Representative Chris Tuck

Serving House District 23 • Dimond Estates, Foxridge, Taku, Campbell, Northwood, and Windemere

DATE: March 23, 2020

TO: Legislative Budget and Audit Committee

FROM: Representative Chris Tuck, Chair
Legislative Budget and Audit Committee

C.T.

RE: Alaska Mental Health Trust Authority Special Audit Request

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In response to concerns over management of the Alaska Mental Health Trust, an audit was requested at the end of 2016. After completing the audit, the Legislative Auditor concluded that the Mental Health Trust Authority's board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting $44.4 million in cash principal from the Alaska Permanent Fund Corporation (APFC). The audit found that despite statutory requirements that cash principal be managed and invested by the APFC, the Authority's board of trustees suspended transfers of cash principal to the APFC for almost 10 years. Instead of transferring cash principal to the APFC for investment, $39.5 of $44.4 million was directly invested in seven commercial real estate properties using the Trust Land Office within the Department of Natural Resources to facilitate the commercial real estate investment transactions and to manage the properties. Six of the seven properties were mortgaged, and the proceeds were used, in part, for additional commercial real estate investments.

On November 13, 2019, the Authority reported that action has been taken to address the audit's concerns.
Given the gravity of the 2018 audit's conclusions, I am recommending the Legislative Auditor conduct a follow-up audit to include the following objectives:

1. The Authority has reported that approximately $40 million of the Trust's settlement income funds were transferred to the Mental Health Trust Fund managed by the APFC to bring the fund to the same funding level it would have been if the cash principal had not been invested in commercial real estate. The audit should:

    a. Verify the funds were transferred;
    b. Evaluate the impact of transferring $40 million of Trust settlement income funds on the Authority's ability to provide for spending if the asset portfolio does not achieve its earnings objectives; and
    c. Determine whether cash principal has been transferred to the APFC in a timely manner since the prior audit was issued;

2. Determine whether the Mental Health Trust Fund managed by APFC was reconstituted for cash principal inappropriately spent on program related investments as discussed in the 2018 audit's Recommendation No. 2;

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3. Identify whether regulations and policies that allowed the Authority to use cash principal for the investment in commercial real estate outside the APFC were amended to comply with statutes in light of the audit's conclusions; and

4. Address other issues of concern identified by the Legislative Auditor during the audit.

Report Highlights

Why DLA Performed This Audit

The audit was requested in response to allegations that the Alaska Mental Health Trust Authority (Authority) was not managing its assets and conducting its business in compliance with applicable laws.

What DLA Recommends

1. The Authority board of trustees should stop investing in commercial real estate through the TLO, consult with the APFC on the treatment of commercial real estate investments acquired to date via TLO, and transfer the Trust Authority Development Account's cash principal balance to the APFC.

2. The Authority's board of trustees should fund future program-related investment (PRI) activities from the Trust income account and reconstitute the APFC with cash principal used on PRIs to date.

3. The Authority's board of trustees should work with the Authority and TLO management to revise the Asset Management Policy Statement and Resource Management Strategy to incorporate industry best practices and facilitate compliance with State investment laws.

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A Performance Review of the Department of Revenue, Alaska Mental Health Trust Authority Asset Management and Other Select Issues

February 8, 2018

Audit Control Number 04-30090-18

REPORT CONCLUSIONS

The audit concluded that the Authority's board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting $44.4 million in cash principal from the Alaska Permanent Fund Corporation (APFC). Alaska statutes clearly and unambiguously command that cash principal be managed and invested by the APFC. Despite the requirement, the Authority's board of trustees suspended transfers of cash principal to the APFC for almost 10 years. The board of trustees' actions appeared to be well intentioned, driven by a desire to maximize revenue for use by beneficiaries. However, the actions did not comply with law and were contrary to the roles and responsibilities outlined in the settlement.

Instead of transferring cash principal to the APFC for investment, $39.5 of $44.4 million was directly invested in seven commercial real estate properties (five located out-of-state) using the Trust Land Office (TLO) to facilitate the commercial real estate investment transactions and to manage the properties. Six of the seven properties were mortgaged and the proceeds were used, in part, for additional commercial real estate investments. The audit concluded that the TLO does not have the legal authority to manage commercial real estate investments. In accordance with the settlement and State law, investment is a function of the APFC. Furthermore, in approving these investments, the Authority's board inflated investment costs and reduced the asset diversification of the Trust portfolio as a whole. It is more appropriate and efficient to carry out commercial real estate investments via the APFC.

The remaining $4.9 million in diverted cash principal was used for land development activities, including constructing and developing properties primarily used by beneficiary programs.

Report Highlights (Continued)

4. The Authority's board of trustees and chief executive officer should design and implement written procedures to ensure trustees comply with the Alaska Executive Branch Ethics Act, the Open Meetings Act, and Authority's bylaws.

REPORT CONCLUSIONS (Continued)

Because statutes require cash principal be managed and invested by the APFC, the only potential funding mechanism available in statutes for land development activities is Trust income. Development activities funded by cash principal included the mining exploration of Icy Cape. As of FY 17, the TLO had spent a total of $1.6 million in cash principal for Icy Cape mine exploration, and the board of trustees approved another $3 million for additional exploration activities.

In 2017, the Authority's management proposed draft legislation to its board of trustees to allow for the use of cash principal to purchase and develop real estate through the TLO and to ratify similar actions previously taken by the board. Public record provides no evidence that the Authority's management or board of trustees considered the proposed statutory changes in context of the settlement. The audit concluded that proposed changes to the Authority's statutes constitute a material change to statutes that present a substantial risk of provoking successful litigation to void the settlement agreement if the proposed changes become law.

As part of this audit, an investment firm was hired to evaluate the Authority's asset management policies for compliance with State investment law and industry best practices. The contractor concluded that the policies fall short in several areas including: lack of an entity-wide perspective that addresses all Trust assets; lack of guidance for the TLO's commercial real estate investment program; and failure to provide a rationale for using the TLO as a real estate investment manager at the time the investment decisions were made.

The audit concluded that the Authority's board of trustees did not comply with the Alaska Executive Branch Ethics Act, Open Meetings Act, and the Authority's bylaws when conducting its business. Evidence showed that multiple trustees were, at times, intentionally trying to avoid discussing board business in a public manner. Other times, evidence showed the board failed to recognize the importance of or need for adhering to State laws when conducting and noticing its meetings.

The review of Authority activities and relationships did not identify less than arm's length transactions. However, the audit found several employee and trustee professional and personal relationships that created an appearance of related parties or increased the risk of fraud or abuse. The audit found no indication that Authority financial statements materially misstated TLO-managed assets.

Trust
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Trust Authority

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November 13, 2019

Representative Chris Tuck
Legislative Budget and Audit Committee
Alaska Capitol
Juneau, AK 99811

Dear Chairman Tuck:

Please accept this letter as the report requested in sec. 8, ch. 2 FSSLA 2019. We appreciate the opportunity to describe the progress the Trust has made in the last three years.

Background

A 2018 legislative audit raised several concerns with recent Trust operations and investments. Perhaps the most important audit finding was a concern that certain Trust investments were not compliant with Trust statutes or the settlement of the Weiss litigation. From 2010-2016 the Trust invested approximately $40 million of principal income in seven commercial real estate properties in Alaska and three other states instead of depositing those funds into the Mental Health Trust Fund (MHTF) to be managed by the Alaska Permanent Fund Corporation (APFC). The legislative audit opined that the Trust did not have the authority to make those investments and that the investments might not be appropriate – even if allowable.

Corrective Actions

Here is a summary of the most significant actions the Trust has taken since 2017 to address concerns related to commercial real estate investments.

The Trust has not made any further commercial real estate investments since the audit findings were released, and no additional commercial real estate investments are contemplated.

The Trust has transferred funds (approximately $40 million) from settlement income funds to the MHTF to bring the MHTF to the same funding level it would have been if the principal funds had not been invested in commercial real estate. To the extent that there is a concern that the MHTF was harmed by the commercial real estate investments, that perceived harm has been eliminated.

The Trust has revised its Asset Management Policy Statement (AMPS), as recommended by the legislative audit, to adopt best practices regarding the management of Trust owned real estate investments and to implement guidelines for including real estate investments within the Trust's overall asset mix. The revised AMPS, based on recommendations from Callan, LLC, identifies parameters and expectations for Trust-owned real estate investments, incorporates industry best practices, and considers the commercial real estate holdings as part of the portfolio-wide asset allocation strategy.

As required by the revised AMPS, the Trust has secured the services of a commercial real estate investment advisor. Harvest Capital Partners, LLC has been retained to evaluate these investments and their management, provide direction on the preparation of a comprehensive annual operating budget, advise on property management decisions, advise on tactical and strategic plans for each of the properties and as a portfolio, and report annually to the Trustees. Harvest Capital is a highly regarded investment services provider serving a variety of institutional investors with current direct real estate holdings of over $8 billion.

Conclusion

Although the Trust does not agree that its commercial real estate investments were ever non-compliant, we have taken several substantive steps to address the concerns raised in the 2018 legislative audit. As such, in response to the specific question in the legislative intent language, the Trust is in full compliance with the Weiss settlement and Alaska statutes with respect to investment in commercial real estate properties.

Finally, as we have stated in prior correspondence regarding the legislative audit, we appreciate the opportunity to review our operations, and to improve our business practices and governance. In addition to addressing the commercial real estate investments, we have completed corrective actions relating to all of the audit's other findings. The legislative audit, the Trust's responses and our AMPS are all available on the Trust website.

Please contact us if you have questions about these or other Trust issues.

Sincerely,

Michael K. Abbott
Chief Executive Officer

cc: Senator Burt Stedman, Co-Chair Senate Finance Committee
Senator Natasha Von Imhof, Co-Chair Senate Finance Committee
Representative Neil Foster, Co-Chair House Finance Committee
Representative Jennifer Johnston, Co-Chair House Finance Committee
Kris Curtis, Legislative Auditor