

August 18, 2021

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

Dear Ms. Curtis:

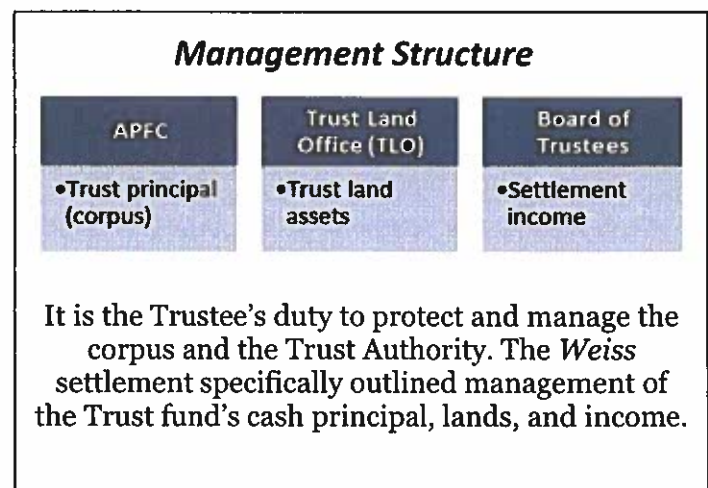
Thank you for the opportunity to respond to Legislative Audit's preliminary audit report pertaining to the 2021 special audit of the Alaska Mental Health Trust Authority.

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.



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.*

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.

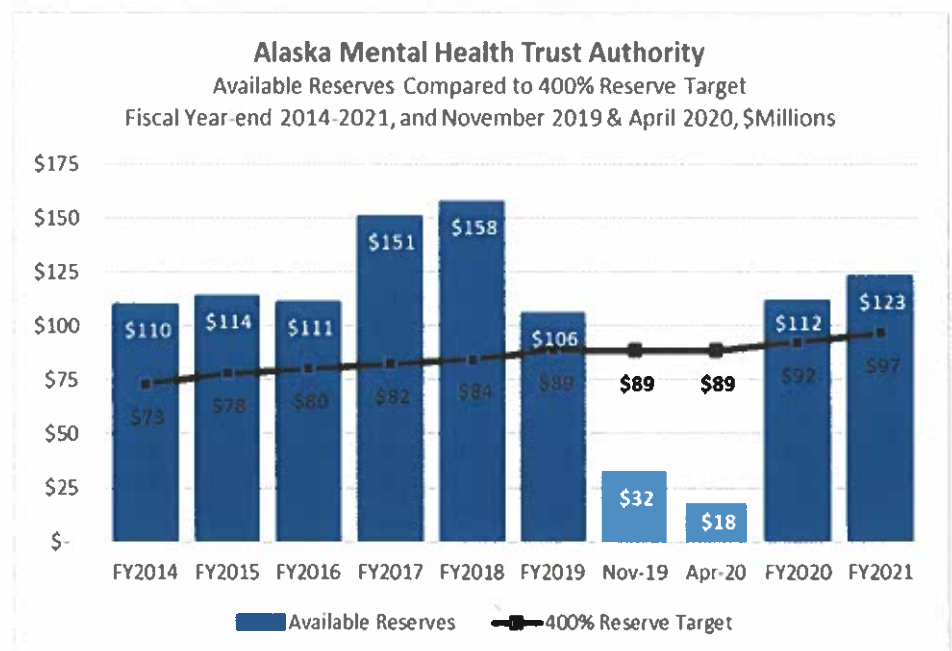
The preliminary audit report also disputes the Trust Authority’s decision to use the TLO to manage our commercial real estate based on a “lack of financial management capability.” The TLO is not being asked to manage Trust financial investments. They are being asked to manage investments in real property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



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

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



# Trust

Alaska Mental Health  
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.