during the 2017-18 experience study.	Partial Statutory standard in Government Code 811.006 for 31 years (and is interpreted as on open, or rolling amortization that is reset every year).	No Enhancement done on an ad-hoc basis by Legislature.	No Funded on fixed percent of payroll with no enforcement mechanism at the system level.
Peer Texas Systems (alphabetically)					
City of Austin ERS	Entry Age Normal Cost (Individual)	5-year smoothing Direct offset with 20% corridor	25 years	Yes The COA plan was not intended to have regular COLAs, but it is a stated priority in the funding policy. The board set criteria for supporting future enhancements if and when the system is has a funding period of 20 years or less, and at least an 80% funded ratio. Board would ideally like to see the plan be 120% funded with regular COLA assumption built into cost rates.	No Funded on a fixed percent of payroll. The city has been contributing additional amounts for the employer rate since 2010 beyond the 8% statutory requirement to improve the funding status of the plan (currently the plan has an employer rate of 18%).
Texas County and District	Replacement life entry age normal cost	5-year smoothing	Closed amortization, 20 years	Yes, if employer selects one. Must be paid off within 15 years, closed amortization.	Yes System sets the rates for the employers and employers must pay it, per state law.

Item 19, Exhibit B – Pension Funding Policy Best Practices and System Comparisons

Texas Municipal	Entry Age Normal Cost (Individual)	10-year with 15% corridor	For plans with unfunded liability, a closed amortization is used, 25 years (or 30 years if meeting criteria), laddered as new unfunded liabilities accrue. Employer plans that are overfunded use an open amortization.	Yes, if employer selects one. Must be paid off within 15 years, closed amortization.	Yes System sets the rates for the employer.
Texas TRS*	Entry Age Normal Cost (Ultimate)	20% gain/loss recognized each year, with a 5-year phase-in.	Partial Statutory standard in Government Code 821.006 for 31 years (and is interpreted as on open, or rolling amortization that is reset every year).	No Enhancement done on an ad-hoc basis by Legislature.	No Funded on fixed percent of payroll with no enforcement mechanism at the system level.
Other State Retirement Systems (alphabetically)					
New Mexico Educational	Entry Age Normal Cost (Individual)	5-year smoothing	Open amortization, 30 years.	Yes Board requires that plan be 100% funded after any enhancements.	No Funded on fixed percent of payroll
North Dakota TRS	Entry Age Normal Cost (Individual)	5-year smoothing with 20% corridor	Transitional Closed amortization, 30 years. When 20 years is reached, the board may switch to open amortization.	No Ad-hoc COLAs occasionally granted	No Funded on fixed percent of payroll
Wisconsin Retirement System	Frozen initial liability	5-year for Core Fund (Variable Fund is not smoothed)	40 years if employer joined before 2009 30 years if employer joined after 2009	WRS does not have traditional COLAs or enhancements. Instead, members choose between Core Fund (less risky) and Variable Funds (more risky), and can receive dividends based on actual investment performance.	Yes System sets the rates for the employers.

*Like Texas ERS, Texas TRS does not currently have a funding policy.

**Exhibit C – Texas Pension Review Board’s Guidelines for
Actuarial Soundness**

Exhibit C will be presented during the meeting.

PRB Guidelines for Actuarial Soundness
(Adopted September 28, 2011)

1. The funding of a pension plan should reflect all plan obligations and assets.
2. The allocation of the normal cost portion of the contributions should be level or declining as a percent of payroll over all generations of taxpayers, and should be calculated under applicable actuarial standards.
3. Funding of the unfunded actuarial accrued liability should be level or declining as a percent of payroll over the amortization period.
4. Funding should be adequate to amortize the unfunded actuarial accrued liability over a period not to exceed 40 years, with 15 - 25 years being a more preferable target. Benefit increases should not be adopted if all plan changes being considered cause a material increase in the amortization period and if the resulting amortization period exceeds 25 years.
5. The choice of assumptions should be reasonable, and should comply with applicable actuarial standards.

PUBLIC AGENDA ITEM - # 20

20. Executive Director Agency Update

May 17, 2016

Legislative Updates

The agency has been busy performing research, preparing presentations, and testifying before House and Senate interim committees. On March 30th, ERS testified to the House Insurance Committee on the subject of acquired brain injuries, to the Senate Finance Committee on state debt and to the House Pensions Committee with a general overview. The following week, ERS appeared before the House Public Health Committee. We provided information on chronic health conditions, their cost to the state, and ideas on how to reduce that cost.

On April 13th, ERS had two committee hearings on the same morning. We returned to the House Pensions Committee to discuss global investments. The Senate State Affairs committee also conducted its general oversight hearing that morning. Finally, on April 20th, ERS testified before the House Appropriations Committee on the great work done by the legislature last session to increase contributions and put the trust fund on a path to actuarial soundness.

Thanks to Tom Tull and Rob Kukla for attending hearings and providing testimony. Also our thanks to Mabelle Pharr, Shar Kassam and the staff of the Governmental Affairs division for doing prep work, research and preparing all of our presentations, with help from Benefits Communications.

At the invitation of the Lt. Governor and Senator Nelson, the Executive Director, CFO and Board Member Brian Ragland attended a presentation on zero-based budgeting. In Senator Nelson's address to the audience, she stated that select agencies would be asked to provide additional detail on specific programs so that a more in-depth review could be conducted. Senator Nelson introduced Teresa MacCarthy to present how Zero-Based Budgeting works in Georgia. Ms. MacCarthy is the Director of the Governor's Office of Budget and Planning in Georgia. Ms. MacCarthy discussed how Zero-Based Budgeting is integrated with other forms of budgeting in Georgia and how it might be utilized in Texas. Senator Nelson advised the audience to eliminate the assumption that current funding level is the starting point for the next biennial budget.

ERS' Office of Procurement and Contract Oversight

On April 1st, ERS created a new division: the Office of Procurement and Contract Oversight to assist the entire agency with procuring and managing contracts. Gabrielle Stokes, the Director of Procurement is directing the new team which combines staff from the legal and benefit contracts divisions. The Division has two managers: Carol Stueler, Contract and Procurement Manager, and Ginger Grissom, Proposal Activity Manager.

The new Division will work closely with the appropriate business division to develop solicitation documents and oversee all steps of the procurement and contract management processes. The business units will continue to make business decisions related to their procurements and contracts, with oversight and guidance from Procurement and Oversight. The new division is busy drafting consistent agency policies and procedures, ensuring compliance with Senate Bill 20 provisions and issuing a number of RFPs, including one of our biggest procurements – a third party administrator for HealthSelect.

This division will report to Paula Jones, who will continue to oversee legal services, in addition to these new responsibilities. Her title will be Deputy Executive Director and General Counsel.

DeeDee Sterns – Named Director of Human Resources

DeeDee has worked at ERS for 21 years. Except for a short stint as Technical Training Coordinator in Customer Benefits, she has devoted her career to Human Resources. She has earned important human resource professional certifications, including the Senior Professional in Human Resources (SPHR®). In June 2013, as part of succession planning, she attended leadership training and shadowed Ralph Salinas until his retirement last December. For the last few months she has served as the Acting Director of Human Resources.

DeeDee brings a wealth of institutional knowledge to this position, along with analytical and collaborative skills. Her goals include working with each division to help them attract and grow staff, and to identify and develop new strategies to make ERS an even better place to work.

Machelle Pharr – Named as the ERS Chief Financial Officer

Machelle joined ERS in June 2014 as the Assistant Director of Finance. When Mike Wheeler, the previous CFO, retired in August 2015 Machelle stepped in as Interim CFO, leading the division through the recent publication of the CAFR, Sunset review, and implementation of new legislation from the 84th session.

Machelle has held CFO and other senior-level positions at Texas agencies for over 20 years. During her time at agencies including Comptroller of Public Accounts, Department of Public Safety and Texas Commission on Environmental Quality Machelle gained a wealth of knowledge about Texas financial reporting, budgeting, purchasing and accounting systems.

Annual Enrollment for Plan Year 2017

Summer Enrollment for Plan Year 2017 will take place over a five-week period from July 11 – August 12, 2016. Summer Enrollment will be divided into four phases. Each phase will span a two-week period in which members can make enrollment changes. (See phase chart below.)

Annual Enrollment for Plan Year 2017				
July 11, 2016 – August 12, 2016				
	Monday	Sunday	Sunday	Sunday
	July 11	July 17	July 24	July 31
Phase 1 (July 11 – July 23)	█			
Phase 2 (July 17 – July 30)		█		
Phase 3 (July 24 – August 6)			█	
Phase 4 (July 31 – August 12)				█

ERS will have new and complex information to communicate to our members this summer as we prepare to implement the new Consumer Directed HealthSelect (CDHS) plan and a new vision plan for September 1, 2016. We will communicate the details of these plans and other benefit information to our members throughout Summer Enrollment. We plan to host 35 Summer Enrollment fairs across the State and conduct 10 webinars, from July 5 through August 10. The fairs provide us an opportunity to share important benefit information and allow members to make their desired benefits changes. The fairs are a great way for ERS to directly interact with our members.

Fall Enrollment for our Medicare-eligible retirees will be in the October-November timeframe to coincide with the federal Medicare enrollment period.

Consumer Directed HealthSelectSM Communications

Communications are underway to introduce members to Consumer Directed HealthSelect, the high-deductible health plan (HDHP) with health savings account (HSA) being offered as a new health insurance option to Texas Employees Group Benefits Program (GBP) participants.

The ERS implementation team worked with an outside consultant and ERS leadership to create the brand name and logo. Articles about the plan have run in *News About Your Benefits*, the monthly email newsletter for active employees, and *Update-express*, the biweekly email newsletter for benefits coordinators. Articles will continue to run in those newsletters, as well as in *Your ERS Connection*, the quarterly retiree newsletter, throughout Summer Enrollment and beyond. ERS also worked with an outside production company to develop a five-minute video that provides an overview of the plan and how its coverage compares to the existing HealthSelect of Texas plan and the regional HMOs.

In addition, ERS and the plan's third-party administrators – UnitedHealthcare, Caremark and Optum Bank will conduct pre-Summer Enrollment seminars and webinars for members and benefits coordinators. There will also be comprehensive information available at the Summer Enrollment fairs and on the ERS website.

Our goal is to help members understand the potential costs and benefits of Consumer Directed HealthSelect, so they can make informed choices about their health coverage.

HealthSelect Innovation Day

On March 29, HealthSelectSM of Texas administrator UnitedHealthcare hosted two Innovation Day events in Austin, with the goal of highlighting value-added programs that can help HealthSelect participants make the most of the health plan and live healthier lives. One event was for legislators and their staff, with about 50 attendees. The second event, for agency and institution benefits coordinators, had 90 attendees. Both events featured presentations about UnitedHealthcare programs – such as Virtual Visits online urgent care, the Real Appeal weight loss program, the Health4Me app and the myHealthcare Cost Estimator. The benefits coordinators were especially appreciative of the information and seemed eager to share it with employees at their agencies and institutions. In a survey conducted after the benefits coordinator event, 100% of respondents said they found it informative and useful, and more than 90% said they shared the information at their agency or institution.

2016 Get Fit Challenge

BACKGROUND:

The 2016 Get Fit Texas! Challenge kicked off January 17 with a challenge to “bring home the gold” and regain bragging rights as the #1 Fittest State Agency.

Since Get Fit's inception in 2013, ERS has dominated the mid-size agency category. In 2013 and 2014, ERS earned #1 Fittest State Agency and took home second place honors in 2015.

RESULTS:

ERS' participation rate in this year's Get Fit Challenge was incredible. 256 employees, or 71%, registered to participate.

218 employees completed the six-week challenge. The results of the challenge were announced on April 20. ERS accomplished its goal of regaining bragging rights as the #1 Fittest State Agency in our category. Additionally, we completed the competition with the greatest margin of victory ever.

Congratulations to the other agencies that placed in our category: Texas Legislative Council and Texas Department of Licensing and Regulation.

Results from the 2016 Survey of Employee Engagement (SEE)

ERS participated in its 8th organizational assessment survey in March 2016. The employee engagement measurement tool is prepared and given by the Institute for Organizational Excellence at the University of Texas. ERS has participated every even numbered year since 2002.

The purpose of the SEE is to:

- o Assess the organizational climate
- o Serve as a measurement tool for employee engagement
- o Focus on the key drivers relative to the ability to engage employees towards successfully fulfilling the vision and mission of the organization

The employee response to the survey was again exceptional, with an 89.4% response rate, exceeding our agency goal of 85%. Survey scores measure employee perceptions of agency success and areas of improvement. State agencies overall survey scores typically range from 325 to 375. ERS scored **391**, compared to its 2014 score of 401.

As a reminder, survey questions were rated on a 1-5 scale, from strongly disagree, disagree, neutral, agree and strongly agree. A score above 375 in an area, or 3.75 on an individual question, is viewed as an area of substantial strength.

The Texa\$averSM 401(k) / 457 Program continues its winning streak

Texa\$aver submitted award entries for its "Pump Up Your Savings" video and was awarded the following:

Pension & Investments announced Texa\$aver received a 2nd Place 2016 Eddy Award in the category of Special Projects.

The P&I Eddy Awards were created over 20 years ago to identify and reward the best practices in providing investment education to defined contribution plan participants. The awards are judged by an independent panel of plan sponsors and consultants. Awards are given out in seven categories, which are broken down by corporate employee size and/or type of firm.

AVA Digital Awards announced Texa\$aver won two 2016 AVA Digital Awards. The Program won the Platinum Award, the highest honor in the competition, in the category Video for the Web: Government,

and also won the Gold Award in the category Video for the Web: Informational.

AVA Digital Awards is an international competition that recognizes excellence by creative professionals responsible for the planning, concept, direction, design and production of digital communication. Work ranges from digital engagement campaigns – to audio and video production – to website development – to social media interaction – to mobile marketing.

Association of Marketing and Communication Professionals (AMCP) announced TexaSaver is the winner of four Platinum Hermes Creative Awards, the highest honor in the competition, in the following categories: Communication/Marketing Campaign, Video for the Web, Benefits Video, Marketing (Service). The Program was also awarded two Gold Hermes Creative Awards in the Government and Video Script categories.

AMCP is an international organization consisting of marketing, communication, advertising, public relations, media production, web and freelance professionals. As part of its mission, AMCP fosters and supports the efforts of marketing and communication professionals who contribute their unique talents to public service and charitable organizations.

National Association of Government Communicators (NAGC) announced TexaSaver is the winner of a 2016 Blue Pencil & Gold Screen (BP&GS) Award in the category of Internal Communications. The First Place, Second Place and Awards of Excellence will be announced at the Blue Pencil & Gold Screen Awards Ceremony and Reception to be held on June 7.

The custom, “Pump Up Your Savings” video targeted enrolled participants on how increasing their contribution, in conjunction with compound growth, could result in even more savings at retirement.

The video, released on June 17, 2015, was promoted from www.texasaver.com via a clickable web banner and a targeted email which resulted in a 40% open rate, well above the industry average. From the video’s release through September 28, an additional 4.4% of eligible participants enrolled in TexaSaver and 10,148 participants increased their contribution percentage in TexaSaver. This is a 123% increase from the same time period as last year.* The “Pump Up Your Savings” video educated and informed current and prospective participants of how TexaSaver can help close the savings gap and help them PUMP UP THEIR SAVINGS.

* Contribution percentage may include individuals automatically enrolled at 1% in the 401(k) plan.

Investments Update

Honorable Mentions:

The Fixed Income team won the Best Institutional ETF User award. ERS has been a vocal and significant adopter of ETFs, particularly Fixed-Income ETFs. The firm showed how the liquidity that ETFs offer allowed it to efficiently migrate capital to adjust for a changing fixed-income environment.

Tom Tull was awarded the Young Jewish Professionals Leadership and Achievement Award at the Young Jewish Professionals CIO Forum in March of 2016. The organization provides business networking and mentoring sessions for the new generation of business leaders.

Anthony Curtiss, ERS’ Hedge Fund Portfolio Manager was named 2016 Forty Under Forty by Chief Investment Officer Magazine. This prestigious honor is comprised of nominations from asset managers and allocators.

PUBLIC AGENDA ITEM - #21

21. Set Date for the Next Joint Meeting of the ERS Board of Trustees and Investment Advisory Committee, the Next Meeting of the Board of Trustees and the Next Meeting of the Audit Committee

May 17, 2016

2016 Meeting Dates:

Tuesday, February 23, 2016

Tuesday, May 17, 2016

Tuesday, August 16, 2016

2 Day Workshop:

Thursday – Friday, December 1 & 2, 2016

PUBLIC AGENDA ITEM - #22

22. Adjournment of the Board of Trustees

May 17, 2016