STATE OF ILLINOIS
OFFICE OF THE
AUDITOR GENERAL
William G. Holland, Auditor General

SUMMARY REPORT DIGEST

COLLEGE ILLINOIS! PREPAID TUITION PROGRAM'S ADMINISTRATIVE OPERATIONS

MANAGEMENT AUDIT

Release Date: May 2012

SYNOPSIS

We identified several deficiencies in the administrative operations of the College Illinois! Prepaid Tuition Program (Program) including a procurement process that lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. We also identified management issues including a lack of support for actuarial assumptions used when setting contract prices, not having a set policy for how Program costs are allocated, and not utilizing key controls governing the Program's investments.

Specifically we found the following:

- The Illinois Student Assistance Commission (ISAC) circumvented the Illinois Procurement Code by selecting two investment managers outside of the normal procurement process. The procurement process was also circumvented when awarding a contract to perform due diligence services on the two investment managers.
- ISAC did not comply with its own conflict of interest policy. There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager while the selection process involving that investment manager was still ongoing.
- The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the Program sought investment managers for alternative investments. The role of the independent Investment Consultant was reduced, including the removal of its role in evaluating proposals.
- We noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the RFP, and lack of support justifying the number of proposers selected for award.
- Internal controls over the investment process were not functioning properly including the Investment Committee that was created but not formally established, the Portfolio Committee that was not fulfilling its requirements, and the Investment Advisory Panel failing to fulfill its statutory duties. In addition, the Investment Advisory Panel raised questions or concerns on certain investment issues which were not communicated to members of the Commission.
- ISAC could not provide support for how actuarial assumptions, such as investment return and future contract sales, were established or any rationale to support the assumptions used.
- Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011 due to a substantial increase in investment management fees and increases in both direct and shared payroll expenses. Fees collected from purchasers of tuition contracts covered only 7 percent of operating costs in fiscal year 2011.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

REPORT CONCLUSIONS

The procurement process (during the period where program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011) lacked consistency, transparency, independence, documentation, and compliance with procurement rules and the Procurement Code. In addition, the lack of implementation of the agency's conflict of interest policy led to the appearance of multiple conflicts, including multi-million dollar investments into funds where a staff member had private investments.

Although the Prepaid Tuition Fund had an annual average return of 3.5 percent from its inception in 1998, the actuarial assumed rates for 2006 to 2011 ranged from 7.5 percent to 9.25 percent. Fees collected from purchasers of tuition contracts covered only 7 percent of operating costs in fiscal year 2011. In fact, as program costs increased (from $6.4 to $18.1 million from fiscal years 2006 to 2011), the fees received actually declined (from $2.3 to $1.4 million).

Background

Established in 1997, the College Illinois! Prepaid Tuition Program (College Illinois or Program) allows participants to purchase a contract that prepays the full cost of tuition and mandatory fees at Illinois public universities and Illinois community colleges. The Illinois Student Assistance Commission (ISAC) administers the Program. ISAC's duties include investing Program funds with investment managers. The funded ratio of the Program has declined from 93.3 percent in 2007 to 70.5 percent in the most recent actuarial report which is as of June 30, 2011. House Resolution Number 174 directed the Auditor General to conduct a management audit of the Program. (pages 8-12)

Investing College Illinois Funds

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers outside of the normal procurement process.

The Illinois Student Assistance Commission circumvented the Illinois Procurement Code by selecting two investment managers (Kennedy Wilson and Lyrical-Antheus Realty Partners) outside of the normal procurement process. As discussed below, **it was later discovered that the former Director of Portfolio Management had become a limited partner in one of the investments**. During fiscal year 2011, these two investment managers received more than $2.6 million in investment fees.

The procurement process was also circumvented when awarding a contract to Mesirow Financial Investment Management (Mesirow) to perform due diligence services on

The procurement process was also circumvented when awarding a contract to perform due diligence services on the two investment managers.

the two investment managers. The fee structure for the due diligence services may have created an incentive for Mesirow to recommend the investments. Mesirow completed the first due diligence review prior to a contract to perform the work being in place. (pages 48-52)

ISAC did not comply with its own conflict of interest policy. A conflict of interest requirement contained in the Program's Investment Policy, which required an annual conflict of interest attestation by Commissioners and employees authorized to make investment decisions, was never implemented. We noted potential conflict of interest issues which included the following:

- There were two instances where the former Executive Director did not disclose potential conflicts of interest that met ISAC's criteria for disclosure. Both involved investment firms that were selected as investment managers, one of which received $20 million in funding.

In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, while the selection process involving that investment manager was still ongoing.

- **In January 2010, the former Director of Portfolio Management made a personal investment with an investment manager, Balestra Capital, while the selection process involving that investment manager was still ongoing** – specifically, a family partnership in which the Director of Portfolio Management had an economic interest made a $500,000 investment in Balestra Capital. He was also a member of the evaluation team that selected Balestra Capital.

- In another potential conflict of interest, the former Director of Portfolio Management introduced an investment with Lyrical-Antheus Reality Partners to ISAC and then, after leaving ISAC, became a limited partner in the investment. (pages 52-57)

In examining investment manager files, we noted one investment manager, Reynoso Asset Management, was provided funding that exceeded the amount authorized by $10 million. We also noted that a private equity investment of $14 million was made with a single company, Fisker Automotive, despite several risks outlined in the Subscription Agreement. (pages 58-62)

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments.

The process of selecting investment managers was inconsistent from fiscal years 2006 through 2011. Changes began to occur at the time that the College Illinois Program sought investment managers for alternative investments. The selection of investment managers changed in several distinct ways:

The evaluation committee became less diversified in later procurements, consisting of only ISAC staff.

- The makeup of the evaluation committee changed over the time period examined. The evaluation committee was more diversified in the earlier procurements including a Commissioner and a member of the Advisory Panel, in addition to staff at ISAC. Later procurements included only ISAC staff on the evaluation committee. Despite ISAC's State Purchasing Officer previously advising against it, the Executive Director of ISAC was included on the evaluation committee for three procurements. Participating on the evaluation team could allow the Executive Director to assert undue influence over the process.

The Investment Consultant assisted in evaluating proposals but was removed from this role in later procurements.

- For earlier procurements, Marquette Associates, the Program's Investment Consultant, assisted in evaluating proposals but was removed from this role in later procurements. It is unclear why ISAC removed the Investment Consultant from the process. One effect was creating greater control for the now smaller evaluation teams, consisting solely of ISAC staff, over the selection process.

The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session.

- The discussion of the selection of investment managers moved from the open session of the Commission meetings to the closed session. By moving these discussions to closed session, ISAC removed transparency from the process.

We reviewed all 14 procurements involving the selection of investment managers during fiscal years 2006 through 2011. We noted several issues with the procurements:

We noted several issues with the procurements including: a lack of documentation for vendor interviews/presentations, missing evaluations, changing evaluation criteria from what was specified in the RFP, and lack of support justifying the number of proposers selected for award.

- For the interviews/presentations of the finalists, none of the 14 procurements examined contained documentation on who attended or what was discussed.

- The procurement files lacked evidence of discussions regarding the rationale for the number of proposers selected for award. The number of winning vendors ranged from 1 to 13. The justification and rationale for the number selected was unclear.

- The procurement files were incomplete. Three of the 14 procurements lacked documentation on the initial scoring of the proposers and 1 of 14 lacked final scoring. Many evaluation forms lacked notes to justify the scores given.

- We noted mistakes during the scoring process for 4 of the 14 procurements. Some of these errors impacted the firms selected.

- For 3 of the 14 procurements, the evaluation criteria were changed to total only 450 points instead of the 500 points outlined in the Request for Proposals. (pages 35-47)

The Investment Advisory Panel, established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission.

The Investment Advisory Panel (Panel), established by the Illinois Prepaid Tuition Act, raised questions or concerns on certain investment issues which were not communicated to members of the Commission. The Commission members approve all investment decisions and may lack the expertise that members of the Panel possess. Specifically, the Panel raised concerns over changing the Investment Policy to allow direct private equity investment. While the Panel raised concerns to the senior staff at ISAC, if those concerns are not, in turn, communicated to the Commission, the purpose of the Panel is negated.

In addition, the Panel failed to fulfill its statutory duties by not meeting at least twice annually as required by the Illinois Prepaid Tuition Act. The Panel also did not meet publicly with the Commission at least once annually to discuss issues and concerns relating to the Illinois Prepaid Tuition Program. There was also at least one vacancy on the seven-member Panel throughout the audit period. (pages 29-35)

The College Illinois Program had several other weaknesses in its internal controls over the investment process. These included:

- The Commission has not approved a new Investment Policy since January 2010 which violates the statutory requirement of annually adopting a comprehensive investment plan.

- The Portfolio Committee, which took over the rebalancing function from the independent Investment Consultant, failed to meet monthly as required in the Investment Policy and had not met since October 2010.

- The Investment Committee, which was to consist of at least two Commission members, was not formally established. (pages 23-28)

Other Issues with Program Administration

The number of employees working for the College Illinois Program increased significantly over the six year period.

The number of employees working for the College Illinois Program increased significantly over the six year period. Twelve of the 20 employees hired during that time period were principal administrative appointments which are positions hired at the discretion of the Executive Director. Two of the positions created were investment positions for which it was not clear what duties and responsibilities were performed. Both of these positions have subsequently been eliminated.

Other testing results showed that 46 percent (11 of 24) of the employees tested lacked position descriptions that listed the education and experience needed for the positions making it impossible to determine if employees were qualified. Eight employees received salary payments totaling $176,000 when they resigned or when they were terminated.

One employee, the Director of Portfolio Management, voluntarily resigned his position effective July 21, 2010. Five days later, on July 26, 2010, the Executive Director of ISAC signed a voluntary separation agreement with the Director of Portfolio Management that included a lump sum payment of $24,166. (pages 64-69)

The annual report, which includes the actuarial report, is one of the primary vehicles for presenting meaningful information on the College Illinois Prepaid Tuition Program. While the reports contain the minimal required statutory information, they do not contain further information required by the Investment Policy. The reports also do not contain certain information that would be useful to contract holders and others who are evaluating the Program. (pages 70-72)

ISAC could not provide support for how actuarial assumptions were established or any rationale to support the assumptions used.

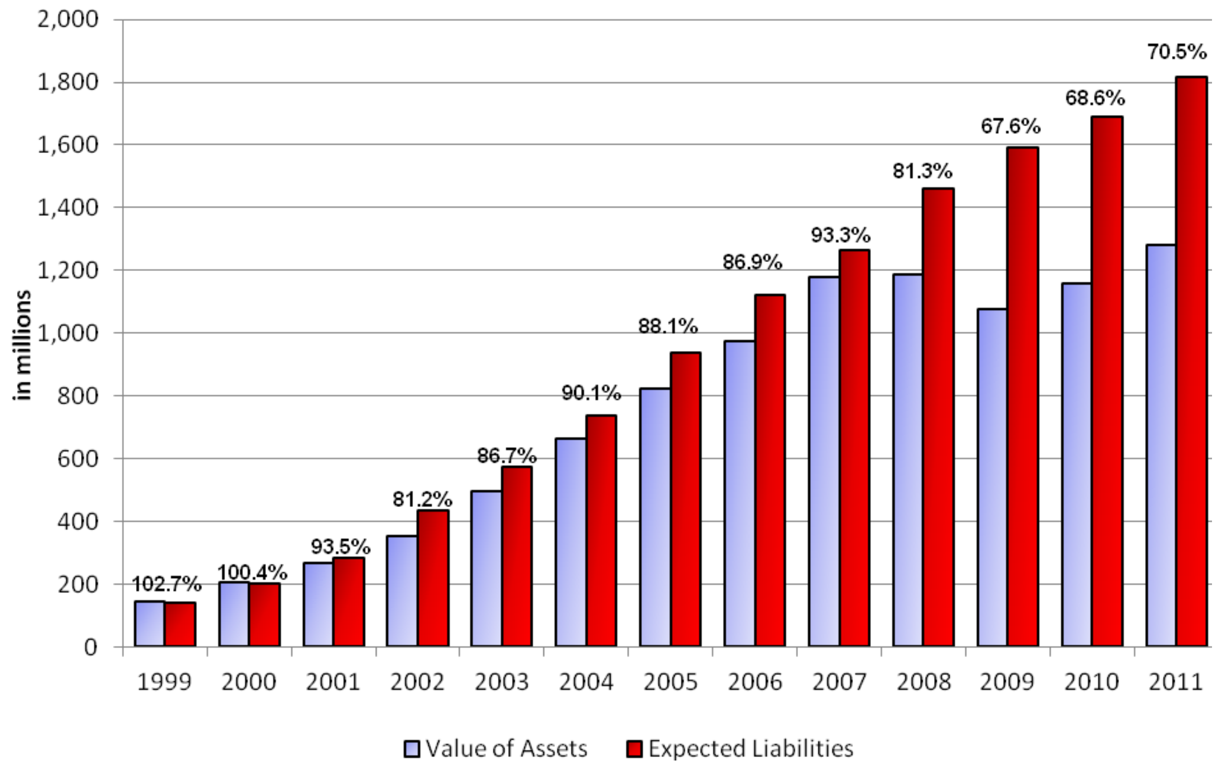
ISAC is responsible for the actuarial assumptions used in both the actuarial report and to set tuition contract prices. **ISAC, however, was unable to provide documentation for how certain assumptions were established or any rationale to support the assumptions used.**

- The investment return assumption of 9.25 percent, which was used in the fiscal year 2010 report, was lowered to 7.50 percent in the fiscal year 2011 report. The lowering of the investment assumption coincided with the change in administration at ISAC.

- Beginning in 2008 the assumption for future contract sales was set at 5,000 new contracts with the amount increasing by 500 per year capping at 15,000 new contracts per year. Based on historical sales, this appears to have been an unrealistic assumption.

- The fiscal year 2010 actuarial report adopted an alternative approach that amortized investment gains and losses over a five year period. This change decreased the actuarial deficit of the Program. The fiscal year 2011 actuarial report, which was done by a new actuary, reverted to the traditional method. The actuary stated that this “smoothing” method “... is not commonly used as an actuarial assumption for prepaid tuition programs but is used more readily in pension investment programs.”

Digest Exhibit One
FUNDED RATIO OF THE COLLEGE ILLINOIS PROGRAM
Fiscal Years 1999 – 2011



Note: The Value of Assets includes the present value of installment contract receivables.

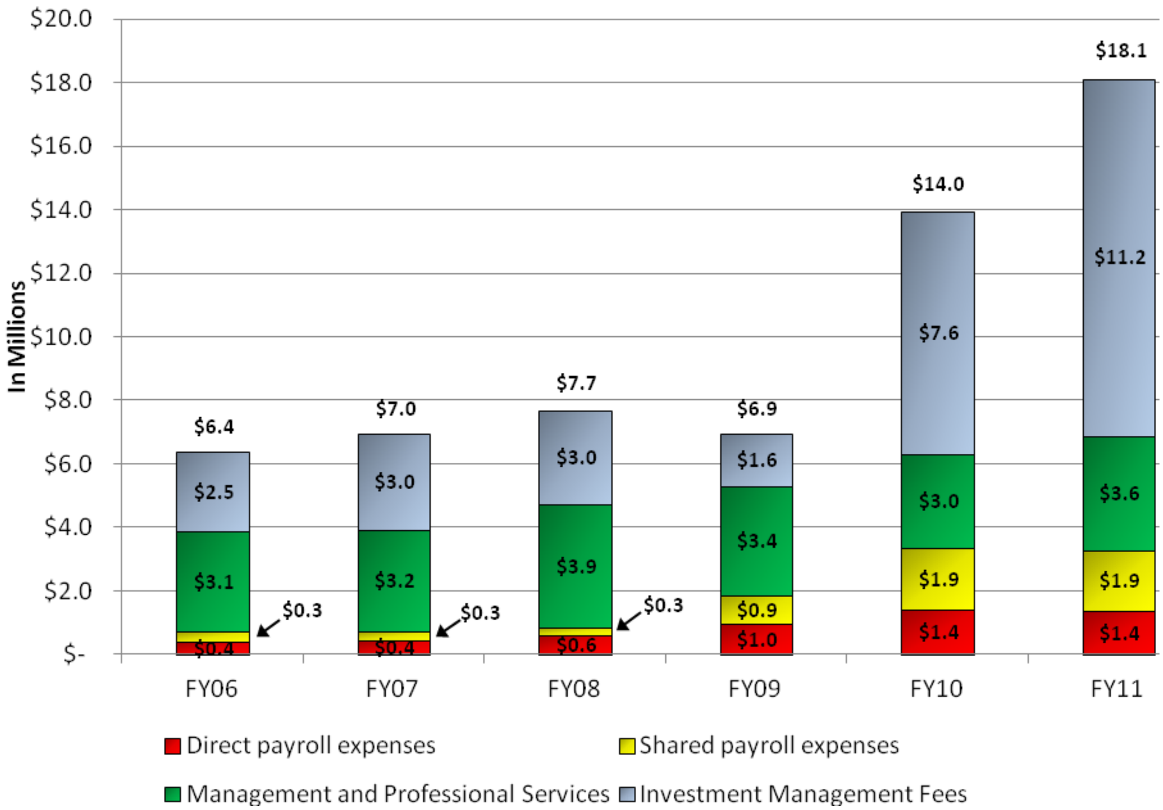
Source: OAG analysis of actuarial reports.

The Program has shown an actuarial deficit for each of the last 11 years. The actuarially determined funded ratio of the Program as of June 30, 2011 was 70.5 percent.

Digest Exhibit One shows the funded ratio of the Program since inception. The first two years of the Program showed an actuarial reserve and funded ratio greater than 100 percent. The last 11 years, however, have all shown an actuarial deficit. In fiscal year 2002, the funded ratio had gone down to 81.2 percent before rebounding to 93.3 percent in fiscal year 2007. The funded ratio fell dramatically over the next two fiscal years to a low of 67.6 percent in fiscal year 2009. The most recent actuarial report showed a funded ratio of 70.5 percent. (pages 72-81)

Contract sales have declined over the last six years from a high of 4,972 contracts in 2005-2006 to a low of 999 contracts in the most recent enrollment period. Recently, cancellations have outpaced sales with 1,523 cancellations in fiscal year 2011 and 778 cancellations during the first six months of fiscal year 2012. As of March 2012, the Program was closed to new enrollees. (pages 81-84)

Digest Exhibit Two
PROGRAM COSTS
Fiscal Years 2006 – 2011



Source: OAG analysis of College Illinois program costs.

Program Costs

The cost of operating the Program has risen dramatically over the last six years nearly tripling from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011.

As shown in Digest Exhibit Two, the cost of operating the College Illinois Program has risen dramatically over the last six years. Program costs nearly tripled from $6.4 million in fiscal year 2006 to $18.1 million in fiscal year 2011. There were several reasons for the increase in costs:

- Investment management fees have increased significantly from $2.5 million in fiscal year 2006 to $11.2 million in fiscal year 2011 because fees paid to managers of alternative investments have been substantially higher.

- Direct payroll expense more than tripled over the six year period increasing from $0.4 million in fiscal year 2006 to $1.36 million in fiscal year 2011. The primary reason direct payroll expense increased was that the number of employees working directly on the Program increased from 4 full time equivalent (FTE) employees in fiscal year 2006 to 11.5 FTE in fiscal year 2011. We questioned $613,000 in salaries and benefits for eight different employees charged as a direct payroll expense to the College Illinois Program because there was insufficient documentation to show how much, if any, of their duties pertained to the Program.

- Shared payroll expense, for ISAC employees that provide services to the Program but do not work directly for the Program, increased significantly over the six year period from $0.3 million in fiscal year 2006 to $1.9 million in fiscal year 2011. (pages 92-99)

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program.

In fiscal year 2011, fees collected from tuition contract purchasers covered only 7 percent of the total cost of operating the program. An administrative load fee was included as part of tuition contract prices. However, ISAC could not provide any information to quantify this fee and its effect on the overall pricing structure. Without further documentation, there is no assurance that ISAC is accounting properly for administrative costs when establishing tuition contract prices. (pages 86-89)

The primary control over Program costs is the passage of an annual budget by the Commission. However, even though Commission members raised questions when approving the budget, there was never a change to the proposed budget in the six years examined. Other large increases, such as a 363 percent increase in intra-agency services in fiscal year 2010, went unquestioned when approved by the Commission. Commission members were not provided information on actual expenses that they could use to compare to the approved budgeted amounts. (pages 89-90)

ISAC does not have a set policy for how Program costs are allocated. The method used resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts.

ISAC does not have a set policy for how Program costs are allocated. Although ISAC follows the same basic method each year, there is no policy or methodology in place to ensure that costs are allocated consistently from year to year. This resulted in expenses being inconsistently allocated in order to bring expenses up to the budgeted amounts. This method also makes the process appear arbitrary and makes it difficult to determine the true cost of operating the program. (pages 90-92)

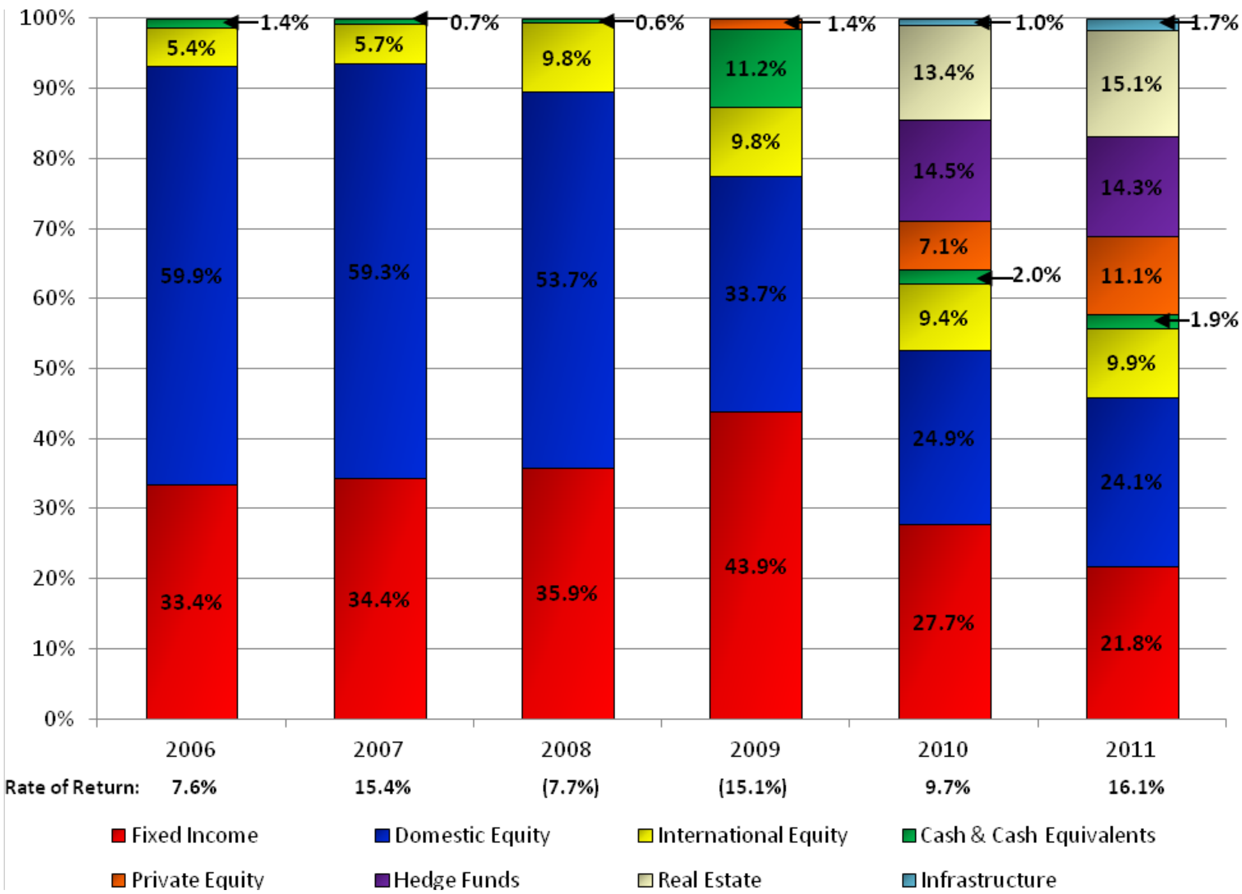
Asset Allocation

The College Illinois asset allocation has evolved over the last six years. In 2006, the Fund was invested entirely in traditional asset classes: fixed income, equity, and cash. Conversely, in 2011, these asset classes accounted for 58 percent of the Fund while the remaining 42 percent was invested in alternative investments: private equity, hedge funds, real estate, and infrastructure. Digest Exhibit Three shows how the asset allocation has evolved over the last six years.

Digest Exhibit Three

COLLEGE ILLINOIS ASSET ALLOCATION – PERCENTAGE ALLOCATION

FY06 – FY11



Source: OAG analysis of College Illinois investment data.

We contracted with a consultant, Ibbotson Associates, to perform an independent asset allocation study of the College Illinois current investment mix as directed by House Resolution 174. **The analysis was of the asset allocation as of June 30, 2011, and was not an analysis of the actual past performance of the portfolio.** Results of the analysis included the following:

Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments.

- Historical analysis showed that the College Illinois asset allocation, as of June 30, 2011, with alternative investments was less risky compared to a standardized portfolio without alternative investments. Returns were lower for the shorter time periods examined but higher for the longer time periods. A forward looking analysis showed that the College Illinois asset allocation with alternatives has the potential to outperform the standardized portfolio without alternatives with potentially lower risk/volatility.

- **It is important to note that the allocation study used benchmark indices for the different asset classes. The actual investments made by College Illinois and their performance may differ.** To perform the analysis, Ibbotson analyzed College Illinois' asset allocation as of June 30, 2011, and selected benchmarks to accommodate the study. Ibbotson noted that decisions made when implementing an asset allocation policy with different investment managers have the potential to significantly add or detract value by introducing manager specific risk. As an example, College Illinois recently invested $14 million in a single company. This investment involved a high degree of risk in that the company is in a relatively early stage of development with little operating history. In addition, Chapter Two notes several issues with ISAC's selection of investment managers including selecting two managers outside of the normal procurement process.

The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined.

- The College Illinois portfolio as of June 30, 2011, was less risky than 3 of the 4 states examined. The state with the least risky portfolio concentrated the majority of its assets in fixed income investments. Only 1 of the other 4 states examined included alternative investments in its portfolio. This state's alternative investments comprised 13 percent of its total portfolio compared to 42 percent for College Illinois.

- The College Illinois program differentiates itself from the programs of other states by having a more diversified asset allocation policy. Both the target and actual asset allocations offer exposures to a larger number of asset classes than the portfolios of the other states. Historically, alternative asset classes such as private equity, hedge funds and infrastructure had lower correlations to the traditional asset classes. Therefore, adding these asset classes to a traditional equity and fixed income portfolio has the potential to improve a portfolio's risk and return characteristics.

- Although the overall asset allocation is well diversified as measured by the number of asset classes in the opportunity set, there is a lack of diversification within the traditional fixed income portion of the portfolio.

- In addition, while the exposure to alternative asset classes was one of the strengths of the College Illinois asset allocation, the individual weights to the alternative asset class do not seem to be optimal given the results for mean-variance optimization and they seem to be concentrated in the hedge fund asset class.

While the asset allocation study showed that a portfolio with alternative investments was less risky compared to a standardized portfolio without alternative investments, there are other issues to consider when using alternative investments. The lengths of the agreements with investment managers for alternative investments are much longer making the portfolio less liquid. Management fees were also substantially higher and additional outside costs were incurred related to legal services and due diligence services. (pages 102-116)

Marketing of the Program

Assessing the intent of marketing materials is a difficult endeavor. There is not a set standard to measure against and the intent is thus open to different interpretations. However, **the marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State**.

The marketing materials examined made statements that could lead a purchaser to believe that an investment in College Illinois was backed by the State, was safe and secure, and transferred the risk to the State.

ISAC made changes to the marketing materials over the years. In 2008, ISAC removed the term “backed by the State” from its marketing materials including press releases, enrollment booklets, and the Annual Report. However, ISAC continued to promote that an investment in College Illinois was safe and secure, was not tied to the stock market, and transferred risk from the purchaser to the State.

At the same time, ISAC added language to its Master Agreement (a document included in a Program contract which describes the basic terms and conditions of the Program) to emphasize the risk involved. (pages 117-124)

RECOMMENDATIONS

The audit report contains 15 recommendations. The Illinois Student Assistance Commission agreed with all of the recommendations. Appendix D to the audit report contains ISAC’s responses.

WILLIAM G. HOLLAND
Auditor General

WGH:DJB

AUDITORS ASSIGNED: This Management Audit was performed by the Office of the Auditor General's staff with assistance from Ibbotson Associates in conducting the asset allocation study.