The Commonwealth of Massachusetts

Office of the Inspector General

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April 24, 2012

Mary Lou Bergeron, Chair
Board of Directors
Greater Lawrence Educational Collaborative
480 Broadway
Methuen, MA 01844

Re: *Retirees' Health Insurance Trust Fund*

Dear Ms. Bergeron:

As you know, the Office of the Inspector General (OIG) has been reviewing a number of matters concerning prior business practices at the Greater Lawrence Educational Collaborative (GLEC). The OIG is conducting this review to assist GLEC to identify and mitigate risks for fraud, waste, and abuse. One such matter brought to the OIG's attention pertains to a $500,000 investment made in December 2005 by a former GLEC treasurer. This investment used funds from GLEC's *Retirees' Health Insurance Trust Fund* (the Trust). Although GLEC terminated this investment in 2010, current GLEC management raised concerns to the OIG about the propriety of this investment.

The OIG review of this investment identified serious risks surrounding this investment and a possible violation of M.G.L. c.44 (municipal finance law) in the choice of investment. The OIG also found a violation of the Declaration of Trust by the transfer of Trust funds to GLEC operating accounts without Trustee approval, and a lack of Trust oversight.

Currently, the Trust has a balance of approximately $2,040,000. According to the Declaration of Trust, "the purposes of this Trust are to collect, hold, manage, preserve and . . . to pay a portion of eligible retirees' health insurance premiums . . . ." According to an actuarial review of the Trust performed in May 2010, the unfunded accrued liability (as of June 30, 2009) exceeded $2.2 million.[1] Of note, the total fund balance in the Trust has decreased since this actuarial review. As a result, the unfunded liability may have increased since the actuarial analysis cited above.

Background

In 2005, a former GLEC treasurer invested $500,000 of Trust funds in a "Fixed Deferred Annuity" through the New York Life Insurance Co. (NY Life).[2] According to the

[1] There are currently 11 retirees and 90 active employees who may become eligible retirees over time.

[2] GLEC created the trust in 2000. According to GLEC's external audit firm, the Trust did not become a part of GLEC's annual financial statements until 2006.

former treasurer, he made this $500,000 investment to maximize interest income through a safe investment. The annuity initially earned 4.5% annually with 3% guaranteed after the first three years (for a minimal 5 year investment term). According to the treasurer, GLEC maintained the remaining trust funds in a low interest earning money-market account (or at times in certificates of deposit) at a local bank. Between 2009 and 2010, this bank account earned between 0.5% and 2% per month.

The former treasurer left GLEC in 2008 and between 2008 and 2010 GLEC had a series of personnel changes at the treasurer's position. According to the former executive director, new management staff remained unaware of the annuity until late 2009 when GLEC's external auditors raised questions about the investment.

Approximately, three months after being informed of the investment (in March 2010), GLEC's executive director terminated the investment incurring penalties for early withdrawal and deposited $568,000 in investment proceeds into GLEC's operating account rather than back into the Trust. As of April 2012, these funds had not been returned to the Trust. Moreover, the former GLEC executive director stated that in December 2010, cash flow problems caused him to "borrow" an additional $500,000 from the Trust to "cover payroll expenses." By May 2011, this $500,000 in "borrowed" funds had been repaid to the Trust - without interest. In total, less than one-half of the almost $1.1 million borrowed from the Trust has been repaid to the Trust, perhaps further jeopardizing the unfunded liability as determined in the actuarial analysis.

Also, GLEC bookkeeping issues and general ledger accounting problems have prevented external audits from being performed since FY2009. These problems have led to the introduction of new accounting software, the hiring of a financial consultant and new staff, the appointment of a new acting executive director and extensive data clean-up efforts. These accounting and data issues prohibited GLEC's external auditor from identifying these Trust transactions in a timely manner and could have allowed these transactions to remain undetected.

Findings

The OIG review identified a number of "red flags" of fraud regarding the creation and administration of the annuity and the Trust. The OIG identified legal and other violations that call for training in proper investing and investment practices, greater staff education in applicable municipal finance and public records law, and fraud prevention and trust governance. The OIG review identified the following red flag issues:

1) <u>GLEC opened the annuity in the name of the former treasurer</u>. The NY Life annuity required that the investment be in the name of an individual (annuitant). The former treasurer informed the OIG that both he and the GLEC executive director both had misgivings about using the treasurer's name and personal information for the annuity. However, the treasurer stated that the potential interest earnings (for the then underfunded Trust) forced the decision. The treasurer also stated that he documented this decision in memoranda to the file

and that GLEC also made its external auditor aware of this investment. This documentation was not included in the annuity-related files that GLEC provided to the OIG.

Issue: Investments should never be made in the name of an individual employee. This facilitates the conversion of the funds from public to private control creating a high risk for fraud and abuse. Such action also exposes the public entity to potential conflicts of interest and creates both tax and accountability issues for the agency and the individual involved. Although GLEC made the Trust the beneficiary for this investment and claimed to be the "owner," this does not adequately protect these funds from theft by the individual employee. According to NY Life, the former treasurer, as the annuitant, could have closed the account under his authority alone at any time. A lack of Trust oversight by a third party, which is a tenet of a sound internal control plan, and routine Trust audits could have led to the treasurer legally closing the account and misappropriating the funds. The lack of oversight provided the treasurer with an opportunity to cover-up any fraudulent activity he might opt to undertake with some certainty that he would not be discovered.

Moreover, the lack of proper recordkeeping resulted in GLEC's external auditor having to notify GLEC management of the existence of the $500,000 annuity. Had the former treasurer (and annuitant) changed the mailing address for the NY Life annual statement from GLEC to his personal mailing address, GLEC might have lost track of the investment for a longer period, relying entirely on GLEC's external auditor to identify this missing investment.

2) <u>This investment appears to violate M.G.L. c.44, §54 of the municipal finance law</u>. This section of the law governs the "Investment of trust funds" for municipalities and other local government entities. According to current GLEC management, they believe that this annuity was an appropriate investment under section 54. Section 54 states in part that municipal entities: ". . . may also invest such funds in securities . . . which are legal for the investment of funds of savings banks under the laws of the commonwealth. . . ." The Massachusetts Division of Banks regulates the legal investments for savings banks referenced in section 54. The OIG consulted with Division of Banks staff who stated that the annuity invested in by GLEC would not be appropriate for use by savings banks and therefore would not be an appropriate investment vehicle for GLEC, a jurisdiction covered by M.G.L. c.44. As a result, GLEC appears to have violated the statute by investing in this annuity.

   The former GLEC treasurer who initiated this investment informed the OIG that he was unfamiliar with the municipal finance law as most of his career was spent in the private sector, working for private banking institutions outside of Massachusetts. He was not aware that this investment would be deemed inappropriate. He believed that it was appropriate because it was a safe investment offering a high rate of return through a well-known insurance firm.

The former treasurer said he would not have considered the annuity had he known it was an unauthorized investment vehicle for GLEC.

The former treasurer also stated that he had no relationship with NY Life or the broker that sold the annuity to GLEC. He offered that he identified this annuity through a newspaper advertisement. He stated that there was no collusion or conflict-of-interest between any parties involved in the purchase.

Issue: Public entities that benefit from investing in long-term investment vehicles should obtain the advice of an experienced municipal financial advisor whose services are obtained through a procurement process pursuant to M.G.L. c.30B – the Uniform Procurement Act. Treasurers and other local government officials with investment responsibilities should be familiar with M.G.L. c.44 and investment guidelines offered by organizations such as the Massachusetts Collectors and Treasurers Association (MCTA) and the Massachusetts Association of School Business Officials (MASBO).

3) <u>The annuity was not an insured investment.</u> Although the former treasurer believed the annuity with NY Life to be a safe investment, it was not protected or guaranteed by an insurance program like the Federal Deposit Insurance Corporation (FDIC). Although the risk of loss for the annuity may have been minimal, the GLEC Board of Directors/Trustees (the Board) should be aware of all risks to deposits and approve of the disposition of these funds. Even with FDIC insured banks, the Board should ensure that the banks holding funds above the FDIC account limits (currently $250,000) have adequately protected these public funds through subsidiary insurance funds or fund collateralization.

   Issue: Treasurers and other officials with investment/money management responsibilities should be aware of deposit limits, the risks involved with certain deposits/investments and should ensure that trustees or applicable governing bodies are aware of and approve these risks.

4) <u>GLEC does not have an investment policy.</u> According to the former treasurer, he was able to invest in the annuity because "I could invest as I saw fit." According to the Declaration of Trust, the Trust's treasurer (who is also GLEC's treasurer) has "sole discretion" to invest Trust funds. Based on the OIG review, GLEC staff has the authority to invest funds at their discretion and most investments have been made in short-term low-interest investment vehicles at local banks.

   Issue: GLEC should have a formal investment policy. The policy should, at a minimum, identify investment priorities, acceptable investments pursuant to M.G.L. c.44, Board oversight policies, the process for choosing and approving investments, a schedule to review investments annually, and recordkeeping and audit requirements.

5) Early termination of the annuity cost GLEC approximately $60,000 in lost interest and penalties. After the annuity came to the attention of GLEC management in 2009, the then-executive director attempted to change the name of the annuitant from the former treasurer to a current employee. According to the executive director, GLEC's external audit firm had advised him that having the investment in the name of the former treasurer was considered a high risk. The executive director pursued the name change in response to this identified risk. However, at no time during this period did the executive director believe the investment vehicle itself to be problematic.

   According to a letter from NY Life, the annuitant could not be changed. The executive director then requested that NY Life change the name of the contact person/mailing information from the annuitant to the then-current GLEC treasurer. NY Life made this change. Shortly thereafter, the former executive director stated that he terminated the annuity after consultation with the GLEC Board because it was a prudent action to take. Board members stated that they have no recollection of this matter being brought to the Board before the annuity was terminated. Files provided by GLEC do not evidence this decision-making process further demonstrating GLEC's poor recordkeeping. Although the executive director claims to have terminated the investment because of the perceived risk, he failed to return the funds to the Trust and instead used the funds to "meet payroll" because of a cash flow issue. In effect, the executive director borrowed these funds from the Trust for operating expenses. This borrowing came at a high financial cost.

   GLEC terminated this investment approximately one and a half years before the end of the initial investment term. As a result, NY Life assessed an early withdrawal penalty of $24,000. GLEC also lost potential interest earnings of $36,000 by the early fund withdrawal. In total, the decision to terminate the investment to apparently cover operating expenses cost GLEC approximately $60,000. The question remains as to whether the executive director terminated the annuity because of a perceived risk or to cover operating expenses.

   Other than attempting to change the name of the annuitant, GLEC files do not indicate that GLEC made any attempt to work with NY Life or the annuitant (the former treasurer) to safeguard the investment for another year and a half - until the investment could be terminated without penalty and to achieve the highest interest yield. The OIG offers that GLEC could have taken steps in lieu of closure to safeguard the investment for the short-term. Some of the steps that GLEC could have taken to "save" $60,000 include: a) advising NY Life and the annuitant that GLEC would not be withdrawing funds from the account for the remainder of the term and that any attempt to do so would be deemed a misappropriation of funds, b) requesting monthly account statements (or on-line internet account access) from NY Life to better monitor account activity, c) requesting that NY Life obtain written GLEC confirmation before allowing any withdrawals, d) request the account be "frozen", e) obtain a sworn statement from the annuitant (the former treasurer) that he would not withdraw any funds, and possible other steps. Files provided to the OIG do not indicate that GLEC explored any option other than closure. This suggests that the motivation for closure may have been GLEC's cash flow problems.

Issue: The OIG does not object to GLEC's decision to close the account, if this decision was appropriate and done with Board consent. The OIG is pointing out that GLEC's decision-making process, lack of an investment policy, and weak controls and oversight for the Trust may have cost approximately $60,000.

The OIG also notes that upon receiving the proceeds from the annuity closure, the executive director deposited these funds into the GLEC operating account rather than the trust. The executive director originally informed the OIG that GLEC staff did not know where this money should be deposited. To the OIG's knowledge this $568,000 has not been returned to the Trust. It strains credulity, to believe that after months of reviewing the matter, consulting with former staff and NY Life, and the fact that the annuity documents themselves reference the Trust that the executive director claimed that he did not know the source of the annuity funds and to what fund the annuity disbursement should be applied to. Moreover, the application of these funds should have been determined by the Board rather than the executive director alone.

6) <u>Trust lost other interest earnings.</u> In addition to losing interest earnings from the early termination of the annuity, the Trust has lost interest earning potential as a result of the following:

   a. In December 2010, GLEC management "borrowed" $500,000 from the Trust. Although management returned these funds within six-months, it did so without interest. Other than in this case, the OIG is unaware of another time when GLEC may have "borrowed" from the Trust. GLEC management should review Trust records to determine if borrowing had occurred previously, for what purpose, and whether all borrowed funds were returned. As part of GLEC's on-going Trust review, GLEC should determine whether any funds are owed to the Trust, whether to reimburse the Trust and whether to reimburse the Trust all interest potentially due.

   b. GLEC maintains Trust funds in commercial bank accounts. Other than the annuity discussed above, the OIG is unaware of any other Trust investments. According to the former treasurer, funds may have been invested previously in certificates of deposit at local banks. Since the Trust has longer-term investment potential, GLEC should consider other investment options with higher earnings potential such as the Massachusetts Municipal Depository Trust.

   c. According to an actuarial analysis prepared for GLEC in May 2010, GLEC should be paying approximately $35,000 into the Trust monthly to address its unfunded liability. In 2010, GLEC had been making monthly payments of $28,000 into the Trust. According to GLEC bank statements, GLEC failed to make four monthly payments in 2010 and failed to make payments for the first-half of 2011; possible evidence of financial mismanagement. GLEC management recently informed the OIG that a decision had been made to stop making monthly payments into the Trust beginning in FY2011. Up to that point, GLEC informed the OIG that GLEC may owe the Trust approximately $124,000 exclusive of any annuity related funds or interest. Failing to make payments increases GLEC's (and the member school districts) possible unfunded liability for retiree health insurance. Moreover, the Trust loses an opportunity to earn interest on these deferred payments. GLEC management stated that they are awaiting the completion of a new actuarial analysis and believe that the Trust may actually be overfunded. After the completion of the analysis the Board will determine a reasonable payment arrangement to make the Trust whole, if necessary. The Board will also determine how to address any unfunded liabilities moving forward.

7) <u>Poor recordkeeping at GLEC poses a risk</u>. As mentioned earlier, staff changes resulted in GLEC losing track of a $500,000 investment. The OIG review also identified that GLEC records no longer contain adequate information concerning the annuity application, the investment documents themselves, or the internal documents that the former treasurer claimed were produced in 2005 to address the "misgivings" at that time concerning making the treasurer the annuitant.

   GLEC's external audit firm has also questioned whether GLEC has paid retiree health insurance and other expenses from the Trust. If GLEC has been paying Trust expenses from GLEC operating expenses, this could impact the actuarial analysis of the Trust and also raises questions about how GLEC is budgeting and billing member school districts for these expenses. GLEC staff recently informed the OIG that it does not appear that the Trust has paid for any expenses and that operating funds have paid 100% of nearly all retiree health benefits. Apparently, GLEC had failed to invoice retirees in the past for their share of health premiums (currently 10%).

   Issue: GLEC must institute better recordkeeping for financial and administrative matters. The OIG recommends that Trust finances be accounted for separately from GLEC's "books." The Trust should receive its own annual audit. According to current GLEC management, GLEC's external auditor had a responsibility to include the Trust in its annual financial auditing. GLEC management should therefore review the audit firm's engagement letters and scope of work and determine whether the audit firm failed to perform as directed and, if necessary, take appropriate action.

8) <u>GLEC violated the Declaration of Trust</u>. As stated earlier, in December 2010, the former GLEC executive director "borrowed" $500,000 from the Trust account for

GLEC's operating budget. According to the executive director, GLEC was having a "cash flow" problem and to "meet payroll," he had to use Trust funds. According to the Declaration, the trustees (composed of the GLEC Board of Directors) must approve any withdrawal of Trust funds. According to documents, GLEC's external audit firm could not identify such Board approval. Board members have informed the OIG that they are unaware of any such approvals.

Issue: Although GLEC may "borrow" Trust funds, this must be done pursuant to the Declaration of Trust and the trustees must be aware of the implications of this borrowing on the Trust as well as GLEC's need to borrow funds mid-year. According to the former executive director, the member school districts create cash-flow problems for GLEC by failing to pay GLEC on a timely basis for services provided. If this cash-flow problem creates the need for short-term borrowing from the Trust, the cost of this borrowing (lost interest earnings such as the $60,000 annuity loss) and a lack of funds to repay this debt should be factored into any tuition or other payments to be made by member school districts. Of great concern to the OIG is the ability of one staff member to borrow significant sums (close to $1.1 million or nearly one-third of the total amount of the Trust fund) from the Trust without appropriate trustee approvals and with virtually no oversight. It is conceivable, that any GLEC executive director or treasurer could have borrowed or misappropriated Trust funds for extended periods as often as he liked without the knowledge of others. Until appropriate controls and oversight are instituted for the Trust, these funds remain vulnerable to fraud, waste, and abuse.

9) <u>The OIG recommends that GLEC staff obtain procurement, public records law, municipal finance law and fraud prevention and trust governance training.</u> Procurement training can be provided through the OIG's Massachusetts Certified Public Purchasing Official (MCPPO) program. Additionally, many procurement-related materials including manuals and bulletins are available on the OIG website. The OIG can also offer anti-fraud training. The Department of Revenue offers municipal finance law guidance. The State Ethics Commission can provide conflict of interest law training. The Office of the Secretary of State can provide public records law training.

Although GLEC has terminated this annuity investment, the OIG findings and recommendations should be considered for future investment strategies. The OIG recommends that the Trust be treated as a distinct financial entity for the purposes of accounting and auditing and that a separate annual Trust audit be performed each year. Currently, it appears that GLEC has failed to return at least $568,000 to the Trust exacerbating any unfunded liability for retiree health insurance. The OIG is aware that GLEC has commissioned both an actuarial analysis and an audit of the Trust. The Board should address the findings of these reviews when completed as well as the findings and recommendations contained in this letter.

During the annuity review it came to the attention of the OIG that prior GLEC management failed to make appropriate payments to the Teacher's Retirement System and to forward employee payroll deductions to designated investment plans such as deferred compensation plans. Current GLEC staff confirmed that this had occurred but stated that all discrepancies had been "rectified." Again, this is further evidence of sloppy management and recordkeeping practices that may have related to what has been previously referred to as GLEC's cash flow problems. However, it is also indicative of significant risks for fraud, waste, and abuse. Although current management has taken steps to address internal control and recordkeeping weaknesses, the fact remains that it took the vigilance of individual employees monitoring their personal investment statements to identify GLEC's failure to forward employee funds as required. Current efforts to get GLEC's "books" in order are vital. Through these efforts, management should identify the full scope of areas that may require more intensive scrutiny to assure the Board and member school districts that GLEC is fiscally sound, accountable, transparent, and that it has not been the victim of fraud.

Please do not hesitate to contact us with any questions or concerns or if may be of further assistance in your efforts. Thank you for your cooperation.

Sincerely,

Gregory W. Sullivan

Gregory W. Sullivan
Inspector General

cc: Anne Booth, Acting Executive Director
Jay Lang, Lowell Public Schools