

# Report Highlights

## Why DLA Performed This Audit

The audit was requested to evaluate the corrective action taken by the Authority to address the prior audit findings related to select asset management issues.

## What DLA Recommends

1. The Authority's board of trustees should consider liquidating the TLO managed commercial real estate investments or transferring the investments to the APFC as inflation-proofing.
2. The board of trustees should develop written procedures to ensure that annual withdrawals are correctly calculated.
3. The board of trustees should develop written policies to ensure Trust income reserves are correctly determined.
4. The board of trustees should consider developing written policies that require inflation-proofing occur annually if Trust income reserves are sufficient.

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

July 6, 2021

**Audit Control Number 04-30099-21**

## REPORT CONCLUSIONS

A legislative audit released June 2018 found the Alaska Mental Health Trust Authority's (Authority) board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting \$39.5 million of the Alaska Mental Health Trust (Trust) cash principal from the Alaska Permanent Fund Corporation (APFC) to purchase seven commercial real estate properties and \$1.8 million of cash principal to purchase/construct several program-related properties. During November 2019, Authority management reported that corrective action had been taken to address the prior audit findings. This audit evaluates the corrective action taken by the Authority. Specifically, the audit determines whether Trust cash principal diverted from the APFC was restored and whether policies and regulations used by the Authority to justify prior actions were amended to comply with statutes. This audit also evaluates the status of the commercial real estate investments and the Authority's intent regarding future management of the investments.

The audit concluded that the Authority's board of trustees restored Trust cash principal with \$41.3 million of Trust income reserves and continued to use the Trust Land Office (TLO) to manage the commercial real estate properties. The audit also found that Authority policies were partially amended to prohibit future investment of cash principal in commercial real estate outside of the APFC.

Beginning in 2014, Trust income reserves significantly exceeded target levels because excess income was not used to fully inflation-proof the Alaska mental health trust fund. The board of trustees

# Report Highlights (Continued)

5. The board of trustees should develop written policies to annually evaluate whether Trust income must be transferred to the general fund.

## REPORT CONCLUSIONS (Continued)

authorized inflation-proofing of up to \$120.3 million during its March 2021 meeting.

The Authority's decision to invest \$39.5 million of Trust income in the TLO managed commercial real estate properties decreased the liquidity of Trust income reserves and impaired the Authority's ability to inflation-proof. If excess Trust income was used to inflation-proof the Trust, the TLO commercial real estate investments would make up 59.5 percent of the remaining income reserves. The illiquid nature of such a large percentage of reserves calls into question the Trust's ability to meet its spending goals in a down market.

Although AS 37.14.041(b) requires Trust income in excess of the amount needed for the State's comprehensive mental health program be transferred to the State's general fund, the audit found the Authority did not have a written policy for identifying the amount available for transfer. When evaluating income reserves, auditors noted deficiencies in the Authority's methodology for calculating reserves and the annual withdrawal amount.

After the 2018 audit was released, the Authority's board of trustees transferred \$16.9 million of cash principal to the APFC from the trust authority development account. Subsequently, no principal was transferred for 15 months. More routine transfers began April 2020. Further, the audit found that cash principal was inappropriately used by the Authority for land development activities approved prior to FY 20. Policies were changed beginning in FY 20 to require land development activities be funded with Trust income.

According to Authority management, the value of the TLO managed commercial real estate investments increased by \$9.6 million since the prior 2018 audit and provided a net equity value of \$60.4 million; however, auditors note that the properties were not subject to an annual independent appraisal and two properties were projected to have negative cash flow for FY 21. At the time of the audit, the Authority intended to continue managing the commercial real estate properties as an investment of Trust income through the TLO.

# ALASKA STATE LEGISLATURE

## LEGISLATIVE BUDGET AND AUDIT COMMITTEE

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July 22, 2021

Members of the Legislative Budget  
and Audit Committee:

In accordance with the provisions of Title 24, we have reviewed the activities of the Alaska Mental Health Trust Authority and the attached report is submitted for your review.

DEPARTMENT OF REVENUE  
ALASKA MENTAL HEALTH TRUST AUTHORITY  
STATUS OF SELECT ASSET MANAGEMENT ISSUES

July 6, 2021

04-30099-21

The audit evaluates the corrective action taken by the Alaska Mental Health Trust Authority to address prior audit findings related to select asset management issues.

The audit was conducted in accordance with generally accepted government auditing standards. 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

A handwritten signature in blue ink, appearing to read "Kris Curtis".

Kris Curtis, CPA, CISA  
Legislative Auditor

## ABBREVIATIONS

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AAC	Alaska Administrative Code
ACN	Audit Control Number
AK	Alaska
AMHEA	Alaska Mental Health Enabling Act of 1956
AMPS	Asset Management Policy Statement
APFC	Alaska Permanent Fund Corporation
AS	Alaska Statute
Authority	Alaska Mental Health Trust Authority
CEO	Chief Executive Officer
CISA	Certified Information Systems Auditor
CPA	Certified Public Accountant
DLA	Division of Legislative Audit
DNR	Department of Natural Resources
DOR	Department of Revenue
FY	Fiscal Year
HB	House bill
IRS	Internal Revenue Service
LLC	Limited Liability Company
PRI	Program-Related Investments
RMS	Resource Management Strategy
TADA	Trust Authority Development Account
TLO	Trust Land Office
Trust	Alaska Mental Health Trust
TX	Texas
UT	Utah
WA	Washington

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# ORGANIZATION AND FUNCTION

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## Alaska Mental Health Trust Authority

The Alaska Mental Health Trust Authority (Authority) was established by AS 47.30 as a public corporation of the State within the Department of Revenue (DOR). It serves as trustee for the Alaska Mental Health Trust (Trust), a perpetual trust created by the federal Alaska Mental Health Enabling Act of 1956 (AMHEA). As trustee, the Authority has a fiduciary obligation to ensure that Trust assets are managed consistent with the AMHEA and a duty to administer the Trust in the interest of the beneficiaries. The Authority must also exercise a high degree of care in administering the Trust and use care and skill to preserve Trust property.<sup>1</sup>

The Authority is governed by a seven-member board of trustees appointed by the governor and confirmed by the legislature. In accordance with AS 47.30.016, the members are appointed based on their ability in financial management and investment, in land management, or in services for Trust beneficiaries. Trustees receive an honorarium of \$200 for each day or any part of a day spent at a board meeting, subcommittee meeting, or as a representative of the board. The duties of the board include preserving and protecting the Trust corpus.<sup>2</sup>

The board selects and employs a chief executive officer who is responsible for the Authority's day-to-day operations. The Authority's FY 22 governor's budget totaled \$4.7 million, including \$3 million for personal services that funded 17 full-time positions.

## Trust Land Office

In accordance with AS 37.14.009, the Authority contracts with the Department of Natural Resources (DNR) through a memorandum of understanding to manage the land assets of the Trust. The Trust Land Office (TLO) is a unit within DNR created to contract exclusively with the Authority to manage and develop Trust land. The TLO's FY 22 governor's budget totaled \$4.4 million, including \$3 million for personal services that funded 19 full-time positions.

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<sup>1</sup> Alaska Statute 37.14.007.

<sup>2</sup> Alaska Statute 47.30.036.

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## **Alaska Permanent Fund Corporation**

In accordance with AS 37.14.009, the Authority contracts with the Alaska Permanent Fund Corporation (APFC) through a memorandum of agreement to manage the mental health trust fund. The mental health trust fund is a separate fund of the Authority that consists of Trust cash principal assets. The APFC is a State-owned corporation within DOR that manages the assets of the Alaska Permanent Fund and other funds designated by law, including the mental health trust fund.

A six-member, governor-appointed board of trustees oversees the APFC. One seat is statutorily assigned to DOR's commissioner. The governor selects one additional cabinet member to sit on the board. Four public members, who are required to have recognized competence and wide experience in finance, investments, or other business management-related fields, fill the remaining seats, which have staggered four-year terms. The APFC board appoints an executive director who manages a staff of approximately 63.



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# BACKGROUND INFORMATION

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## Legal Framework

In 1956, the federal Alaska Mental Health Enabling Act (AMHEA) was passed by congress to transfer responsibility for providing mental health services from the federal government to the Territory of Alaska by creating the Alaska Mental Health Trust (Trust). The AMHEA provided broad discretion to Alaska for land management:

*All lands granted to the Territory of Alaska under this section, together with the income therefrom and the proceeds from any dispositions thereof, shall be administered by the Territory of Alaska as a public trust and such proceeds and income shall first be applied to meet the necessary expenses of the mental health program of Alaska. Such lands, together with any property acquired in exchange therefor or acquired out of the income or proceeds therefrom, may be sold, leased, mortgaged, exchanged, or otherwise disposed of in such manner as the Legislature of Alaska may provide, in order to obtain funds or other property to be invested, expended, or used by the Territory of Alaska [...]*<sup>3</sup>

Per the AMHEA, management of the Trust is subject to Alaska statutes promulgated by the legislature.

In 1982, the State of Alaska's management of the Trust was challenged in a class action suit, *State v. Weiss*, alleging that the State violated terms of the Trust. In a 1985 decision, the Alaska Supreme Court affirmed that the Alaska legislature breached the Trust by removing federal grant lands from the Trust.

After lengthy negotiations and two unsuccessful settlement attempts, the parties finally reached a settlement in June 1994. As a part of settling the lawsuit, the Alaska legislature passed House Bill (HB) 201 to change the Trust statutes. This bill was incorporated into the settlement agreement and became an integral part of the settlement. The *Memorandum Decision and Order Granting Final Approval to the HB 201 Settlement and Dismissal Order*, written by

<sup>3</sup> AMHEA Section 202(e).

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Superior Court Judge Mary E. Green in December of 1994, finalized the settlement process.

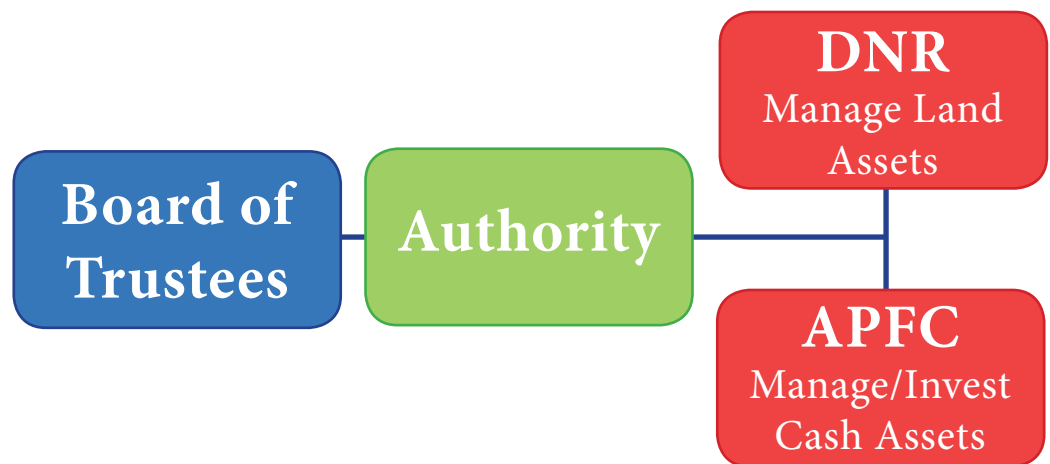
Several parties were not satisfied with the result and challenged the HB 201 settlement in a 1997 lawsuit. The Alaska Supreme Court denied the petition, reciting legislative efforts to settle litigation and passage of HB 201.

The HB 201 settlement reconstructed the Trust with 500,000 acres of original Trust land and approximately 500,000 acres of replacement land, plus \$200 million in cash to be retained perpetually. It also created the Alaska Mental Health Trust Authority (Authority) to serve as trustee of the Trust assets and created the asset management and oversight structure described in Exhibit 1. This structure, as set up in statute, was incorporated as a condition of the settlement.

### Exhibit 1

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#### Trust Management and Oversight Structure Created by the HB 201 Settlement



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Source: Alaska statutes and settlement documents.

The Authority, governed by a board of trustees, was given a fiduciary obligation to ensure that the Trust assets are managed consistent with the requirements of the AMHEA. Statutes require Trust cash principal to be managed by the Alaska Permanent Fund Corporation (APFC).

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Trust land assets must be managed by Department of Natural Resources (DNR)<sup>4</sup> in accordance with AS 38.05.801, which states:

*(a) Mental health trust land shall be managed [by DNR] consistent with the trust principles imposed on the state by the Alaska Mental Health Enabling Act, P.L. 84-830, 70 Stat. 709 (1956).*

*(b) Subject to (a) of this section, the department (1) shall manage mental health trust land under those provisions of law applicable to other state land.*

## Trust Cash Assets

The Trust cash assets are comprised of principal and income.

- *Trust Cash Principal*

The cash principal includes the initial appropriation of \$200 million made as a part of the settlement and the proceeds received from management of the Trust land attributable to principal.<sup>5</sup> The APFC manages the mental health trust fund, which includes the Trust cash principal from the original endowment and the portion of the Trust Land Office's (TLO) land management proceeds attributed to principal, which have been transferred to the APFC for investment.

Assets invested by the APFC have been comingled with the assets of the Alaska Permanent Fund for investment purposes, with the Trust owning unit shares rather than direct asset interest. The APFC maintains a diverse investment portfolio, which includes debt securities, preferred and common stocks, private equity, and real estate. The APFC's real estate investments are comprised of directly owned real estate, real estate investment trusts, a multi-family real estate operating company, private real estate funds, and other entities in which the assets consist primarily of real property.

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<sup>4</sup> Alaska Statute 37.14.009 requires the Authority to contract with DNR to manage the land assets of the Trust.

<sup>5</sup> Alaska Statute 37.14.031.

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Cash proceeds derived from the TLO's land management transactions attributed to principal are deposited in the trust authority development account (TADA). The TADA was designed as a holding account to facilitate transfers to the APFC. Department of Revenue's (DOR) treasury division manages cash balances of the TADA.

- *Trust Income*

Trust income is comprised of the “*fees, charges, income earned on assets, and other money received by the trust that is not attributable to the principal.*”<sup>6</sup> Trust income is generated by the APFC from the cash principal investments and by the TLO from its land management and real estate activities.

Conceptually, Trust income is split into two categories:

1. *Operational monies.* Operational monies are used during the year to provide services for beneficiaries and to manage the Trust. The operational monies are primarily made up of an “annual withdrawal” from investments and income generated from real estate and land management activities. The annual withdrawal equals 4.25 percent of the average of the prior four years net asset value of investments managed by the APFC and DOR. The operational monies are managed by DOR's treasury division.
2. *Income reserves.* Reserves act like a savings account that provides for spending in the event the Trust's investment portfolio does not meet its earning objectives. Authority policy requires reserves be maintained at 400 percent of the annual withdrawal calculation. Management of income reserves is carried out by the APFC and DOR's treasury division.

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<sup>6</sup> Alaska Statute 37.14.036.

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Trust income is deposited in the Trust settlement income account. Alaska Statute 37.14.041 defines the allowable use of Trust income (see Exhibit 2). As noted in AS 37.14.041(b), if money in the trust settlement income account is not needed to meet the necessary expenses of the State’s integrated comprehensive mental health program, the Authority must transfer the money to the unrestricted general fund.

**Exhibit 2**

**Allowable Use of Trust Settlement Income Account  
AS 37.14.041**

(a) Money in the mental health trust settlement income account may only be used for the following purposes:

(1) the awarding of grants and contracts in fulfillment of the authority’s purpose to ensure an integrated comprehensive mental health program for the state;

(2) obtaining private and federal grants for a purpose described in (1) of this subsection;

(3) soliciting gifts, bequests, and contributions for a purpose described in (1) of this subsection;

(4) reimbursement to

(A) the Alaska Permanent Fund Corporation for the costs of managing the principal of the mental health trust fund; and

(B) the Department of Natural Resources for the cost of managing mental health trust land;

(5) offsetting the effect of inflation on the value of the principal of the mental health trust fund; and

(6) subject to AS 37.07 (Executive Budget Act), meeting the necessary administrative expenses of the authority that are required for it to properly discharge its responsibilities.

(b) If money in the mental health trust settlement income account is not needed to meet the necessary expenses of the state’s integrated comprehensive mental health program, the authority shall transfer the money to the unrestricted general fund for expenditure through legislative appropriation for other public purposes.

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## Trust Land Assets

Trust land assets are managed by DNR's TLO. TLO land management activities include land, minerals and materials, energy, forestry, and real estate. Real estate activities are comprised of the following:

- *Real estate development.* Multiple surface leases throughout the state are managed through the TLO. According to Authority management, as of the end of FY 20, the real estate development included marketing the Anchorage "U-Med" district and master-planning for the Anchorage Community Park and the Eagle River holdings.
- *Program-related real estate.*<sup>7</sup> Through construction and intergovernmental transfers, the Trust acquired several buildings for the purpose of serving Trust beneficiaries. As of the end of FY 20, the Authority reported that program-related real estate included four program-related properties.

## Commercial Real Estate

In 2009 a global financial crisis caused the largest negative return in the APFC's history. A return of minus 18 percent was allocated to Trust cash assets managed by the APFC resulting in a loss of \$75.8 million. The decrease in financial markets coincided with the decline in commodity prices that adversely affected the revenues generated by the TLO using Trust cash principal from its land transactions.

Driven by revenue concerns, the Authority's board of trustees started looking for other sources of stable income aside from the financial markets. Trustees viewed commercial real estate investments as an opportunity to generate consistent rental income. Trustees also believed that, due to the 2009 financial crisis, real estate was undervalued and good investment opportunities were available. In FY 11 the board of trustees decided to pursue alternative sources of income by beginning "a long-term strategy to mitigate risk in the Trust's holdings through geographical and property type diversification."<sup>8</sup> As part of that strategy, the Authority used cash

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<sup>7</sup> Also referred to by the Authority and the TLO as "program-related investments".

<sup>8</sup> 2014 TLO Annual Report.

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principal funds to purchase, through the TLO, seven commercial real estate investment properties during FY 12 through FY 17.

The first TLO commercial real estate investment was the Cordova building located in Anchorage. It was purchased in FY 12 with cash principal and houses the TLO office along with other multi-tenant office space. The next acquisition was the Commercial Drive building in Anchorage, purchased in late FY 12 and leased to Cummins, a multinational corporation. Commercial Drive was the first property that was mortgaged and owned by the Trust through a limited liability company (LLC). All subsequent properties were mortgaged and acquired through LLCs to increase the return on investment and reduce liability.

In May 2013 the Authority purchased through TLO the first out-of-state property, a facility in Ogden, Utah, which was long-term leased to the Internal Revenue Service (IRS). This purchase was followed by the acquisition of an office building in Tumwater, Washington, leased to two Washington state government agencies. The last three commercial real estate investments, acquired in 2014, 2015, and 2016, are located in Texas and are multi-tenant office complexes (Promontory Point, Austin; North Park, San Antonio; and Amber Oaks, Austin). The commercial real estate investment properties are summarized in Exhibit 3 on the following page.

### Exhibit 3

TLO Managed Commercial Real Estate Investments as of March 31, 2021					
Property Name	Address	Acquisition Date	Fair Market Value	Mortgage Balance	Equity
Cordova	2600 Cordova Street Anchorage, AK 99503	7/1/2011	\$ 3,560,000	\$ -	\$ 3,560,000
Cummins	2618 Commercial Drive Anchorage, AK 99501	4/6/2012	\$ 2,965,000	\$ 964,948	\$ 2,000,052
IRS	1973 North Rulon White Boulevard Ogden, UT 84201	5/14/2013	\$ 20,100,000	\$ 6,381,883	\$ 13,718,117
Israel	1111 Israel Road SW Tumwater, WA 98504	1/7/2014	\$ 18,860,000	\$ 6,343,129	\$ 12,516,871
Promontory Point	2420 & 2500 Ridgepoint Drive Austin, TX 78754	10/1/2014	\$ 15,500,000	\$ 9,262,922	\$ 6,237,078
North Park	17319 San Pedro Avenue San Antonio, TX 78232	9/11/2015	\$ 13,500,000	\$ 6,431,852	\$ 7,068,148
Amber Oaks	9601 Amberglen Boulevard Austin, TX 78729	8/2/2016	\$ 26,556,735	\$ 11,191,421	\$ 15,365,314
Total			\$ 101,041,735	\$ 40,576,155	\$ 60,465,580

Source: TLO records.

## Trust Inflation-Proofing

According to statutes, the Authority's board of trustees has a duty to preserve and protect the Trust corpus.<sup>9</sup> To ensure that the Trust corpus can continue to provide funding for future beneficiaries, the Authority may use income to offset the effect of inflation. This is referred to as "inflation-proofing."

The concept of preserving a trust for future beneficiaries is described in the *Principles of State Trust Portfolio Management* published by the National Association of State Trust Lands that specifies:

*State trusts exist to provide perpetual benefit for trust beneficiaries. Said differently, the portfolio must provide intergenerational equity for the beneficiaries. [...] The*

<sup>9</sup> AS 47.30.036(1).



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*trustees of endowed institutions are the guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations.*

Although AS 37.14.041(a)(5) permits inflation-proofing as a use of Trust income, the rest of the Authority's statutes and regulations are silent regarding amount and frequency.

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# REPORT CONCLUSIONS

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A legislative audit released June 2018 found the Alaska Mental Health Trust Authority's (Authority) board of trustees violated State statutes and terms of the *State v. Weiss* settlement by diverting \$39.5 million of the Alaska Mental Health Trust (Trust) cash principal from the Alaska Permanent Fund Corporation (APFC) to purchase seven commercial real estate properties and \$1.8 million of cash principal to purchase/construct several program-related properties. The commercial real estate properties were purchased through and managed by Department of Natural Resources' (DNR) Trust Land Office (TLO), and were considered investments of Trust cash principal held outside the APFC. The board of trustees' actions appeared to be well-intentioned, driven by a desire to maximize revenue and to facilitate services for beneficiaries. However, the actions did not comply with law and were contrary to the roles and responsibilities outlined in the settlement.

During November 2019, Authority management reported that corrective action had been taken to address the prior audit findings. This audit evaluates the corrective action taken by the Authority. Specifically, the audit determines whether Trust cash principal diverted from the APFC was restored and whether policies and regulations used by the Authority to justify prior actions were amended to comply with statutes. This audit also evaluates the status of the commercial real estate investments and the Authority's intent regarding future management of the investments.

The audit concluded that the Authority restored Trust cash principal with \$41.3 million of Trust income reserves and continued to use the TLO to manage the commercial real estate properties. The audit also found that Authority policies were partially amended to prohibit future investment of cash principal in commercial real estate outside of the APFC.

Beginning in 2014, Trust income reserves significantly exceeded target levels because excess income was not used to fully inflation-proof the Alaska mental health trust fund. The board of trustees authorized inflation-proofing of up to \$120.3 million during

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its March 2021 meeting; \$50 million of Trust income was to be transferred to principal as soon as practicable and the rest was to be transferred by the end of FY 21.

The Authority's decision to invest \$39.5 million of Trust income in the TLO managed commercial real estate properties decreased the liquidity of Trust income reserves and impaired the Authority's ability to inflation-proof. As of March 31, 2021, if the excess income was moved to principal to inflation-proof the Trust, the TLO managed commercial real estate investments would make up 59.5 percent of the remaining income reserves. The illiquid nature of such a large percentage of reserves calls into question the Trust's ability to meet its spending goals in a down market.

Although AS 37.14.041(b) requires Trust income in excess of the amount needed for the State's comprehensive mental health program be transferred to the State's general fund, the audit found the Authority did not have written policies for identifying the amount available for transfer. When evaluating income reserves, auditors noted deficiencies in the Authority's methodology for calculating reserves and the annual withdrawal amount.

After the 2018 audit was released, the Authority's board of trustees transferred \$16.9 million of cash principal to the APFC from the trust authority development account (TADA). Subsequently, no principal was transferred for 15 months. More routine transfers began April 2020. Further, the audit found that cash principal was inappropriately used by the Authority for land development activities approved prior to FY 20. Policies were changed beginning in FY 20 to require land development activities be funded with Trust income.

According to Authority management, the value of the TLO managed commercial real estate investments increased by \$9.6 million since the prior 2018 audit and provided a net equity value of \$60.4 million; however, auditors note that the properties were not subject to an

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annual independent appraisal and two properties were projected to have negative cash flow for FY 21.

Detailed conclusions are presented below.

**The Authority considered several options for corrective action.**

At the time of the prior audit, \$39.5 million of cash principal had been diverted from the APFC and used by the Authority to purchase seven commercial real estate properties. The audit found the actions violated statutes that require Trust cash principal be invested by the APFC and recommended the Authority's board of trustees stop investing in commercial real estate and consult with the APFC regarding future treatment of the properties. After the audit was issued, the board of trustees considered eight options to address the finding. The options included, in part, maintaining the status quo (e.g. ignoring the audit findings); selling the properties and using the proceeds to restore the Trust cash principal; transferring the properties to the APFC to be managed as a separate portfolio; and using Trust income to restore the Trust cash principal while retaining the commercial real estate properties as Trust income investments with TLO continuing to manage the properties. The full list of options considered by the trustees is listed in Appendix A.

The board of trustees asked Authority management to provide additional information on four of the eight options, including the option of transferring the properties to the APFC to be managed as a separate portfolio. Auditors noted that inaccurate cost estimates were presented to the board of trustees when deliberating the APFC separate portfolio option, which made the option less desirable. Auditors also noted that the board of trustees did not formally consider transferring the properties to the APFC to be absorbed into the APFC's investment portfolio with the Trust and the Alaska Permanent Fund owning unit shares. The option was not considered because the board of trustees wanted the properties' full income stream to remain within the Trust and did not want to lose control over the investment properties.

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**Approximately \$41.3 million of Trust income was transferred to the APFC to restore cash principal and the commercial real estate properties continued to be managed by the TLO.**

After considering information presented by both APFC and Authority management, the board of trustees decided to retain control of the commercial real estate investments by using Trust income to repay the \$39.5 million of cash principal. Additionally, the board decided to transfer \$1.8 million of income to the APFC to repay cash principal diverted for program-related real estate. The board of trustees believed that transferring \$41.3 million of Trust income to the APFC would bring the Authority into compliance with investment statutes that required cash principal be invested by the APFC and noted that there is no statutory requirement that Trust income be invested by the APFC. Documentation showed a total of \$41.3 million was transferred from Trust income to APFC Trust principal on May 31, 2019.

Despite the 2018 legislative audit conclusion that commercial real estate investments are more appropriately and efficiently carried out by the APFC, and that the TLO was not authorized to manage a national commercial real estate investment program, the Authority's board of trustees decided to continue using the TLO to manage the Trust's commercial real estate investment properties. The Authority's rationale for using TLO to manage the properties cites TLO's unique and comprehensive knowledge of the Trust settlement lands and resources; TLO's understanding of the Trust mission and objectives; and TLO's ability to perform the duties within their current responsibilities, thereby creating a low incremental cost for services. The rationale did not provide a reasonable justification for using the TLO as an investment manager because it did not cite TLO's expertise in financial investing, particularly knowledge and expertise in managing a nationwide commercial real estate investment program.

**Trust income reserves exceeded target levels for 10 years.**

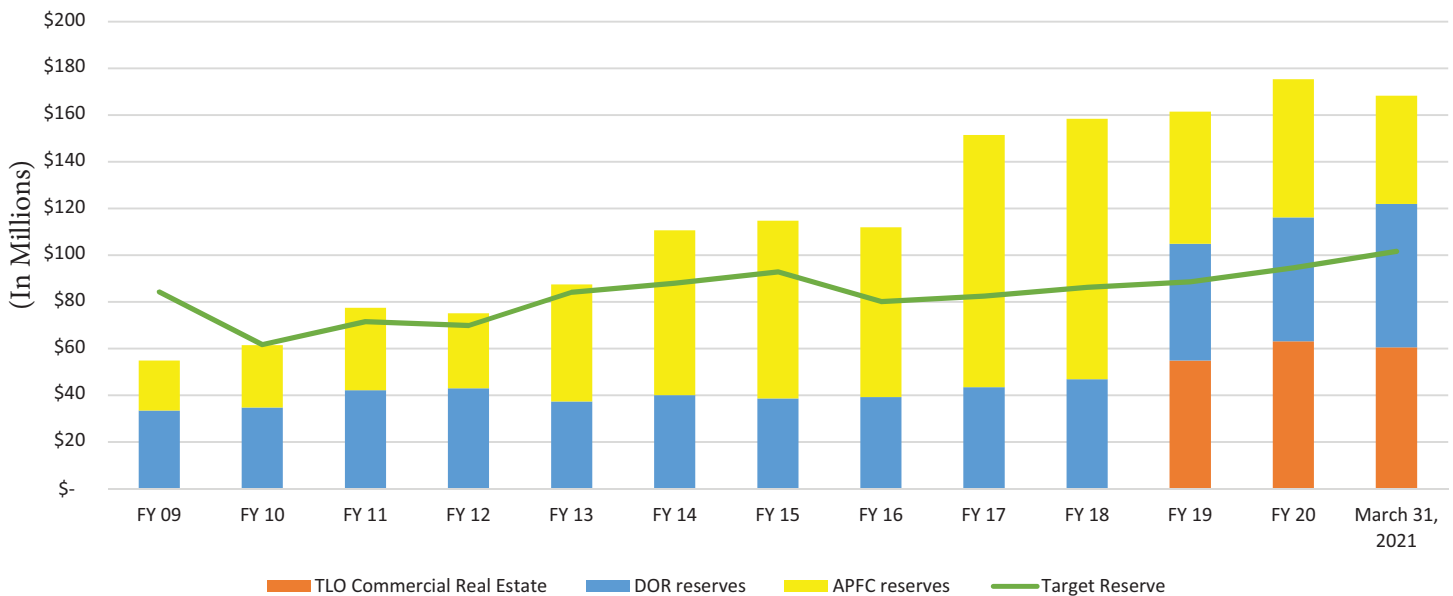
The Authority maintains a reserve of Trust income to ensure beneficiary services continue during a down economy. The reserve target is set by Authority policy at 400 percent of the

annual withdrawal amount.<sup>10</sup> Reserves above the target amount are considered excess reserves.

Exhibit 4 shows the Trust income reserve balances as of June 30<sup>th</sup> compared to the target reserve levels for FY 09 through FY 20 and the target reserve balance as of March 31, 2021. Beginning FY 14, Trust income reserves significantly exceeded target levels. Income exceeded target levels in amounts ranging from \$21.8 million to \$116.7 million during the periods FY 14 through March 31, 2021. The March 31, 2021, balance in Exhibit 4 excludes the \$50 million that was obligated for inflation-proofing just prior to that date, which is discussed on page 18.

**Exhibit 4**

**Trust Income Reserve Balances Compared to Target Levels  
FY 09 through March 31, 2021**



Source: Authority records.

<sup>10</sup> The Trust annual withdrawal is calculated at 4.25 percent of the rolling four year-end average of the aggregate net asset value of the funds invested through the APFC and income reserves invested by the Department of Revenue (DOR) treasury division.

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**Trust income reserves significantly exceeded target levels due to a lack of inflation-proofing.**

Up until 2009, the Authority’s investment management policy required excess Trust income reserves be transferred to principal to offset the effects of inflation. This practice, referred to as “inflation-proofing,” helps ensure the Trust can meet the needs of future beneficiaries. In 2009 the policy was revised to make inflation-proofing discretionary.

Once inflation-proofing became optional, the board of trustees chose not to transfer excess reserves to principal and excess reserves grew. At the end of FY 14, excess reserves totaled \$22.6 million and the board approved an inflation-proofing transfer of \$5 million; however, the amount was not transferred until FY 18. By the end of FY 20, excess reserves totaled \$80.8 million.

The Authority’s board of trustees approved an inflation-proofing transfer of “up to \$120.3 million” at its March 2021 board meeting with \$50 million of Trust income to be transferred to principal as soon as practicable and the balance to be transferred by the end of FY 21.<sup>11</sup> Auditors reviewed the calculation and confirmed the \$120.3 million was materially accurate and represented the inflation-proofing liability as of March 2021. Exhibit 5 shows Trust inflation-proofing authorized from FY 95 through March 31, 2021, the amounts transferred, and the remaining liability.

The audit recommends that the board of trustees consider changing policy to require inflation-proofing occur annually if excess reserves allow. (See Recommendation 4)

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<sup>11</sup> If excess income reserves were not high enough at the end of FY 21 to allow for the full authorized amount of inflation-proofing, the amount of inflation-proofing was to be reduced accordingly.



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**Exhibit 5**

**Trust Inflation-Proofing  
FY 95 through March 31, 2021  
Approved Versus Actual**

FY 95	\$3,533,000
FY 98	\$6,910,543
FY 00	\$41,544,000
FY 04	\$15,337,401
FY 08	\$2,436,354
FY 18	\$5,000,000
FY 21	\$120,280,300
Total	\$195,041,598
Transferred to Principal	(\$124,761,298)
Remaining Liability	\$70,280,300

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Source: Authority records.

**Investment of Trust  
income in commercial  
real estate reduced  
liquidity.**

The Authority's decision to invest Trust income in commercial real estate properties resulted in exchanging cash for long-term investments (commercial real estate). The audit found that if the Authority used excess income reserves to meet its inflation-proofing liability, 59.5 percent of the remaining reserves as of March 31, 2021, would be composed of the TLO managed commercial real estate investments. Since the properties are not readily convertible to cash, the decision to invest Trust income in the TLO commercial real estate reduced the Trust's ability to meet its spending goals in the event of a down market.

To ensure the Trust can inflation-proof and maintain a prudent degree of liquidity, the audit recommends the board of trustees

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consider liquidating the TLO managed commercial real estate investments. (See Recommendation 1)

**Excess Trust income must be transferred to the State’s general fund.**

Trust statutes require excess Trust income be transferred to the State’s general fund. Specifically, AS 37.14.041(b) states:

*If money in the mental health trust settlement income account is not needed to meet the necessary expenses of the state’s integrated comprehensive mental health program, the authority shall transfer the money to the unrestricted general fund for expenditure through legislative appropriation for other public purposes.*

At the time of the audit, no transfer of excess Trust income had ever occurred and Authority policies did not define “income not needed to meet the expenses of the State’s integrated mental health program.” During 2020, the board passed a motion that “no Trust funds exist above the current and projected needs of the beneficiaries of the Alaska Mental Health Trust.” A similar motion was passed in 2021. However, no specific calculations or other analyses were provided to support the motions.

It is feasible that future market returns could generate surplus Trust income that should be transferred to the general fund. The audit recommends written policies be developed to annually evaluate whether surplus Trust income must be transferred to the general fund. (See Recommendation 5)

**Deficiencies were identified in the Authority’s calculation of Trust income reserves.**

As discussed above, the Authority maintains an income reserve to ensure the Trust can meet spending goals in a down market. The audit found two deficiencies with the Authority’s methodology for calculating income reserves.

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1. Beginning in 2019, Authority management began to include unrealized gains/losses<sup>12</sup> on Trust principal in the determination of income reserves. Given that principal is not available for spending, its unrealized gains cannot be used to meet the Trust's spending goals and should not be included as part of income reserves. The 2019 methodology change appeared to be a result of Authority management turnover.
  2. The TLO managed commercial real estate properties were not considered by Authority management or the board of trustees to be part of income reserves. Prior to the board of trustees restoring the Trust principal with Trust income, the TLO managed commercial real estate properties were considered Trust principal investments and properly excluded from the calculation of income reserves. Once Trust income was used to invest in the properties the investments should have been considered part of income reserves. The board of trustees' motion that authorized the investment specifically identified the properties as long-term investments within the income reserve.

The analyses conducted as part of this audit correct for the above two deficiencies. Specifically, the amount of reserves shown in Exhibit 4 and referenced throughout the report exclude the unrealized gains/losses on Trust principal from reserves and add the net value of TLO managed commercial real estate to the reserves. The audit recommends the board of trustees develop written policies to correctly determine income reserves. (See Recommendation 3)

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<sup>12</sup> An unrealized gain refers to the potential profit that could be made from selling an investment. An unrealized loss refers to the drop in an asset's value before it is sold. Once an investment is sold, the gain or loss is realized. For accounting purposes, both unrealized and realized gains and losses are tracked and reported. The APFC reports to the Authority the realized and unrealized gains and losses for the Trust's principal and income monthly.

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**Errors were found in the Authority’s methodology for calculating annual withdrawals.**

To provide a consistent and predictable funding stream for Alaska’s comprehensive integrated mental health program, a pre-defined amount is withdrawn annually from Trust investments to fund the Authority’s current year activities. The Trust annual withdrawal is calculated as 4.25 percent of the rolling four year-end average of the aggregate net asset value of the Trust investments managed by the APFC and the DOR treasury division, including both principal and income investments. The annual withdrawal methodology was recommended in a 2011 study conducted by Callan and Associates. At the time of the study, there were no Trust investments held outside of the APFC and the DOR treasury division. Consequently, the treatment of the TLO managed commercial real estate was not addressed by the study.

The 4.25 percent has never been applied to the TLO managed real estate investments when calculating the annual withdrawals. Excluding the commercial real estate from the annual withdrawal calculation is not consistent with how Trust real estate investments managed by the APFC and the DOR treasury division are treated, and the audit found no reasonable justification for excluding the investments. Excluding the properties effectively decreased the annual withdrawal amount, thereby reducing the funds available for beneficiary services. For example, excluding the properties from the FY 21 calculation reduced the annual withdrawal by approximately \$1.2 million. The audit recommends that written procedures be implemented to ensure 4.25 percent is applied to the TLO commercial real estate investments when calculating the annual withdrawal. (See Recommendation 2)

When examining Trust income reserve levels, auditors found two errors in the annual withdrawal calculations:

1. The amount calculated for the FY 18 annual withdrawal did not consider the reserves invested by the DOR treasury division, which caused Authority staff to draw \$462 thousand less than the accurate amount.

2. Incorrect source documentation was used for the FY 19 annual withdrawal calculation, which caused Authority staff to draw \$30 thousand more than the accurate amount.

The target reserve amounts shown in Exhibit 4 and the target reserve amounts referenced throughout the audit report correct for the two errors identified above and include the TLO managed real estate investments in the annual withdrawal calculation. The audit recommends that the board of trustees develop written procedures to ensure that annual withdrawals are correctly calculated. (See Recommendation 2)

**Transfers of cash principal were not made timely after the prior audit was issued.**

An objective of the audit was to determine whether the Authority transferred cash principal to the mental health trust fund managed by the APFC in a timely manner after the prior audit was released June 2018. Statutes do not provide a specific timeline for transferring principal. According to Authority management, the transfer of principal to the APFC is considered timely if performed quarterly; however, at the beginning of each fiscal year a transfer may be delayed until completion of administrative matters, including completion of the financial audit and approval by the board of trustees.

**Exhibit 6**

**Summary of Cash Principal Transferred to the Mental Health Trust Fund as of March 31, 2021**

Date	Amount
December 2018	\$16,883,000
April 2020	\$9,300,000
June 2020	\$300,000
October 2020	\$20,000,000
December 2020	\$2,494,000
January 2021	\$600,000
March 2021	\$500,000

Source: Authority records.

Exhibit 6 shows the Authority transferred \$16.9 million to the APFC in December 2018. Subsequently, no transfers occurred for 15 months. Transfers resumed in April 2020 and occurred on a timely basis through the end of the audit period. As of

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**Cash principal was inappropriately used by the Authority for land development activities.**

March 31, 2021, there was a balance of \$2.2 million of cash principal in the TADA. Of this amount, \$1.7 million was held for commitments for land development activities (\$1 million for a United States Forest Service land exchange and \$700 thousand for the Icy Cape development).

The prior audit confirmed the TLO has a responsibility to develop and maintain Trust land assets; however, the *State v. Weiss* settlement did not clearly identify a funding mechanism for such purposes. The only funding mechanism appears to be found in AS 37.14.041, which addresses the appropriate use of Trust income and holds that income can be used as a “reimbursement to [...] the Department of Natural Resources for the cost of managing mental health trust land.” The prior audit concluded that Trust cash principal was not an allowable funding source for land development activities because cash principal must be invested by the APFC. In response to the audit, the Authority changed policies to require land development activities approved after FY 19 be funded with Trust income.

This audit found that cash principal continued to be used to fund land development activities approved prior to the change in policy. The Authority spent \$4.7 million of cash principal on land development activities from June 2018 through March 2021. The expenditures included \$1.1 million for a land exchange with the United States Forest Service; \$551 thousand for sewer and water infrastructure improvements for Yosemite Road access; and \$3 million for mining exploration of Icy Cape. In addition, \$1.7 million in cash principal held in the TADA was committed for land development activities as of March 31, 2021.

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**Authority policies were partially amended to prohibit investing cash principal in commercial real estate outside of the APFC.**

The prior audit concluded that Authority policies and regulations that enabled the Authority to use Trust cash principal for commercial real estate investment through the TLO violated Authority statutes. An objective of this audit was to evaluate whether such policies and regulations were amended after the audit was released June 2018.

The prior audit found that regulation 20 AAC 40.700(a)<sup>13</sup> was interpreted by the board of trustees as the authority to invest cash principal outside the APFC. The regulation was not changed; however, policies were partially amended to require cash principal be transferred to the APFC. (See Exhibit 7 for a description of the Trust asset management policies)

**Exhibit 7**

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**Trust Asset Management Policies**

The Trust asset management policies are outlined in two documents: the Asset Management Policy Statement (AMPS) and Resource Management Strategy (RMS). The Authority created the AMPS to delineate the asset management philosophy and practices for assets, both cash and non-cash, entrusted to the board of trustees. The RMS, created by the TLO to address its regulation 11 AAC 99.090(c) and approved by the board of trustees, outlines the long-term asset management strategy that establishes goals for managing Trust land assets by the TLO.

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Source: AMPS and RMS.

The Authority’s AMPS was amended to clearly communicate that cash principal was not available for expenditure outside of the APFC. Amendments to the RMS were also drafted to require cash principal be transferred to the APFC; however, as of March 31, 2021, the changes had not been finalized.

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<sup>13</sup> 20 AAC 40.700(a) states “From time to time, the board may determine that it is in the interest of the trust and its beneficiaries to use receipts from the management of trust land to (1) acquire for the trust new trust land; or (2) improve or develop existing trust land.”

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**Authority management reported that the value of the TLO commercial real estate investments increased by \$9.6 million since the prior audit; however, two properties were projected to have negative cash flow for FY 21.**

An objective of the audit was to determine the status of the TLO managed commercial real estate property and the Authority's intent regarding the investments. The seven commercial real estate properties provided \$50.8 million of equity as of June 30, 2017, according to the prior audit. Authority management reported that the equity increased to \$60.4 million as of March 31, 2021.

As shown in Exhibit 8, auditors noted the following concerns (highlighted in bold):

- Two of the seven commercial real estate properties were projected to have a negative cash flow in FY 21.
- Two of the seven properties were not fully occupied—the North Park property in San Antonio, Texas had a 52 percent occupancy and the Amber Oaks property in Austin, Texas had a 71 percent occupancy.
- Three properties have lease expirations expected within the next two years. (Auditors note that the Promontory Point property in Austin, Texas reflects a 50 percent lease expiration; however, another tenant is expected to take over the space in 2021.)

As of March 2021, the Authority's board of trustees was in the process of refinancing five of the seven commercial real estate properties. According to management, the board was refinancing the properties to increase investment income. The Cordova property in Anchorage, Alaska was not included in the refinancing because it had no mortgage and the Amber Oaks property in Austin, Texas was not included due to original mortgage restrictions.



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## Exhibit 8

### TLO Managed Commercial Real Estate Investments Projected Cash Flow and Occupancy Rates as of March 31, 2021

Property Name	FY 21 projected cash flow	Percentage of FY 21 space occupied	Percentage of calendar year 2021 lease expirations	Percentage of calendar year 2022 lease expirations	Percentage of calendar year 2023 lease expirations
Cordova	\$ 78,760	100.00%	4.00%	21.00%	11.00%
Cummins	\$ (33,786)	100.00%	0.00%	0.00%	0.00%
IRS	\$ 490,716	100.00%	0.00%	0.00%	0.00%
Israel	\$ 86,539	100.00%	0.00%	0.00%	89.00%
Promontory Point	\$ 620,004	100.00%	50.00%	0.00%	0.00%
North Park	\$ (580,934)	52.00%	0.00%	0.00%	0.00%
Amber Oaks	\$ 56,267	71.00%	22.00%	14.00%	10.00%
<b>Total</b>	<b>\$ 717,566</b>				

Source: Harvest reports and TLO records.

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# FINDINGS AND RECOMMENDATIONS

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## Recommendation No. 1:

**The Alaska Mental Health Trust Authority's (Authority) board of trustees should consider liquidating the Trust Land Office (TLO) managed commercial real estate investments or transferring the investments to the Alaska Permanent Fund Corporation (APFC) as inflation-proofing.**

In response to a legislative audit that found the Authority's board of trustees violated State statutes by diverting \$39.5 million of Alaska Mental Health Trust (Trust) cash principal from the APFC to purchase seven commercial real estate properties, the board of trustees transferred \$39.5 million of Trust income to the APFC to restore Trust principal. Upon transfer, the properties became an investment of Trust income reserves. The board of trustees believed that using Trust income rather than Trust principal for the commercial real estate investments would bring the Authority into compliance with State statutes and the *State v. Weiss* settlement that require Trust cash principal be invested by the APFC.

Alaska Statute 37.10.071(c) states that the Trust fiduciary shall apply the prudent investor rule and exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary. Per AS 47.30.031(a), the board shall adopt regulations consistent with state law and the fiduciary responsibilities imposed by law on members of boards of directors of corporations having trust responsibilities. Regulation 20 AAC 40.600 requires the board's asset management policies be set out in the Asset Management Policy Statement (AMPS). The AMPS defines the investment horizon for the TLO managed commercial real estate investments as long-term, which is defined as seven to twenty years.

The board of trustees' decision to invest Trust income in commercial real estate properties decreased liquidity of Trust income reserves, which reduced the Authority's ability to meet its spending goals during a down market.

To meet inflation-proofing needs and maintain a prudent degree of liquidity, the audit recommends the board consider liquidating the TLO commercial real estate investments. Alternatively, the board of trustees may want to consider transferring the commercial real estate assets to the APFC-managed Trust principal as part of inflation-proofing, thereby freeing up more liquid investments to meet the Trust income reserve target. However, the APFC has advised that the corporation is not interested in absorbing the commercial real

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estate properties within its existing portfolio. The APFC does not consider the properties to be institutional quality real estate and believes that the properties do not have a meaningful valuation, given that the properties are not appraised annually. If the TLO managed commercial real estate properties were transferred to the APFC, the APFC executive director stated that the properties would likely be liquidated and the proceeds reinvested in accordance with APFC's asset allocation and investment policy.

**Recommendation No. 2:**  
**The board of trustees should develop written procedures to ensure annual withdrawals are correctly calculated.**

Auditors found that Authority management did not include the TLO managed commercial real estate properties in the aggregate net asset value when calculating the annual withdrawal. Per Authority policies, the annual withdrawal is calculated by multiplying 4.25 percent by the rolling four year-end average aggregate net asset value of the following:

- Principal invested at APFC
- Income reserves invested at APFC
- Income reserves invested at Department of Revenue (DOR)

The commercial real estate investments were not included in the net asset value because the Authority's policies did not specifically refer to the TLO managed investments in the calculation procedures. The exclusion of the investments from the calculation resulted in drawing \$1,252,900 less in FY 21.

Additionally, the audit found errors in the FY 18 and FY 19 annual withdrawal calculations. Specifically, the FY 18 annual withdrawal calculation did not include the income reserves invested by the DOR treasury division and the FY 19 calculation used amounts obtained from incorrect source documents. The errors were caused by turnover in Authority staff performing the calculation and a lack of detailed written procedures. The errors caused the Authority to underdraw by \$462 thousand in FY 18 and overdraw by \$30 thousand in FY 19.

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Alaska Statute 37.10.071(c) states that the Trust fiduciary shall apply the prudent investor rule and exercise the fiduciary duty in the sole financial best interest of the fund entrusted to the fiduciary. To help fulfill its fiduciary responsibilities, the Authority has established policies designed to provide a consistent funding stream for beneficiary services. Policies provide that annually 4.25 percent of the four year-end average aggregate net asset value of Trust investments be withdrawn from the Trust income to fund the Authority's current year activities.

We recommend the board of trustees develop written procedures to ensure that annual withdrawals are correctly calculated. This includes amending the Authority's policies so that the 4.25 percent is applied to all principal and income investments regardless of the entity responsible for managing the investments.

**Recommendation No. 3:** The audit identified that, starting in 2019, the Authority's management began to consider unrealized gains/losses attributable to principal to be part of income reserves. Prior to that time, only the unrealized gains/losses related to income were included. Principal unrealized gains/losses should not be included in the determination of income reserves because the unrealized principal amounts are not income and not available for use. The change in methodology was caused by turnover in Authority management and a lack of written procedures. The inclusion of the unrealized gains attributable to principal inflated the income reserves by amounts ranging from \$42.7 million to \$98.7 million between June 30, 2018, and March 31, 2021.

**The board of trustees should develop written policies to ensure Trust income reserves are correctly determined.**

Additionally, starting in 2019, Trust income reserves were invested by the Authority's board of trustees in TLO-managed commercial real estate properties, yet the investments were excluded from the determination of income reserves. The Authority's management excluded the commercial real estate investments from income reserves on the basis that the investments are long-term and not readily available for spending. Excluding the commercial real estate

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investments understated income reserves in amounts ranging from \$54.8 million to \$60.4 million between June 30, 2019, and March 31, 2021. Not determining reserves correctly may lead to under or over spending, which may negatively impact Trust beneficiaries.

Additionally, by excluding the TLO managed properties from income reserves, the Authority raised the question of whether the income was needed. Alaska Statute 37.14.041(b) states that if income is not needed to meet the necessary expenses of the State's integrated comprehensive mental health program, the Authority shall transfer the money to the unrestricted general fund for expenditure through legislative appropriation for other public purposes. Excluding the properties from the income reserves indicated that the income used for the investments was not needed to meet the necessary expenses of the comprehensive mental health program, thereby making it appear that the monies should have been transferred to the general fund. Regardless of appearance, the audit found the Trust did not have income in excess of its inflation-proofing liability. Therefore, there was no excess income available for transfer to the general fund.

Per AS 47.30.031(a), the board shall adopt regulations consistent with state law and the fiduciary responsibilities imposed by law on members of boards of directors of corporations having trust responsibilities. Regulation 20 AAC 40.600 requires the board's asset management policies be set out in the AMPS. Per the 2019 AMPS, the target income reserve is set at 400 percent of the annual withdrawal amount. The reserve helps ensure the Trust can meet its spending goals in a difficult market environment and helps ensure liquidity in future years.

We recommend the board of trustees develop written policies to correctly determine income reserves.

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**Recommendation No. 4:**

**The board of trustees should consider developing written policies that require inflation-proofing occur annually if Trust income reserves are sufficient.**

Trust inflation-proofing did not occur routinely from FY 14 through FY 20 even though income reserves were sufficient to allow inflation-proofing.

Inflation-proofing did not occur because the Authority's policies did not require inflation-proofing. The 2004 version of the AMPS required inflation-proofing when excess reserves were available. In 2009 the AMPS was changed to make inflation-proofing discretionary. Inflation-proofing was not performed routinely after the change. As of mid-March 2021, the Trust's inflation-proofing liability totaled approximately \$120.3 million. Failing to inflation-proof increases the risk that the Trust corpus will not be sufficient to meet the needs of future beneficiaries.

Per AS 47.30.036(1), the board of trustees shall preserve and protect the Trust corpus.

We recommend the board of trustees consider developing written policies that require inflation-proofing occur annually if Trust income reserves are sufficient.

**Recommendation No. 5:**

**The board of trustees should develop written policies to annually evaluate whether Trust income must be transferred to the general fund.**

Authority policies do not clearly identify how to evaluate Trust income to determine whether amounts exist that are not reasonably necessary to meet the expenses of the integrated comprehensive mental health program.

Per AS 47.30.046, the board shall submit a budget for the next fiscal year that includes the Authority's determination of the amount in the mental health trust settlement income account, if any, that is not reasonably necessary to meet the projected operating and capital expenses of the integrated comprehensive mental health program that may be transferred to the general fund. Per AS 37.14.041(b), if money in the mental health trust settlement income account is not needed to meet the necessary expenses of the State's integrated comprehensive mental health program, the Authority shall transfer

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the money to the unrestricted general fund for expenditure through legislative appropriation for other public purposes.

According to Authority management, the gap between the beneficiaries' financial needs and available resources has been so large that it has not been necessary to calculate the gap, and, accordingly, it has not been necessary to identify any surplus Trust income.

The lack of clear policies that define the amount "needed to meet the necessary expenses of the state's integrated comprehensive mental health program" may result in a failure to transfer excess income to the general fund.

We recommend the board of trustees develop written policies to annually evaluate whether Trust income must be transferred to the general fund.



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# OBJECTIVES, SCOPE, AND METHODOLOGY

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In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Alaska Mental Health Trust Authority (Authority).

## Objectives

The audit evaluates the corrective action taken by the Authority to address audit findings for select asset management issues identified in a prior legislative audit of the Authority that was released June 2018. Specifically, the audit objectives were to:

- Verify that approximately \$40 million of Alaska Mental Health Trust (Trust) income was transferred to the mental health trust fund managed by the Alaska Permanent Fund Corporation (APFC).
- Evaluate the impact of transferring approximately \$40 million of Trust income on the Authority's ability to provide for spending if the asset portfolio does not achieve its earnings objectives.
- Determine whether cash principal has been transferred to the APFC in a timely manner since the prior audit was issued.
- Determine whether the mental health trust fund managed by the APFC was reconstituted for \$1.8 million in cash principal inappropriately spent on program-related investments as identified in the prior audit.
- Determine 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 prior audit's conclusions.
- Report on the status of commercial real estate investments and the board's intent regarding the investments.

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## Scope

The audit examined the Authority and Trust Land Office (TLO) operations from February 8, 2018,<sup>14</sup> through March 31, 2021.

## Methodology

To address the objectives, auditors:

- Reviewed the prior audit report that was released June 2018 (ACN 04-30090-18) to gain an understanding of the conclusions and recommendations related to asset management issues.
- Interviewed the Authority’s board of trustees chair, the Authority’s chief executive officer, the Authority’s former senior management, as well as pertinent staff. Interviews were conducted to gain an understanding of Authority and TLO operations, Trust asset management practices, and corrective action taken to resolve findings-related asset management issues identified in the prior audit.
- Gained an understanding of the Authority’s legal framework by reviewing the following pertinent laws and documents guiding the Authority’s operations:
  - ◆ Alaska Mental Health Enabling Act of 1956;
  - ◆ House Bill (HB) 201 – 18<sup>th</sup> Legislature (1993-1994) and meeting minutes documenting legislative deliberations of the bill;
  - ◆ Trust statutes AS 37.14.001—.099;
  - ◆ Authority statutes and regulations AS 47.30.010—.190 and 20 AAC 40, respectively;
  - ◆ TLO statutes and regulations AS 38.05.801 and 11 AAC 99, respectively;
  - ◆ *State v. Weiss* (Alaska 1985) settlement-related documents including the 1994 Settlement Agreement, *Memorandum*

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<sup>14</sup> Fieldwork end date for prior audit 04-30090-18.

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*Decision and Order Granting Final Approval to the HB 201, and the Dismissal Order;*

- ◆ *Weiss v. State* (Alaska 1997) Supreme Court opinion;
  - ◆ Memorandum of understanding between the Authority and Department of Natural Resources dated June 8, 2005;
  - ◆ Memorandum of agreement between the Authority and the APFC dated July 1, 1995;
  - ◆ Authority's bylaws approved and adopted on May 7, 2014, and October 27, 2017;
  - ◆ Uniform Prudent Investor Act (AS 13.36.225—.290);
  - ◆ Uniform Prudent Management of Institutional Funds Act (AS 13.65.010—.095); and
  - ◆ *Principles of State Trust Portfolio Management* published by National Association of State Trust Lands.
- Using the State's accounting system, retrieved and evaluated the Authority financial information to identify balances and uses of funds.
  - Obtained and evaluated support from the APFC accounting system to identify transfers to principal and to confirm balances.
  - Reviewed Authority board meeting packets and minutes from February 8, 2018, through March 31, 2021. The information was reviewed to gain an understanding of the corrective action taken to address prior audit findings and to identify balances reported on the income reserves and annual withdrawal amounts.
  - Reviewed appraisals, brokers' opinions, and financial statements for the seven commercial real estate investments managed by the TLO to calculate the fair market value, mortgage balance, and equity of the investments as of March 31, 2021.

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- Reviewed Authority's draft amendments to the Resource Management Strategy to identify the nature of proposed changes.
  - Reviewed and compared the Authority's 2014 and 2019 Asset Management Policy Statements to identify changes.
  - Reviewed Authority and TLO annual reports, budgets, and newspaper articles to gain an understanding of the Authority and TLO activities.
  - Reviewed the asset management study by Callan and Associates published in 2011 and sponsored by the Authority's management to gain an understanding of the income reserves.
  - Obtained and reviewed TLO's third party real estate advisor's reports from November 2019 through March 2021 to identify the status of the seven TLO managed commercial real estate investment properties.
  - Evaluated TLO job postings from FY 19 and FY 20 to identify staff responsibilities for positions related to the seven commercial real estate properties.
  - Inquired with APFC management on the possibility of absorbing the seven commercial real estate investments in the existing APFC portfolio with the permanent fund and the mental health trust fund each owning unit shares.

No sampling was conducted as part of the audit. Additionally, no internal controls were tested, as no controls were found significant to the audit objectives.

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## APPENDIX SUMMARY

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Appendix A provides a summary of the options considered by the Alaska Mental Health Trust Authority board of trustees for treatment of the seven Trust Land Office (TLO) managed commercial real estate investments purchased with cash principal during FY 12 through FY 17.

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# APPENDIX A

## Options Considered by the Alaska Mental Health Trust Authority Board of Trustees for Treatment of the TLO Managed Commercial Real Estate Investments

### Option No. 1 Status quo

The Alaska Mental Health Trust (Trust) retains oversight of the seven commercial real estate investment properties and the Trust Land Office (TLO) continues to manage the investment properties. Cash principal invested in commercial real estate is not replaced with Trust income.

### Option No. 2 Divest commercial real estate holdings

The Trust markets the commercial real estate properties and transfers cash from the sales to the Alaska Permanent Fund Corporation (APFC) equal to the original principal amount invested in the properties.

### Option No. 3 Transfer the commercial real estate investment portfolio to APFC

The Trust transfers oversight responsibility of the commercial real estate properties invested with cash principal into a separate account managed by the APFC. APFC retains a qualified real estate investment firm to oversee the investment properties. The Trust is not involved in the operations of the properties, but retains final authority over the purchase or sale of any assets.

### Option No. 4 Refinance commercial real estate properties and transfer cash to APFC

The Trust retains the commercial real estate holdings and borrows additional funds secured by the properties and transfers cash to the APFC equal to the original principal amount invested in the properties.

### Option No. 5 TLO maintains management of the commercial real estate portfolio and diverted cash principal is replaced with Trust income

The Trust transfers \$39.5 million of Trust income to the mental health trust fund managed by the APFC to replace the cash principal that was invested in the seven commercial real estate properties. The Trust retains oversight of the seven investment properties and TLO continues to manage the investment properties.

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## APPENDIX A

### (Continued)

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#### Options Considered by the Alaska Mental Health Trust Authority Board of Trustees for Treatment of the TLO Managed Commercial Real Estate Investments (Continued)

Option No. 6 TLO maintains management of the commercial real estate portfolio and diverted cash principal is replaced with Trust income over a 15 year period

The Trust commits to transferring income each year, up to 15 years, to the mental health trust fund managed by APFC to replace the \$39.5 million cash principal invested in commercial real estate. The annual transfer would be based on funds generated from the commercial real estate investments. The Trust retains oversight of the seven investment properties and TLO continues to manage the investment properties.

Option No. 7 Partial sale combined with reimbursement

The Trust selectively disposes of some commercial real estate properties and transfers the sales proceeds to APFC. Additional payments would be made in the future until the total amount of cash transferred is equal to the original principal amount invested in the properties.

Option No. 8 Expansion of the existing commercial real estate investment portfolio

The Trust selectively acquires new properties in the future. The additional properties would allow for spreading of some of the expenses of managing the properties over a greater base of assets.

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Source: Authority January 3<sup>rd</sup> and 30<sup>th</sup>, 2019, full board meeting minutes and meeting documentation.



# Agency Response from the Department of Natural Resources



THE STATE  
of **ALASKA**  
GOVERNOR MIKE DUNLEAVY

## Department of Natural Resources

OFFICE OF THE COMMISSIONER

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August 16, 2021

Eileen Donahue  
Deputy Legislative Auditor  
P.O. Box 113300  
Juneau, AK 99811-3300

RECEIVED

AUG 16 2021

LEGISLATIVE AUDIT

Re: Confidential Preliminary Audit Report Alaska Mental Health Trust Authority

Dear Ms. Donahue,

I received the preliminary audit report regarding the Alaska Mental Health Trust follow up audit authorized by the Legislature.

The Trust Land Office (TLO) within DNR manages Trust owned lands solely for the Trust as is legally required by the 1994 settlement resolving a class action lawsuit that restored the Alaska Mental Health Trust lands. The land management functions were separated from the Alaska Mental Health Trust Authority (AMHTA) because of land management expertise at DNR, yet the coordination of the two entities is structured by statute. Furthermore, the Alaska Mental Health Trust Authority board of trustees later delegated management of seven commercial real estate investment properties to the TLO. Consistent with the Alaska Mental Health Trust Enabling Act, the TLO effectively and efficiently manages Trust owned lands and the seven commercial real estate investment properties as described in the report. The TLO has demonstrated that it has managed the investment properties well through a challenging economic time during the Covid-19 pandemic, producing positive income returns and increased value from the portfolio.

The TLO management actions are coordinated with the AMHTA board of trustees and any Trust funding or disposal of the commercial real estate investment properties must be approved by the board of trustees. The majority of the content of the preliminary audit report addressed things that are solely in control of or decided by the AMHTA therefore I will not address any of those issues. Nor can I say if I concur with the conclusions or recommendations that directly affect the AMHTA. I understand that the AMHTA will address the substantive issues from the report.

Sincerely,

A handwritten signature in blue ink that reads "Corri A. Feige".

Corri A. Feige  
Commissioner

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# Agency Response from the Department of Revenue



THE STATE  
of **ALASKA**  
GOVERNOR MICHAEL J. DUNLEAVY

## Department of Revenue

Office of the Commissioner

State Office Building  
333 Willoughby Avenue, 11<sup>th</sup> Floor  
P.O. Box 110400  
Juneau, Alaska 99811-0400  
Main: 907.465.2300  
Toll free fax: 888.224.4538

August 18, 2021

Kris Curtis, Legislative Auditor  
Division of Legislative Audit  
PO Box 113300  
Juneau, AK 99811

RECEIVED

AUG 20 2021

LEGISLATIVE AUDIT

Dear Ms. Curtis,

Thank you for providing a copy of the *Department of Revenue, Alaska Mental Health Trust Authority Status of Select Asset Management Issues* dated July 6, 2021. None of the recommendations are directly addressed to the Department of Revenue and as such, the Department declines to provide a response to the findings in your letter.

AMHTA is an independent corporate entity and it would not be appropriate for us to make recommendations.

Sincerely,

A handwritten signature in cursive script that reads "Lucinda Mahoney".

Lucinda Mahoney  
Commissioner  
Department of Revenue

Attachment

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# Agency Response from the Office of the Governor

STATE CAPITOL  
P.O. Box 110001  
Juneau, AK 99811-0001  
907-465-3500



550 West Seventh Avenue, Suite 1700  
Anchorage, AK 99501  
907-269-7450

Governor Mike Dunleavy  
STATE OF ALASKA

August 13, 2021

Ms. Kris Curtis  
P.O. Box 113300  
Juneau, AK 99811

**RECEIVED**  
AUG 13 2021  
**LEGISLATIVE AUDIT**

Dear Ms. Curtis:

I agree with the findings of the July 2021 Alaska Mental Health Trust Authority Status of Select Asset Management Issues audit report completed by Legislative Budget and Audit.

Recognizing the Alaska Mental Health Trust Authority is an independent entity, answering to the Alaska Mental Health Trust Authority Board of Trustees, I would urge the Trustees to direct the Trust to implement all five recommendations.

If you have any questions or need additional information, please contact Courtney Enright, Director of Boards and Commissions. She can be reached at (907) 269-0006 or [courtney.enright@alaska.gov](mailto:courtney.enright@alaska.gov).

Sincerely,

A handwritten signature in blue ink, appearing to read "Mike Dunleavy".

Mike Dunleavy  
Governor

Enclosures

cc: The Honorable Lucinda Mahoney, Commissioner, Department of Revenue  
The Honorable Adam Crum, Commissioner, Department of Health and Social Services  
Courtney Enright, Director of Boards and Commissions, Alaska Office of the Governor  
Miles Baker, Legislative Director, Alaska Office of the Governor

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# Agency Response from the Alaska Mental Health Trust Authority



3745 Community Park Loop, Suite 200  
Anchorage, AK 99508  
Tel 907.269.7960  
www.mhtrust.org

August 18, 2021

Kris Curtis, Legislative Auditor  
Legislative Audit Division  
Legislative Budget and Audit Committee  
4341 B Street, Suite 400  
Anchorage, AK 99503

RECEIVED

AUG 18 2021

LEGISLATIVE AUDIT

Dear Ms. Curtis:

Thank you for the opportunity to respond to Legislative Audit's preliminary audit report pertaining to the 2021 special audit of the Alaska Mental Health Trust Authority.

We appreciate that the preliminary audit report indicates that the Trust has successfully responded to the findings of the 2018 legislative audit and is actively upholding state statutes and the terms of the *Weiss v. State* settlement.

While we generally agree with the recommendations outlined in the 2021 legislative audit, we do not necessarily agree with all of the conclusions and findings leading to the recommendations. Our comments on the report's recommendations and conclusions are compiled herein.

Further, we believe our financial practices are prudent, lawful, aligned with the rights and fiduciary responsibilities of the board of trustees, consistent with generally accepted standards in the financial industry, and conducted in the best interest of Trust beneficiaries per the 1994 settlement.

The Alaska Mental Health Trust Authority is unique, complex, and, by explicit design, an independent public corporation established in 1994 as a result of the state of Alaska settlement of *Weiss v. State* class action lawsuit. As a public corporation, the Trust Authority has a measure of independence from the department in which it is housed, much like the Alaska Housing Finance Corporation or the Alaska Permanent Fund Corporation (APFC). It is governed by a board of trustees charged with administration of the Mental Health Trust Authority, a fiduciary duty to protect the Trust fund corpus and Trust beneficiaries, and a shared responsibility with the state for the development of an integrated comprehensive mental health program.

**Management Structure**

APFC	Trust Land Office (TLO)	Board of Trustees
•Trust principal (corpus)	•Trust land assets	•Settlement income

It is the Trustee's duty to protect and manage the corpus and the Trust Authority. The *Weiss* settlement specifically outlined management of the Trust fund's cash principal, lands, and income.

Through the *Weiss* settlement, the state's fiduciary duty to administer a public trust originally established by Congress in 1956 through passage of the Mental Health Enabling Act was delegated to the

board of trustees. The Enabling Act granted the Territory of Alaska one million acres of federal land to be held in public trust for the creation and operation of mental health care facilities in Alaska. In 1978, the Alaska legislature passed a law redesignating the land received under the Enabling Act as general grant land managed by the Department of Natural Resources (DNR). This led to the *Weiss* litigation, originally filed in 1982, wherein beneficiaries argued that the state had failed to uphold its fiduciary responsibilities to mental health beneficiaries, and which ultimately concluded with the *Weiss* settlement and the related statutory law enacted through passage in 1994 of HB 201. The *Weiss* settlement, codified in law, required coordination and agreement amongst the executive branch, the legislature, the class action plaintiffs, and approval by the court. This multi-branch coordination continues today, as the Trust Authority works in concert with the executive branch and the state legislature to develop the state's integrated comprehensive mental health program budget.

The creation of the Trust Authority as a public corporation with independence and authority over the Trust Authority's settlement income account was an integral part of the *Weiss* settlement. A unique feature of the Trust Authority is its ability to allocate funds from the settlement income account without legislative action. HB 201 explicitly requires annual transfer of net income from the Trust's principal cash account (managed by APFC) and net income from the Trust's real property holdings (managed by DNR's Trust Land Office, or TLO) to the settlement income account, which is managed by the Trust Authority.

With the exception of the Trust Authority's administrative and operating expenses, which are subject to the Executive Budget Act, the Trust Authority is empowered to use the money in the income account to fulfill its purpose of ensuring an integrated comprehensive mental health program for the state. The Trust Authority was intentionally granted flexibility in determining how to use settlement income to serve current and future beneficiaries.

#### RECOMMENDATIONS

*Recommendation 1: The Alaska Mental Health Trust Authority (Authority) board of trustees should consider liquidating the Trust Land Office (TLO) managed commercial real estate investments or transferring the investments to the Alaska Permanent Fund Corporation (APFC) as inflation-proofing.*

This recommendation seems to have two parts. First, consideration of liquidating the existing commercial real estate assets and second, to dedicate the proceeds from the liquidation to inflation-proofing the Alaska Mental Health

*Considering the recommendations of this Legislative Audit, the current and anticipated statewide need for Trust beneficiary support, and the significant decline in FY2020 asset values followed by the significant gains in FY2021 asset values, the Trust Authority will engage with an independent investment advisor in a review of practices related to:*

- Trust reserves,
- inflation-proofing
- the annual payout percentage
- related subjects

*It is the objective of the Trust Authority to have this review completed by the end of FY2022, and that approved recommendations developed as a part of the review be incorporated in the Trust Authority's Asset Management Policy Statement (AMPS).*



Trust fund.

We agree with the first: the board of trustees has a process in place to consider liquidation of its commercial real estate investments and will continue to do so regularly. The Trust Authority has contracted with an independent real estate advisor, Harvest Capital Partners, which makes a hold/sell recommendation annually for each asset. Harvest is a U.S. Securities & Exchange Commission-registered independent real estate consulting firm that advises endowments, pensions, and institutional investors. The evaluation presented by Harvest in July, 2021 recommended retaining the assets.

Our reaction to the topic of inflation-proofing is discussed in our response to recommendation #4.

*Recommendation 2: The board of trustees should develop written procedures to ensure annual withdrawals are correctly calculated.*

We agree that written procedures are important and appreciate the observations cited in the Legislative Audit report. To ensure correct application of the withdrawal policy in the AMPS, detailed written procedures were completed in June, 2021. To be clear, recent annual payouts have been calculated correctly as defined in our Asset Management Policy Statement (AMPS). The withdrawal policy represents a long-standing practice of the Trust Authority.

*Recommendation 3: The board of trustees should develop written policies to ensure Trust income reserves are correctly determined.*

We agree that written policies are important and appreciate the Legislative Audit report's observations. The audit has identified a valid concern with the process the Trust Authority has used recently to determine the amount of settlement income derived from investments of Trust fund principal - which directly affects the values of Trust reserves. It appears that the Trust Authority is subject to the statutory calculation used for the Alaska Permanent Fund to determine earnings. While this methodology was not intended to affect the Trust Authority when established, it appears that it does. As a result of what we have learned through the audit, this issue will be considered by the board of trustees and changes to the AMPS will be made as deemed necessary. Additionally, working with the APFC, the Trust Authority now has written procedures for calculating spendable reserves.

This Legislative Audit recommends including the \$60MM of commercial real estate equity in the calculation of the Trust Authority's reserves target and in the calculation of the annual POMV withdrawal. We disagree with this. Our existing AMPS does not include commercial real estate or other real assets in these calculations. In our planned upcoming asset study, the board of trustees will request advice on the inclusion of the commercial real estate assets in target reserves and POMV calculations.

*Recommendation 4: The board of trustees should consider developing written policies that require inflation proofing occur annually if Trust income reserves are sufficient.*

We agree that written policies related to protecting purchasing power for future beneficiaries are important, and that the board of trustees should evaluate inflation proofing opportunities on an annual basis and transfer settlement income to the Alaska Mental Health Trust fund when deemed

appropriate. We expect the upcoming recommendations from the independent investment advisor to inform the board's future inflation proofing decisions.

Although the statute identifies inflation proofing as an allowable use of Trust income, it does not require inflation proofing.

Further, while we agree that an annual evaluation of the Trust corpus should be conducted, and that this evaluation should consider the effects of inflation, a requirement to inflation-proof regardless of market conditions and fund performance may not align with prudent fiduciary decision-making. A decision whether to inflation proof should follow the careful consideration of many factors, and not be based solely on an annual deadline.

The duty of impartiality requires that the board of trustees make decisions without favoring future beneficiaries over present beneficiaries (AS 37.10.071(c)). The evaluation must be fair.

*Recommendation 5: The board of trustees should develop written policies to annually evaluate whether Trust income must be transferred to the general fund.*

We agree that the board of trustees should annually evaluate the responsibilities defined in statute and the *Weiss v. State* settlement, and determine if there is excess settlement income that could be transferred to the state's general fund. Although we believe transfers in the foreseeable future are highly unlikely given the amount of beneficiary needs outlined in the integrated comprehensive mental health program plan, we agree that an annual review is appropriate and will plan to complete that review prior to our statutory budget transmittal deadline each year.

## CONCLUSIONS

In response to the *Report Conclusions* stated in the preliminary audit report, comments to each conclusion are provided below. Our comments also apply to this section's general introduction.

*The Authority considered several options for corrective action.*

We agree, and we believe that the proposals the board of trustees relied on to address the 2018 Legislative Audit's finding regarding the commercial real estate holdings and to make their decision had accurate and useful cost estimates when considered. Management costs have since changed.

While there are/were no guarantees that the proposed costs of other alternatives would remain the same, Harvest (our third party commercial real estate advisor) recently reviewed the earlier cost estimates for TLO management of the portfolio. They found the evaluation method sound. They also

*Integration of the commercial real estate assets into APFC holdings was not a viable option because the assets did not fit APFC's investment criteria. However, our commercial real estate assets are institutional quality for a fund of the Trust's size and serve a purpose in Trust Authority asset allocation: acting as an "inflation hedge" and generating predictable spendable income along with long-term appreciation.*

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concluded TLO management was still financially justified. Strategically, there are staff and economic efficiencies from having the TLO manage the portfolio alongside its other commercial real estate activities.

Approximately \$41.3mm of Trust income was transferred to the APFC to restore cash principal and the commercial real estate properties continued to be managed by the TLO.

We agree with this conclusion. However, we disagree with the report’s determination that the selection of the TLO to manage the commercial real estate properties is unjustified. The TLO is fully capable of managing seven real estate assets in five cities in a manner that suits the Trust Authority’s objectives. Our external real estate advisor, Harvest, has confirmed that the TLO is capable of fulfilling this responsibility.

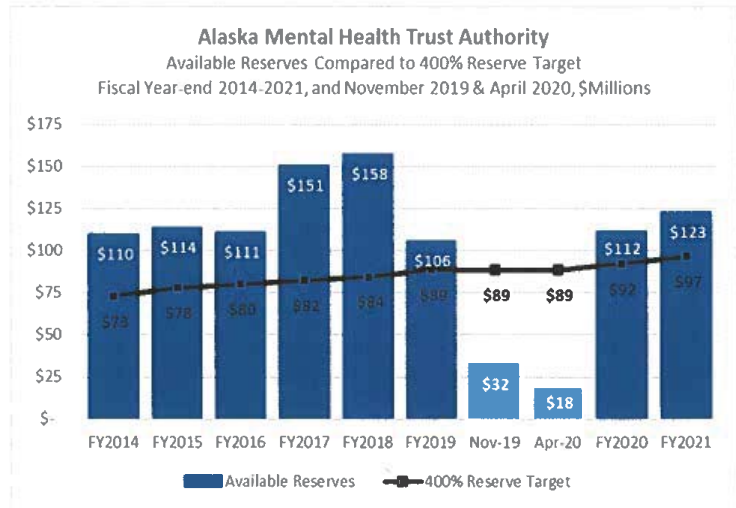
The preliminary audit report also disputes the Trust Authority’s decision to use the TLO to manage our commercial real estate based on a “lack of financial management capability.” The TLO is not being asked to manage Trust financial investments. They are being asked to manage investments in real property assets. The selection of the TLO is appropriate for a land trust such as the Trust Authority.

Trust income reserves exceeded target levels for 10 years, and Trust income reserves levels significantly exceed target levels due to a lack of inflation proofing.

We do not agree with the methodology the Auditor uses to calculate the value of the Trust Authority’s reserves, however we do agree that the year-end reserve balances have exceeded the targets set in the AMPS in recent years.

The Trust Authority’s commercial real estate assets are considered assets acquired with Trust fund settlement income, but they are not included in the calculation of Trust Authority target reserves or our annual POMV withdrawal. The long-standing practice of the Trust Authority, as reflected in AMPS, has been to base these calculations on financial assets managed by APFC and Department of Revenue (DOR), not on the Trust Authority’s real property assets.

The Trust Authority’s reserve policy outlined in our AMPS targets a balance of spendable income held at APFC and DOR equivalent to 400% of the annual withdrawal amount. For example, FY20’s annual POMV withdrawal, at \$23,056,000, established the



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target FY20 'buffer' of \$92,226,400. Given the dynamics of the financial markets, the Trust fund may be above or below this target at the time a decision is to be made. This is demonstrated in the chart on the prior page. In FY2020, inflation proofing was twice considered as an agenda item by the Finance Chair after the state finished its financial closing. In November 2019 and April 2020 total reserves were well below the targeted 400%.

Further, Alaska statute provides the board of trustees significant discretion in how they deploy Trust Authority settlement income be it for near-term beneficiary support, or investing in long-term beneficiary support through land development or inflation proofing.

### Investment of Trust income in commercial real estate reduced liquidity

We agree that the commercial real estate assets are less liquid, but that was anticipated and considered by the board of trustees at the time of investment. The audit incorrectly assigns the commercial real estate assets as elements of Trust Authority's reserves and POMV withdrawal calculations. The Trust Authority's financial reserves are managed to provide a greater degree of liquidity, and the Trust Authority's commercial real estate assets are managed for predictable income and value appreciation.

Further, in response to the Auditor's assertion that the commercial real estate investments reduced our ability to meet spending goals in event of the down market, the reserves policy governing our liquid assets managed by APFC and the DOR ensure we can consistently meet the needs of beneficiaries regardless of market performance. If there were a 20% market decline from FY2021 year-end market values, the roughly \$50 million in reserves invested by DOR alone would fund two years of programmatic support as the market recovered.

### Excess Trust income must be transferred to the State's general fund

The board of trustees agree with this conclusion, as it is a statutory obligation. We believe given the extent of support statutorily required for the state's integrated comprehensive mental health program outlined in AS47.30.056(i), Trustees are unlikely to determine that there is excess settlement income in the near to medium term.

*According to AS47.30.056(i), a comprehensive mental health program plan identifies Trust beneficiary service needs associated with the following summarized categories:*

- emergency services
- screening examination and evaluation services
- crisis stabilization services
- treatment services
- case management
- daily structure and support
- residential services
- vocational services
- outpatient screening, diagnosis, and treatment services
- prevention and education services
- administrative services

*While the Trust endeavors to work with state and other partners to ensure that beneficiaries have access to all the services outlined in the comprehensive mental health program plan, it is almost impossible to anticipate a date when all these services will be fully available to every beneficiary who needs them. This is the prime reason the Trust Authority manages its resources with an anticipation of perpetual need, and must balance the needs of current and future beneficiaries.*

*Deficiencies were identified in the Authority's calculation of Trust income reserves*

We agree there were some deficiencies. We do not agree that by excluding the commercial real estate investments we have miscalculated reserves balances for the purposes of our spending and reserves. The spending and reserve policies are established in the Trust's AMPS.

Given what we learned through the legislative audit, our financial reporting is now consistent with APFC: the Trust Authority calculates Statutory Net Income (settlement income available for spending determined by adjusting for Trust fund principal's unrealized gains and losses) in addition to traditional earnings reported in our audited financial statements. Trustees are now receiving reports that include both methods.

Since inception of the commercial real estate investment strategy, the commercial real estate equity value has not been incorporated in either reserve or principal calculations, but has been included in Total Trust Funds. Legislative Audit is correct that the board of trustees earlier approved classifying the commercial real estate as part of budget reserves. Shortly after that action, Trustees approved a new version of the AMPS which excluded their equity value in the calculation for the annual withdrawal and the target reserve. The upcoming external review noted above can assess the impact of the inclusion of the commercial real estate on payout methodology and reserve policy.

*Errors were found in the Authority's methodology for calculating annual withdrawals*

We agree that there were errors in calculating annual withdrawals in FY17 and FY18. Recent calculations of the annual withdrawal have been correct and are consistent with the Trust Authority's AMPS. Additional written procedures for calculation of the withdrawal are now in place.

The audit report suggests that by not including the commercial real estate in the Trust Authority's withdrawal calculation that the Trust under-allocated funds for beneficiary support. The AMPS does not include the commercial real estate in the payout calculation. We are pleased to note that since 2016, when the last commercial real estate asset was purchased for the commercial real estate portfolio, the average annual revenue to the Trust Authority has been \$1.5MM. This affirms the board of trustees' decision to keep the flow of commercial real estate revenue to the Trust consistent with distributions from other real assets managed by the TLO. This \$1.5MM compares favorably to the POMV applied to the Trust Authority's financial assets, where the Legislative Audit estimates the commercial real estate would have contributed \$1.2MM annually. Nonetheless, this policy will be reviewed when we engage an independent investment advisor to review our asset management.

*Transfers of cash principal were not made timely after the prior audit was issued*

We agree that Trust Authority Development Account (TADA) transfers to the APFC were inconsistent. This was due to turnover within our Chief Financial Officer position, and regular transfers now focus on optimizing investment earnings. However, we believe Legislative Audit misunderstands the Trust

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Authority's process. There are several land development projects the board of trustees authorized that reinvested funds from the TADA account before the 2018 Legislative Audit. These are near completion, but until that time, Trustees must annually approve a minimum balance in the TADA account before other funds can be authorized to be transferred to the Trust fund's principal account. This annual authorization usually occurs at the January board meeting, after the completion of the financial audit. (An exception: in fall 2020, the board of trustees authorized the \$20MM Norwegian Cruise Line receipt to accelerate that specific transfer.)

### Cash principal was inappropriately used by the Authority for land development activities

We do not agree cash principal was used inappropriately. The board of trustees agree that the original settlement and statutes did not provide a clear source of funding for the type of expenses described in this section. Since 2017, no additional commitments of principal have been made to land development projects, and no further use of principal is anticipated going forward. Per Legislative Audit's recommendation in 2018 to fund land improvements with spendable income, AAC40.610 was amended December, 2020, enabling the board of trustees to opt to return some spendable income invested in land to reserves, rather than be realized as principal. The board of trustees respects prior Trustee decisions and support their financial commitments to use principal for the USFS Land Exchange, Icy Cape, and Yosemite Road projects.

### Authority policies were partially amended to prohibit investing cash principal in commercial real estate outside of the APFC

We believe that all necessary Trust Authority policies designate that future principal revenue is to be transferred into APFC-managed principal. The 2019 revision of the AMPS designates that principal is to be transferred into the Trust fund. AMPS is the only Trust Authority policy statement that need be considered when addressing this concern.

### Authority management reported that the value of the TLO commercial real estate investments increased by \$9.6 million since the prior audit; however, two properties were projected to have negative cash flow for FY21

As noted by the Legislative Auditors, the commercial real estate assets' annual valuations have held up despite the economic impact of COVID-19, demonstrating expectations that the assets will continue to perform well long-term. As also noted by the Legislative Audit, consistent with industry best practices, the TLO is refinancing properties where appropriate to take advantage of lower interest rates, thus reducing debt payments and increasing cash available for beneficiary use.

This concludes our comments on the report's recommendations and conclusions. We have several corrections and comments related to some of the information presented in the *Organization and Function* and *Background Information* sections of the preliminary audit. The attached table notes changes that we hope will be useful in improving the accuracy of the final audit report.

Again, thank you for the opportunity to review and comment upon the preliminary audit report. As an organization that was established to help ensure that the needs of Alaskans who experience behavioral

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# Trust

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Trust Authority

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health conditions and developmental disabilities are met, we take our responsibility to manage and administer Trust Authority assets on behalf of our beneficiaries very seriously and understand that the preliminary Legislative Audit report was developed in the same spirit.

Sincerely,



Christopher R. Cooke  
Chair, Alaska Mental Health Trust Authority Board of Trustees

*Organization and Function*

Page	Para	Line	Recommendation	Correction or Comment
2	3	2	Please correct the Authority's FY22 budget from \$4.7MM	"\$4.2 million" (Trustee approval is \$4,179,897. The Governor's budget included \$500K in alcohol funds that was not included in the enacted budget.)

*Background Information*

Page	Para	Line	Recommendation	Correction or Comment
3	1	quote	Please insert the complete text of AMHEA Sec. 202(e) on page 712 to reflect the purpose of the income disposition. The text in bold was excluded in the Management Letter.	"All lands granted to the Territory of Alaska under this section, together with the income therefrom and the proceeds from any disposition thereof, shall be administered by the Territory of Alaska as a public trust and income shall first be applied to meet the necessary expenses of the mental health program of Alaska. Such lands, together with any property acquired in exchange therefor or acquired out of the income or proceeds therefrom, may be sold, leased, mortgaged, exchanged, or otherwise disposed of in such manner as the Legislature of Alaska may provide in order to obtain funds or other property to be invested, expended, or used by the Territory of Alaska. <b>The authority of the Legislature of Alaska under this subsection shall be exercised in a manner compatible with the conditions and requirements imposed by other provisions of this Act.</b> "
3	2		Please revise, "Per the AMHEA, management of the Trust..."	"Per the AMHEA, management of <b>the public trust lands</b> was subject to ..." OR revise to state "Per the AMHEA, management of the Trust ....promulgated by the Legislature <b>in a manner consistent with the enabling act.</b> We believe this will be consistent with the intent of Sections 371, 372 and 202 of AMHEA.
3	4	4	Please revise "...passed HB 201 to change the Trust statutes..."	"passed HB 201 <b>establishing a Trust Authority...</b> " There were no pre-existing statutes. The Trust Authority was established per l(1)(c) of the Settlement Agreement, page 3.



# Legislative Auditor's Additional Comments

## ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



P.O. Box 113300  
Juneau, AK 99811-3300  
(907) 465-3830  
FAX (907) 465-2347  
legaudit@akleg.gov

August 19, 2021

Members of the Legislative Budget  
and Audit Committee:

We have reviewed the responses to the audit report from the Alaska Mental Health Trust Authority (Authority), Department of Natural Resources, Department of Revenue (DOR), and the Office of the Governor. Nothing contained in the responses causes us to revise or reconsider the report conclusions and recommendations.

I offer the following comments to address the Authority's disagreements with several audit conclusions.

The Authority's chairperson does not disagree with the audit's conclusion that investing Alaska Mental Health Trust (Trust) income in commercial real estate through the Trust Land Office (TLO) decreased the liquidity of Trust income, which reduced the Authority's ability to meet its spending goals during a down market. However, the chairperson appears to be satisfied with the lower level of liquidity and states that "If there were a 20% market decline from FY 2021 year-end market values, the roughly \$50 million in reserves invested by DOR alone would fund two years of programmatic support as the market recovered." We emphasize that our conclusion was based on the Authority's own policy that requires reserves be maintained at 400% of the annual withdrawal calculation. The 400 percent was determined by the Authority's consultant during 2011 as the appropriate level of reserves to ensure the Authority could provide for spending in a down market. If the Authority intends to maintain a level of reserves below the 400 percent, we recommend consulting with the appropriate expertise to obtain assurance that the lower level is adequate.

The chairperson disagrees that the TLO managed commercial real estate investments should be included in the calculation of income reserves and the calculation of the annual withdrawal. As explanation, the Authority's chairperson refers to existing Authority policies, which do not include the TLO managed commercial real estate or other real assets in the calculation of the Trust reserves or the annual withdrawal. We acknowledge that the Authority's policies support the Authority excluding TLO's managed real estate investments. However, we highlight that the Authority provided no reasonable explanation as to why the

Members of the Legislative Budget  
and Audit Committee:

- 2 -

August 19, 2021

policies excluded the investments. The board invested Trust income in the properties. The properties are reported as investments in the Authority's financial statements in the same manner as the Alaska Permanent Fund Corporation (APFC) and DOR investments. Therefore, the audit found the investments should be included.

The Authority's chairperson also indicates that the TLO managed commercial real estate properties are not investments when addressing the audit's conclusion that the TLO should not be managing a national real estate investment program. The Authority's chairperson states "The TLO is not being asked to manage Trust financial investments. They are being asked to manage investments in real property assets." Again, we emphasize that commercial real estate properties are reported in the Authority's FY 20 financial statements as "Cash and Investments." This presentation of the commercial real estate properties is similar to other real estate investments managed under the APFC and DOR investment portfolios.

In support of the Authority's decision to invest income in the commercial real estate properties, the Authority's chairperson references the \$1.5 million in average annual revenue. It is unclear whether the chairperson considered property expenses. Per the Authority's policies, income generated by the commercial real estate properties is to be used for the property operations, debt service, and capital improvements before consideration of beneficiary programs. We want to reiterate that excluding the properties from the annual withdrawal calculation reduced the FY 21 amount available to beneficiaries by \$1.2 million.

Further, the Authority's chairperson concludes that only the Authority's policies needed to be amended to prohibit investing cash principal in commercial real estate outside of the APFC. Contrary to this statement, the audit found that the TLO's policies for managing Trust land assets should be amended and, as of March 31, 2021, the TLO policy amendments had been drafted but not finalized.

Additionally, the Authority's response requested that the Organization and Function section of the audit report that referenced the Authority's FY 22 governor budget amount be changed to reflect the enacted budget. We declined to make this change because the audit period ended March 31, 2021, at which point the enacted budget had not passed. We also declined to make the Authority's suggested changes to the Background Information section of the report because we did not consider the suggested wording as necessary to understand the Report Conclusions.

In summary, we reaffirm the report conclusions and recommendations.

Sincerely,



Kris Curtis, CPA, CISA  
Legislative Auditor