THE UNITED STATES VIRGIN ISLANDS

OFFICE OF THE VIRGIN ISLANDS INSPECTOR GENERAL

INSPECTION REPORT

INSPECTION OF
THE ALTERNATIVE INVESTMENT PROGRAM
ADMINISTERED BY THE
GOVERNMENT EMPLOYEES RETIREMENT SYSTEM

ILLEGAL OR WASTEFUL ACTIVITIES SHOULD BE REPORTED TO THE OFFICE OF THE VIRGIN ISLANDS INSPECTOR GENERAL BY:

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EXECUTIVE SUMMARY

The following summarizes the major findings from the Inspection of the Alternative Investment Program Administered by the Government Employees Retirement System (GERS) (INR-01-GERS-15).

Finding 1: Alternative Investment Program (pages 5 to 12)

- ✓ The Alternative Investment Program law as it now exists does not provide adequate controls and protection against the risk of loss of the pension funds entrusted to GERS.
- ✓ Some investments that meet the industry definition of alternative investments are not included in the alternative investments sections of the Virgin Islands Code.
- ✓ Current non-traditional investments have limits and practices which expose a high percentage of GERS' investment portfolio to highly volatile and risky alternative investments.
- ✓ The 2005 revisions to the Code, created two sections covering alternative investments, and one section covering viatical senior and/or life settlements (viatical), thereby creating confusing and unmanageable requirements in dealing with non-traditional investments.
- ✓ A 2015 revision of the Code added five additional categories of alternative investments, and it allowed the entire investment portfolio of GERS to be invested in these five risky alternative investments.

Finding 2: Lending Authority (pages 13 to 18)

- ✓ GERS entered into loan agreements which are not authorized under the Alternative Investment Program or any other authority as defined by the Code.
- ✓ Six Alternative Investment Program investments were actually commercial loans to businesses, and one was a loan to the Government of the Virgin Islands.
- ✓ The total value of these seven loans was, at least, $77.1 million.
- ✓ The interest rate charged for four of the loans was below the rate charged to members and the industry desired investment rate of return of 7 to 8%.

Finding 3: Viatical (pages 19 to 29)

- ✓ GERS entered into an extremely risky and questionable viatical investment that jeopardized about $42 million of its investment portfolio.

- ✓ The viatical investment was done without performing the necessary due diligence and obtaining the necessary expert advice before exposing the pension fund to this high-risk investment.
- ✓ GERS has written-off 20% or $8.4 million of the remaining value, and plans to continue writing-off the remaining balance at a rate of 20% per year.
- ✓ GERS also granted a $10 million line of credit to the same partnership that is handling the viatical. The majority of the proceeds were to pay past due and near term premiums for the policies.

Finding 4: Due Diligence (pages 30 to 34)

- ✓ GERS entered into numerous agreements and investments without performing the necessary due diligence to ensure a reasonable rate of return.
- ✓ There is no assurance that the funds disbursed will produce the desired rate of return or even if the funds disbursed will be recovered.

Finding 5: Monitoring (pages 35 to 40)

- ✓ GERS did not conduct sufficient monitoring and oversight activities of investments under the Alternative Investment Program to protect GERS' interest.
- ✓ GERS did not establish any procedures, policies, or benchmarks to ensure that funds were being utilized for the requested purpose of the investments.
- ✓ Funds may have been used for purposes not agreed to or approved by GERS.

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March 7, 2016

Dr. Wilbur Callender
Chairman
Government Employees Retirement System
GERS Building
Charlotte Amalie, Virgin Islands 00802

Dear Dr. Callender:

This final report contains the results of our inspection of the Alternative Investment Program administered by the Government Employees Retirement System (GERS). The objective of the inspection was to determine whether the investment practices used by GERS under the non-traditional investment methods were; authorized by the Virgin Islands Code (Code), secured, monitored, and effectively managed to reduce GERS' exposure to the risk of loss.

The Alternative Investment Program as administered by GERS is not meeting the intended purpose of safely increasing the return on investments. Specifically, (i) viatical senior and/or life settlements (viatical) and some real estate investments considered by the industry as alternative investments are not included in the alternative investments section of the Code; (ii) GERS' current non-traditional investments limit is higher than the industry standards; (iii) in the 2005 revisions to the Code, there are two sections dealing with alternative investments and one section dealing with viatical; (iv) a 2015 revision to the Code added five additional categories of alternative investments; (v) GERS entered into loan agreements that were not authorized under the Alternative Investment Program or any other authority as defined by the Code; (vi) the interest rate charged for four of the loans was below the rate charged to GERS members and the industry desired investment rate of return; (vii) GERS entered into an extremely risky and questionable viatical investment; (viii) GERS also granted a $10 million line of credit to the same partnership that is handling the viatical investment; (ix) GERS entered into numerous agreements and investments without performing the necessary due diligence evaluation to ensure limited risk and a reasonable rate of return on the funds used; (x) GERS did not conduct efficient monitoring and oversight activities of investments under the Alternative Investment Program to protect GERS' interest; and, (xi) GERS did not establish any procedures, policies, or benchmarks to ensure that funds were being utilized for the requested purpose of the investments.

As a result, (i) the law as it now exists does not provide adequate controls to protect against the risk of losing pension funds; (ii) a high percentage of GERS' investment portfolio is exposed to highly volatile and risky alternative investments; (iii) duplications in the Code creates confusing and unmanageable requirements when dealing with non-traditional investments; (iv) the 2015 revisions to the Code allows the entire investment portfolio of GERS to be invested in the five risky alternative investments; (v) at least $77.1 million of the investment portfolio was

used to fund seven unauthorized loans; (vi) potential interest earned on the loans did not justify the high risk taken or meet the desired 7 to 8% rate of return established by the Board of Trustees; (vii) GERS has already written-off $8.4 million of its investment portfolio, with about $42 million in additional investment funds in jeopardy of being lost due to an ill-advised viatical investment; (viii) in addition to being illegal, an additional $10 million line of credit to the same viatical is also in jeopardy of being lost; (ix) there was no assurance that funds disbursed in non-traditional investments will produce the desired rate of return, or even if the funds disbursed will be recovered; and, (x) funds may have been used for purposes not agreed to or authorized by GERS.

We made several recommendations to address the conditions and causes cited in the report. Our recommendations addressed the following areas; (i) the existing law, (ii) investing in alternative investments, (iii) due diligence, and (iv) monitoring. An exit conference was held on December 14, 2015, where there was general agreement with the findings and recommendations made in the report.

A draft report was issued on January 7, 2016, requesting a response by January 29, 2016. A request for an extension to February 19, 2016 to respond was granted, and a response was received on February 18, 2016. The response is included as Appendix I to this report, beginning on page 46. Additional information needed to close the recommendations is included as Appendix II beginning on page 52.

If you require additional information, please call me at 774-6426.

Sincerely,

Steven van Beverhoudt

Steven van Beverhoudt, CFE, CGFM
V. I. Inspector General

TABLE OF CONTENTS

Page

INTRODUCTION

Background ..1
Objectives, Scope, and Methodology ..3
Prior Audits and Inspections ..3

RESULTS

Conclusions ..4

Finding 1: Alternative Investment Program ..6
Background ..6
Inclusion of All Non-Traditional Investments ..7
Limit on High-Risk Investments ..7
Duplicate Code Provisions ..9
Recent Code Amendments ..10
Recommendations ..10
GERS Board of Trustees' Response ..11
V. I. Inspector General's Comments ..11

Finding 2: Lending Authority ..14
Background ..14
Unauthorized Loans ..14
Interest Rate ..16
Recommendation ..18
GERS Board of Trustees' Response ..18
V. I. Inspector General's Comments ..18

Finding 3: Viatical ..20
Background ..20
Partnership ..21
Investment Activities ..21
Line of Credit ..24
Recent Investment Activities ..26
Due Diligence ..26
Red Flags ..26
Recommendations ..28
GERS Board of Trustees' Response ..29
V. I. Inspector General's Comments ..29

TABLE OF CONTENTS

Page

Finding 4: Due Diligence 31
- Background 31
- Due Diligence 31
  - Airline 32
  - Hotel 33
  - Fast Food Chain 33
  - Grocery 33
- Recommendation 34
- GERS Board of Trustees' Response 34
- V. I. Inspector General's Comments 34

Finding 5: Monitoring 36
- Oversight Structure 36
- Monitoring 36
  - Airline 36
  - Hotel 38
  - Fast Food Chain 38
  - Grocery 39
- Recommendation 40
- GERS Board of Trustees' Response 40
- V. I. Inspector General's Comments 40

EXHIBIT

Exhibit GFOA Advisory: Using Alternative Investments for Public Employee Retirement Systems and OPEB Establish Trusts 42

APPENDICES

Appendix I GERS Board of Trustees' Response 46
Appendix II Additional Information Needed to Close Recommendations 52
Appendix III Official Report Distribution 53

INTRODUCTION

BACKGROUND

On November 2, 2005, Act 6794, the Retirement System Reform Act of 2005, became law. Among other things, the Act allowed the Board of Trustees of the Government Employees Retirement System (GERS) to enter into alternative investments by the establishment of the Alternative Investment Program. The Act defined alternative investments as "…investment opportunities that have not been identified by the traditional public equity or fixed income capital markets." The legislation identified five categories of alternative investments as follows:

GOVERNMENT EMPLOYEES RETIREMENT SYSTEM
CATEGORIES OF AUTHORIZED ALTERNATIVE INVESTMENTS

Category of Alternative Investment	Specific Option	Definition *(as per the Virgin Islands Code)*
Private Equity	Venture Capital	Capital to fund a new business or venture that is subject to more than the normal degree of risk with capital given directly or indirectly in a comingled fund.
	Mezzanine	Investments in subordinate debt or equity of public owned companies.
	Acquisition/Buyout	Partnerships that provide funding to acquire controlling interest in a business.
	Restructuring	Investments made in distressed or poorly performing companies, with the intent of initiating recovery.
	Subordinate Debt	Debt obligation with unsecured junior claims to interest and principal subordinated to other debt obligations of the issuing corporation.
	Special Situations	Unusual investment opportunities due to some special development that is expected to favorably affect earnings or public psychology.
Natural Resources	Oil and Gas	No definition provided in the Virgin Islands Code.
	Agriculture	No definition provided in the Virgin Islands Code.
Managed Futures/Commodities	Active	No definition provided in the Virgin Islands Code.
	Indexed	No definition provided in the Virgin Islands Code.
	Long-Only and Long/Short	No definition provided in the Virgin Islands Code.
Hedge Funds and Portfolio Overlay	Macro	No definition provided in the Virgin Islands Code.
	Long/Short	No definition provided in the Virgin Islands Code.
	Event-Driven	No definition provided in the Virgin Islands Code.
	Market Neutral	No definition provided in the Virgin Islands Code.
Real Estate		Real estate wherever situated and includes investments in real estate trust but does not include any real estate acquired by the system prior to December 31, 2005. [The restriction is only applicable to Title 3, Chapter 27, Section 717(b)(20) of the Virgin Islands Code.]

The intent of the Alternative Investment Program was to increase income for GERS by allowing more risky investments with higher rates of return.

The Act initially limited the amount which may be invested in the Alternative Investment Program to "…no more than 5% of the total amount of the available investment portfolio." In 2010, Act 7233 amended the investment percentage limit to 10%.

Act 6794 also allowed GERS to invest in another type of non-traditional investment called viatical senior and/or life settlements (viatical). With such settlements, life insurance policies would be purchased at a discount from licensed insurers and annual policy premiums would continue to be paid by GERS. When the insured dies, GERS would collect the proceeds of the acquired policies. The Act limited investments in these policies to not more than "…20% of the total investments of the system."

The Alternative Investment Program has been codified under two titles of the Virgin Islands Code (Code), Title 3, Chapter 27, Section 717(b)(20) and Title 3, Chapter 28A, Section 766(b)(19). The viatical provision of the Code can only be found in Title 3, Chapter 27, Section 717(b)(9).

From August 2006 through June 2015, GERS entered into 11 financial instruments requiring funding to date of $162,541,309 under the Alternative Investment Program and viatical provisions of the Code. Although GERS indicated that there were 11 non-traditional investments as defined by Act 6794, based on the industry definition of alternative investments, we are also considering the Havensight Mall investment on St. Thomas as an alternative investment in the "real estate" category. Accordingly, we consider the number of non-traditional investments to be 12, costing $212,212,608. These 12 non-traditional investments are summarized as follows:

GOVERNMENT EMPLOYEES RETIREMENT SYSTEM NON-TRADITIONAL INVESTMENTS

No	Type of Agreement	Date of Agreement	Initial Funding	[1]Subsequent Funding	Total Funding
1	[2]Real Estate – Purchase of the Havensight Mall on St. Thomas	June 30, 1993	$32,000,000	17,671,299	$49,671,299
2	Real Estate – Purchase of Undeveloped Land in Estate Hoffman/Nullyberg on St. Thomas	August 6, 2006	$4,595,000	$760,935	$5,355,935
3	Viatical – Partnership Investment in Settlements of Life Insurance Policies	August 10, 2006	$50,000,000		$50,000,000
4	Loan – Establishment of an Ethanol Dehydration Facility on St. Croix	December 5, 2007	$8,000,000		$8,000,000
5	Venture Capital – Partnership Investment	October 2008	$25,000,000		$25,000,000
6	Loan – Expansion of Operations of an Inter-Island Airline Company	December 4, 2009	$3,300,000	$1,500,000	$4,800,000
7	Loan – Pay-off Receivership and Renovations to a Hotel on St. Croix	December 8, 2009	$15,000,000	$12,087,385	$27,087,385
8	Real Estate – Purchase of Undeveloped Land in Coakley Bay on St. Croix	October 10, 2010	$5,000,000	$92,000	$5,092,000
9	Loan – Property Tax Revenue Anticipation Note to the V. I. Government	November 14, 2011	$13,000,000		$13,000,000
10	Loan – Line of Credit to the Life Insurance Partnership Investment Noted in Item 3 Above	July 11, 2012	$10,000,000		$10,000,000
11	Loan – Renovations of Properties of a Fast Food Franchise in the Virgin Islands	September 24, 2013	$6,000,000		$6,000,000
12	Loan – Establishment and Construction of a Grocery on St. Thomas	June 30, 2014	$8,205,989		$8,205,989
Total					**$212,212,608**

[1]The amounts provided here are amounts that we were able to determine based on records provided to us. We could not verify that the total amounts provided represent all of the funds related to these "non-traditional investments".

[2]Although this property was acquired before the Alternative Investment Program became law, one section of the Code excludes it in the definition, while another does not. In addition, all research shows that real estate acquired for investment purposes are alternative investments, and should be treated as such. In GERS' June 2015 Newsletter, the Havensight Mall was included as an "Alternative Asset".

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the inspection was to determine whether the investment practices used by GERS under the non-traditional investment methods were; authorized by the Code, secured, monitored, and effectively managed to reduce GERS' exposure to the risk of loss. Our inspection covered the 11 agreements entered into under the Alternative Investment Program and viatical provisions of the Code. Although we have included as an alternative investment the Havensight Mall property that was acquired before Act 6794 was passed in 2005, we did not review any supporting documentation relating to its acquisition, subsequent funding, and valuation. We included it in order to arrive at a total cost of the non-traditional investments.

We performed our inspection in accordance with the Council of the Inspectors General on Integrity and Efficiency "Quality Standards for Inspections" between March 2014 and December 2014. We obtained and reviewed all documents related to the 11 agreements. Updated financial information, as of November 13, 2015, relating to the alternative investments was received from GERS. We interviewed GERS officials who had a role in administering the Alternative Investment Program and viatical investment, as well as consultants, and a member of the Board of Trustees. In addition, we interviewed local commercial banking experts to document traditional lending standards when approving and servicing commercial loans.

PRIOR AUDITS AND INSPECTIONS

We are unaware of any prior audits or inspections done over the last five years on GERS' Alternative Investment Program.

RESULTS

CONCLUSIONS

The Alternative Investment Program as administered by GERS is not meeting the intended purpose of safely increasing the return on investments. Specifically:

- viatical and some real estate investments considered by the industry as alternative investments are not included in the alternative investments sections of the Code;
- GERS' current non-traditional investments limit is higher than the industry standards;
- in the 2005 revisions to the Code, there are two sections dealing with alternative investments and one section dealing with viatical;
- a 2015 revision to the Code added five additional categories of alternative investments;
- GERS entered into loan agreements that were not authorized under the Alternative Investment Program or any other authority as defined by the Code;
- the interest rate charged for four of the loans was below the rate charged to GERS members and the industry desired investment rate of return;
- GERS entered into an extremely risky and questionable viatical investment;
- GERS also granted a $10 million line of credit to the same partnership that is handling the viatical investment;
- GERS entered into numerous agreements and investments without performing the necessary due diligence evaluation to ensure limited risk and a reasonable rate of return on the funds used;
- GERS did not conduct efficient monitoring and oversight activities of investments under the Alternative Investment Program to protect GERS' interest; and,
- GERS did not establish any procedures, policies, or benchmarks to ensure that funds were being utilized for the requested purpose of the investments.

As a result:

- the law as it now exists does not provide adequate controls to protect against the risk of losing pension funds;

- a high percentage of GERS' investment portfolio is exposed to highly volatile and risky alternative investments;

- duplications in the Code creates confusing and unmanageable requirements when dealing with non-traditional investments;

- the 2015 revisions to the Code allowed the entire investment portfolio of GERS to be invested in the five risky alternative investments;

- at least $77.1 million of the investment portfolio was used to fund seven unauthorized loans;

- potential interest earned on the loans did not justify the high risk taken or meet the desired 7 to 8% rate of return established by the Board of Trustees;

- GERS has already written-off $8.4 million of its investment portfolio, with about $42 million in additional investment funds in jeopardy of being lost due to an ill-advised viatical investment;

- in addition to being illegal, an additional $10 million line of credit to the same viatical is also in jeopardy of being lost;

- there was no assurance that funds disbursed in non-traditional investments will produce the desired rate of return, or even if the funds disbursed will be recovered; and,

- funds may have been used for purposes not agreed to or authorized by GERS.

We made several recommendations to address the conditions and causes cited in the report. Our recommendations addressed the following areas; (i) the existing law, (ii) investing in alternative investments, (iii) due diligence, and (iv) monitoring.

FINDING 1: ALTERNATIVE INVESTMENT PROGRAM

The Alternative Investment Program law as it now exists does not provide adequate controls and protection against the risk of loss of the pension funds entrusted to GERS. Some investments that meet the industry definition of alternative investments are not included in the alternative investments sections of the Code. In addition, current non-traditional investments have limits and practices which expose a high percentage of GERS' investment portfolio to highly volatile and risky alternative investments. As a result of the 2005 revisions to the Code, there are two sections dealing with alternative investments, and one section dealing with viatical, thereby creating confusing and unmanageable requirements in dealing with non-traditional investments. Finally, a 2015 revision of the Code added five additional categories of alternative investments, and it allowed the entire investment portfolio of GERS to be invested in these five risky alternative investments.

Background

Alternative investments are defined as any investment other than the traditional types (cash or cash equivalents, fixed-income such as government or corporate bonds, and equities such as stocks). Alternative investments can be in non-traditional investments like real estate, private equities, commodities, or hedge funds.

In 2005, GERS was given the authority to invest in alternative investments. In Title 3, Chapter 27, Section 717(b)(20) and Title 3, Chapter 28A, Section 766(b)(19) of the Code, as it relates to alternative investments, five categories of alternative investments are defined and the investment percentage is limited to 10% of the total amount of the available investment portfolio. In the definition of the alternative investment category "real estate" under Section 717(b)(20), the Code excludes real estate acquired before December 31, 2005. Section 766(b)(19), however, does not include that restriction. In addition, the Code, under Title 3, Chapter 27, Section 717(b)(9), allows GERS to invest an additional 20% of the total investments of the system in viatical investments, which is another category of alternative investments, although not classified as such in the Code.

The National Association of State Retirement Administrators (NASRA) on their website indicates that "based on the latest information from the Public Fund Survey, the average public pension fund asset allocation is as follows:

- Public Equities: 50%
- Fixed Income: 24%
- Real Estate: 7%
- Alternative Investments: 15%
- Cash and Other: 4%."

Inclusion of All Non-Traditional Investments

The Code does not include all non-traditional investments in the definition of alternative investments. This allows GERS to invest a significant amount of the pension investment portfolio in high-risk investments considered by the industry as alternatives. By excluding the viatical from the section of the Code dealing with alternative investments, and excluding real estate investments acquired before December 31, 2005 from Section 717(b)(20) of the Code definition of real estate, an additional $99.7 million of pension funds has been exposed to the risky non-traditional investment market.

Throughout the industry, alternative investments have been classified as extremely risky investments that require significant expertise in the field and extensive due diligence, to include an assessment of the risk tolerance of the investment portfolio in addition to close monitoring to ensure that pension funds are protected.

The Government Finance Officers Association (GFOA), in an October 2008 GFOA Advisory entitled "Using Alternative Investments for Public Employee Retirement Systems and OPEB (Other Post Employee Benefits) Establish Trusts", states that: "GFOA recommends that state and local governments exercise extreme prudence and appropriate due diligence be exercised in the use of alternative investments in public and OPEB portfolios."

We have included, as an exhibit to this report, a copy of the entire GFOA Advisory. It is being included in its entirety because of the important information provided by the GFOA report. It discusses the extreme risk, the required due diligence and monitoring needed to ensure that the funds invested in alternative investments are properly managed and protected.

Taking into consideration the risk factors, due diligence and monitoring requirements cited in the GFOA Advisory report, we strongly recommend that all non-traditional investments authorized by the Code be classified as alternative investments and included in the limits in accordance with industry standards.

Limit on High-Risk Investments

The Code, as currently written, allows GERS to invest up to 30% of its investment portfolio in these highly volatile and risky non-traditional investments. This amount far exceeds the industry average of investment in the risky alternative markets. As noted above, the NASRA reports that the average investment in alternatives amounts to 15%, and with an additional 7% in real estate, for a total average of 22% invested in non-traditional investments.

A June 2014 report, entitled "State Public Pension Investments Shift Over the Past 30 Years" by the PEW Charitable Trusts and the Laura and John Arnold Foundation stated that as public pension systems throughout the United States strive to meet the industry standard of 7 to 8% rate of return on investments, they have significantly changed their asset investment strategies over the past three decades. In their attempts to boost investment returns, many

systems have shifted funds away from the more secure fixed-income investments, such as government and corporate bonds. During the 1980's and 1990's, as bonds have become less attractive, systems began to significantly increase their reliance on stocks, also known as equities. Now, during the past decade, systems have increasingly turned to much more risky and volatile alternative investments such as private equity, hedge funds, real estate and commodities in their attempts to reach the 7 to 8% target rate of return. This shift has increased the riskiness and complexity of pension portfolios and has resulted in significantly higher investment fees.

The report further stated that in 2006, 61% of pension assets were invested in equities, and 11% were invested in alternative investments. By 2012, the alternative investments had increased to 23% of plan portfolios.

The Virgin Islands Government, in November 2005, authorized GERS, with Act 6794, to include in their investment strategy alternative investments. This Act allowed GERS to invest up to 10% of the investment portfolio in specifically defined alternative investments. However, in another section of the same law, GERS was also allowed to invest an additional 20% of investments in viatical, another type of alternative investment. As a result, GERS was authorized to commit up to 30% of their investment portfolio in non-traditional investments.

The following table, based on GERS' audited financial statements from Fiscal Year 2006 through 2013, shows the total assets, total investment assets, the investment limits on alternative and viatical investments, and the total limit on non-traditional investments.

Government Employees Retirement System
Computation of Alternative Investment and Viatical Limits

Category	2006	2007	2008	2009	2010	2011	2012	2013
Total Assets	$1,785,957,959	$1,946,591,375	$1,596,241,559	$1,553,219,607	$1,548,879,338	$1,460.502,713	$1,446,671,573	$1,318,507,984
Less: Non-Investment Assets	400,780,841	416,269,291	380,235,568	317,368,684	287,143,382	299,079,262	234,959,645	133,658,801
Total Investment Assets	$1,385,177,118	$1,530,322,094	$1,216,005,991	$1,235,850,923	$1,261,735,956	$1,161,423,451	$1,211,711,928	$1,184,849,183
Total Limit for Alternative Investments (5% to 2010; 10% 2011 to Present)	**$69,258,856**	**$76,516,104**	**$60,800,300**	**$61,792,546**	**$63,086,798**	**$116,142,345**	**$121,171,193**	**$118,484,918**
Total Limit for Viatical (20%)	**$277,035,424**	**$306,0640,417**	**$243,201,198**	**$247,170,185**	**$252,347,191**	**$232,284,690**	**$242,342,386**	**$236,969,837**
Total Limit for Non-traditional Investments	**$346,294,280**	**$382,580,521**	**$304,001,498**	**$308,962,731**	**$315,433,989**	**$348,427,035**	**$363,513,578**	**$355,454,755**

Based on the most recent audited financial information (Fiscal Year 2013) as summarized above, GERS alternative investment limit was $118.5 million and the limit on viatical was $237 million, for a total non-traditional limit of $355.5 million.

Although more recent audited financial information was not available, as reported in the July 2015 GERS newsletter, the "unaudited asset allocation" of GERS as of June 30, 2015, was $862,047,641. The newsletter stated that of the total asset allocation, 16.2% or $139.7 million was invested in alternative assets, including the real estate investments of "Havensight Mall, Estates Hoffman & Nullyberg & Estate Coakley Bay." This percentage exceeded the 10% limit established by the Code.

Using the alternative investment and viatical information provided to us by GERS and the "unaudited asset allocation" as reported in GERS' newsletter, we calculate the outstanding balance in alternative investments as of June 30, 2015, at $142.4 million or 16.5%, which also exceeds the 10% Code limit. If the Havensight property, acquired prior to December 31, 2005, is excluded from the alternative investment calculation, the outstanding balance of alternative investments as of June 30, 2015, would total $92.7 million or 10.8%, slightly more than the Code allowed 10% limit. The viatical investment total of $50 million or 5.8% falls well below the 20% Code limit, and if all non-traditional investments are included the total would be $192.4 million or 22.3%.

Although the combined total of 22.3% does not exceed the combined Code established 30% limit on non-traditional investments, by not including all investments as defined by the industry as alternative investments, GERS will be allowed to far exceed the industry average as reported by the NASRA.

Duplicate Code Provisions

The 2005 revisions in Act 6794 created duplicate sections of the Code addressing alternative investments that result in a confusing and unmanageable investment system for GERS to operate in accordance with the new requirements. When the two-tier category of Government employees was created, the 2005 revisions also created two sections dealing with investments, member loans, and alternative investments, with different definitions in some sections and the exclusion of the viatical type of investment from one tier of Government employees.

Title 3, Chapter 27 of the Code relates to Tier I members of GERS, or employees who entered Government service before October 1, 2005. Act 6794 created a new group of employees, Tier II members of GERS, or employees who entered Government service on or after October 1, 2005. These employees are covered under Title 3, Chapter 28A of the Code.

Chapter 27, Section 717 deals with the various types of investments and member loans for Tier I employees. Under this section, the viatical form of investment is covered under Section 717(b)(9). Section 717(b)(20) establishes and defines alternative investments. In the definition of "real estate" investments properties acquired prior to December 31, 2005, are excluded.

Chapter 28A, Section 766 deals with the various types of investments and member loans for Tier II employees. The viatical form of investment is not covered. Section 766(b)(19) establishes and defines alternative investments for this tier of employees. In the definition of "real estate" investments, there is no exclusion for properties acquired "prior to December 31, 2005".

These differences in the investment provisions of the Code create an unmanageable situation where Tier I contributions can be invested in a certain type of activity, and Tier II contributions can be invested in another. GERS does not separately account for Tier I and Tier II employees'/employer's contributions; therefore, it is impossible to differentiate between the two

Code sections when determining the investment options. Although not covered by this inspection, there are also some other language differences in other investment sections when comparing Section 717 and Section 766 of the Code.

The GERS statute should be completely revised with one chapter dealing with the operations of GERS to include the definitions, structure, management, operations, investments and all matters that would be applicable to all tiers of employees. There should be another chapter dealing with the different tiers and the requirements, benefits, and matters dealing with the peculiarities of the different tiers of employees.

Recent Code Amendments

In October 2015, Bill 31-0251, amending Chapters 27 and 28A of the Code, became law. The new act among other things added five additional categories of alternative investments to Section 717(b)(20) and Section 766(b)(19). The five additional categories are:

- Financial Futures
- Swaps, to include, Interest Rate Swaps and Credit Default Swaps
- Financial Options and swap options
- Non-USD currency exposure
- Currency forwards.

The sections also state that "The investments identified….do not apply to the fixed income portfolio 10% maximum." As a result, GERS would now have the authority to invest the entire investment portfolio in these five new high-risk alternative investments, placing the portfolio at further risk. As will be shown throughout this report, GERS does not have a positive history in the alternative investment market. As pointed out in the GFOA Advisory, extreme caution, and close monitoring are a must when dealing with alternative investments. GERS' alternative investments limit should be maintained at the industry standard level. Given the significant unfunded liability, it is imperative for GERS to safeguard the portfolio to ensure its viability for its members.

Recommendations

We recommend that the Board of Trustees of GERS:

1.1 Request that the Virgin Islands Legislature amend the Code to include all non-traditional investments in the definition of alternative investments.

1.2 Request that the Virgin Islands Legislature amend the Code to ensure that the limit on investing in the high-risk alternative investment market is within the industry standard.

1.3 Request that the Virgin Islands Legislature revise the entire GERS statute to ensure that the sections of the Code are organized in a consistent and logical manner.

GERS Board of Trustees' Response

The GERS Board of Trustees submitted a 6-page response dated February 18, 2016, to the draft inspection report. The first three pages of the response discussed the reasons why there was disagreement with the conclusions section of the report. The final two pages dealt with the nine recommendations that were made. We will summarize the portions of the discussion and responses to the recommendations in the appropriate finding sections of the report.

Regarding the first finding and the three recommendations, the response stated that while viatical and real estate investments are considered alternative investments by the industry, they are not considered alternative investments by the Code. There was also disagreement with the report's statement that the current limits of GERS' non-traditional investments are higher than industry standards.

The response further stated that the report used "non-traditional investments" and "alternative investments" interchangeably, and disagreed that the Code 10% alternative investment limit has been exceeded. The GERS Board of Trustees also disagreed with the method used in determining whether GERS exceeded the 10% limit. It was further claimed that the inclusion of the Havensight, Estate Hoffman & Nullyberg and Estate Coakley Bay as alternative investments was incorrect.

Regarding the three recommendations made in this section of the report, to request legislation to; (i) amend the Code to include all non-traditional investments in the definition of alternative investments, (ii) amend the Code to ensure that the limit on investing in alternative investments is within the industry standards, and (iii) revise the GERS statute to address the inconsistencies and conflicts in the Code, the GERS Board of Trustees concurred with each. It was indicated that amendments will be recommended.

V.I. Inspector General's Comments

First, we must indicate our disappointment with the February 18, 2016 response submitted by the GERS Board of Trustees to the inspection report on the Alternative Investment Program. We found it to be confusing, contradictory and very general in addressing our serious concerns and recommendations regarding the millions of dollars invested in alternative and viatical investments (non-traditional investments).

The response consisted of five pages of narrative (the sixth page was a signature page), three of which focused on their disagreement with eleven conclusions listed in the conclusion page of the report. In the remaining two pages, the GERS Board of Trustees concurred with three of the recommendations, partially concurred with four recommendations, and did not concur with two of the nine recommendations made. We will address each of the recommendations in the respective sections of the report; however, we also must point-out the inconsistencies and contradictory comments made in the response.

Before we comment on the recommendations in this section of the report, we must first comment on the incorrect and conflicting statements made relating to Finding 1 dealing with the Code and our concerns with the sections covering non-traditional investments. In the response, it was stated that "While viatical and real estate investments are considered by the industry as alternative investments, they are not considered alternative investments by the Virgin Islands Code." That statement is not completely correct. We agree that viatical investments are excluded from the alternative investment section of the Code. In fact that is one of our major points in this Finding and the basis of our first recommendation. However, it is incorrect to state that real estate investments are not considered alternative investments in the Code. Again as discussed in this Finding, real estate investments are considered as alternative investments, the only difference, as we discussed, is from what point are they considered. Title 3, Chapter 27, Section 717(b)(20) excludes real estate acquired before December 31, 2005; while Title 3, Chapter 28A, Section 766(b)(19) does not have the exclusion. Therefore, depending on which section of the Code you read, the real estate investment in the Havensight Mall would not be considered an alternative investment under Section 717, but would be considered an alternative investment under Section 766. The other two properties in Estate Hoffman/Nullyberg and Estate Coakley Bay acquired in 2006 and 2010 respectively do meet the alternative investment criteria in both sections of the Code.

We had to use the term "non-traditional investments" when referring to the Code defined alternative investments and the viatical investments because in the Code they are treated as two different types of investments, although in the industry they are all considered alternative investments. We have reviewed our report to ensure that when we used the term "non-traditional investments", we were referring to the Code defined alternative investments and viatical investments.

Regarding the high GERS limit on non-traditional investments, as reported, viatical investments are limited to 20% of the investment portfolio and alternative investments have a limit of 10%, or a total non-traditional limit of 30%. The industry standard is about 22-23%. In addition, the 2015 amendments to the Code does not establish any limits on the five new types of alternative investments; thus, the reason for our second recommendation.

Finally, regarding the statement that the alternative investments do not exceed the 10% limit, we used the information reported by GERS in their July 2015 newsletter where they indicated that of the total asset allocation, 16.2% or $139.7 million was invested in alternative assets, including the real estate investments of "Havensight Mall, Estates Hoffman & Nullyberg & Estate Coakley Bay." In addition, we recently received a copy of the January 2016 newsletter that showed the "Investment Manager Asset Allocation" at an unaudited value of $751,023,715. The "Alternative Assets" are shown at 18.2% (a 2% increase over the July 2015 amount). Prudent management oversight would have dictated that with the obvious decline in the investment asset base, investments in alternatives would have been frozen, and the investment portfolio would have been redistributed to ensure that the various percentage limits as required by law are maintained. However, to the contrary, as reported and as will be discussed in our comments to Finding 2, the GERS has recently given an additional $3 million in an illegal loan to the grocery discussed in the report.

Regarding the three recommendations made in this section of the report, as previously discussed, the GERS Board of Trustees indicated disagreement with all of the conclusions made in the report; however, they indicated that they concurred with each of the recommendations made in this section. We are confused because the findings and conclusions are the basis for our recommendations. Based on the concurrence, however; we will consider the three recommendations resolved, but not implemented. Our reason for considering the recommendations not implemented is because the GERS Board of Trustees failed to establish a time-frame for requesting legislative approval for the recommended changes to the Code. In addition, we will require that the GERS Board of Trustees provide us with a copy of any proposed legislation that will be submitted.

FINDING 2: LENDING AUTHORITY

GERS entered into loan agreements which are not authorized under the Alternative Investment Program or any other authority as defined by the Code. Six Alternative Investment Program investments were actually commercial loans to businesses, and one was a loan to the Government of the Virgin Islands (Government). The total value of these seven loans was, at least, $77.1 million. The interest rate charged for four of the loans was below the rate charged members and the industry desired investment rate of return of 7 to 8%.

Background

Title 3, Chapter 27, Section 717(b)(20)(A) and Section 766(b)(19)(A) of the Code introduces and defines the Alternative Investment Program. It also identifies five categories of alternative investments, with specific examples of each type of alternative investment. The Code under Section 717(b)(20)(B) and Section 766(b)(19)(B) further defines the various examples mentioned in the previous Code section.

Unauthorized Loans

We found that of the twelve non-traditional investments, six were actually commercial loans to new, expanding or financially struggling businesses. In addition, one was a loan to the Government secured by property tax revenues. The total GERS funds committed as of June 30, 2015, was $77,093,374. The other five non-traditional investments consisted of three real estate acquisitions totaling $60,119,234, one venture capital investment totaling $25,000,000 and one viatical investment totaling $50,000,000.

The following table summarizes the seven loans.

LOANS

No	Type of Agreement	Date of Agreement	Total Funding to Date
1	Loan – Establishment of an Ethanol Dehydration Facility on St. Croix	December 5, 2007	$8,000,000
2	Loan – Expansion of Operations of an Inter-Island Airline Company	December 4, 2009	$4,800,000
3	Loan – Pay-off Receivership and Renovations to a Hotel on St. Croix	December 8, 2009	$27,087,385
4	Loan – Property Tax Revenue Anticipation Note to the V. I. Government	November 14, 2011	$13,000,000
5	Loan – Line of Credit to a Viatical Partnership Investment	July 11, 2012	$10,000,000
6	Loan – Renovations of Properties of a Fast Food Franchise in the Virgin Islands	September 24, 2013	$6,000,000
7	Loan – Establishment and Construction of a Grocery on St. Thomas	June 30, 2014	$8,205,989
Total			**$77,093,374**

Regarding the $13 million loan to the Government, in 1972, the then Chairman of GERS Board of Trustees requested and received an opinion from the then Attorney General (7 V.I. Op. Atty Gen. 62), who stated that GERS can make loans to the Government. However, the language in the 2005 Retirement System Reform Act contains no provisions giving GERS the authority to make loans to non-members, including the Government, under the guise of alternative investments. In addition, as will be discussed in the section entitled "Interest Rate", we have concerns with the terms of the loan agreement with the Government that was apparently forced onto GERS, at a less than favorable rate of return.

In our opinion none of the loans were authorized under the Alternative Investment Program. There is no language in the Code that defines any of the alternative investment options as loans. They consider alternative investment opportunities as "investments". We reviewed transcripts of legislative sessions where the Alternative Investment Program was discussed, and nowhere did we find any discussion of loans being treated as alternative investments.

When we met with the GERS Administrator and other officials, they all asserted that lending was permitted. During one-on-one conversations, they stated that the authority for lending was found in the alternative investment type of "Private Equity" under the specific option of "Special Situations." The Code defines "Special Situations" as "…unusual investment opportunities due to some special development, i.e. a merger, oil discovery, new product development, etc., that is expected to most favorably affect the earnings outlook or the public's psychology with respect to the prospects for a particular company."

We researched and reviewed industry meanings of the term "investment", and all definitions contained the requirement that an asset or equity be purchased with expectations that income or increase in value will result. One source defines investment as, "An asset or item that is purchased with the hope that it will generate income or appreciate in the future. In an economic sense, an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or appreciate and be sold at a higher price."

On the contrary, a "loan" is defined as "The act of giving money, property or other material goods to another party in exchange for future repayment of the principal amount along with interest or other finance charges."

Title 27, Section 717(b)(11, 12, 13, 14, and 15) and Title 28A, Section 766(b)(10, 11, 12,13, and 14) of the Code, are the only sections that do authorize GERS to give personal loans, mortgage loans, and chattel mortgages (vehicles and cars), however, only "to members or retirees of the system".

As will be shown in the other findings of this report, GERS engaged in highly speculative and risky activities by entering into these loan agreements without performing sufficient due diligence or having a mechanism to adequately monitor these questionable activities. In addition, GERS has been forced to liquidate millions of dollars from traditional investments to disburse large sums of money to these commercial borrowers.

Specifically, GERS through its Board of Trustees approved six commercial loans worth over $64 million to six new, expanding or financially struggling businesses, in addition to the $13 million loan to the Government. To date, only two entities have satisfied their obligation to GERS. In addition, the largest loan of $15 million to a struggling hotel establishment on St. Croix ended in default, forcing GERS to take ownership and further spend an additional $12.1 million to date for the property to be maintained. As a result of these unauthorized loan agreements, GERS funds have been placed in jeopardy of being lost.

Interest Rate

In addition to giving unauthorized loans, the low interest rates charged by GERS on these loans defeats the purpose of the Alterative Investment Program and the industry desired rate of return of 7 to 8%. We found that for these seven loans, the interest rates ranged from 4.91% to 15%, with the interest rate for four of the loans at 6.4% and less.

Interest rates on commercial loans are typically determined by a benchmark. Most of the time, that benchmark is the prime rate. The prime rate is the interest rate a bank charges it's most creditworthy customers, which includes the overnight rate at which banks lend to one another. The average yearly prime rate since 2005 ranged from 3.25% to 8.08%. A local bank confirmed that the interest rate on commercial loans normally is 2% above the prime rate; however, with the prime rate currently very low, good clients usually get a rate between 6.50% and 7.00%. This rate would increase based on less than favorable evaluations on the client's ability to pay. In order to determine the ability to pay, the banks review the client's past payment history (a personal character indicator), market conditions that the business must operate in, as well as the collateral or cash on hand available to secure the loan. A less than favorable rating indicates a riskier loan and riskier loans are usually approved at higher interest rates. These industry driven procedures were not followed under the Alternative Investment Program. In fact, our review of all seven loans granted under the Alternative Investment Program disclosed an unstructured approach to establishing an interest rate. For example:

- The $13 million loan to the Government was approved for a record low interest rate of 4.91% in the face of legitimate opposition by GERS' management. Specifically, on July 16, 2011, the Administrator received an email from the Commissioner of the Department of Finance with a proposed term sheet for the loan from GERS to the Government. The Commissioner stated in the email that the proposed term sheet was reviewed by GERS' financial advisor as had been suggested by the Administrator in his call. This term sheet, which was dated July 7, 2011, proposed an interest rate of 5.75%. The Administrator wrote to the former Board of Trustees' Chairperson that he was totally against lending to the Government when they were hurting the System significantly. Further, he indicated that the interest that GERS will recoup from the loan will never offset what is being lost over the long term. Another GERS official also stated that given the risk, the interest rate was too low and did not comply with the 8% rate of return on investments found in GERS' investment policy. The official also indicated that GERS charges its members more for a personal loan and their credit ratings are far more favorable, and the loans are

secured with funds that can be easily accessed. Further, the official also indicated that GERS is not a bank. Despite these practical industry endorsed concerns, the loan was approved and funded in November 2011. Further, the loan was approved at a 4.91% interest rate, far below the recommended Alternative Investment Program rate of 8%, and even lower than the 5.75% rate proposed initially. GERS' officials (Board of Trustees and Management) later justified the lower interest rate by requesting that their investment advisor prepare a memorandum with suggested language to amend the Investment Policy requirement of an interest rate of 8%. The memorandum further stated that "the Government's published investment grade rating of Baa/BBB/BBB+ issued by Moody's, Standard & Poor, and Fitch, respectively qualifies the Government to pay a lower interest rate." GERS' Board of Trustees then passed resolution 31-2011 to amend the Alternative Investment Program to authorize investments where the rate of return is less than 8%. The Board of Trustees then approved two resolutions on October 25, 2011, authorizing the lower interest rate for the Government loan.

Although the Government loan marked the lowest interest rate granted, recent loans to a fast food chain and a "to be constructed" grocery establishment were for 6.25% and 6.40% respectively. At local banks, these rates are only offered to creditworthy, highly rated customers that have great collateral and/or a tremendous track record of repayment. In fact, the clients GERS extended loans to through its Alternative Investment Program were very likely to have been turned down by banks. One client who ended up defaulting admitted in his testimony before the Board of Trustees that the bank would not fund his company's loan.

Presented is a chart of all loans issued under the Alternative Investment Program. It is important to note that the desired pension fund industry return on investments is 7 to 8%, GERS' interest rate to members is 8%, and the previous interest rate established by the GERS Board of Trustees was 8%. Also, as previous stated, when banks do grant risky loans, they always grant them at higher interest rates.

Interest Rate on Loans

Loan	Loan Amount	Interest Rate
Establishment of an Ethanol Dehydration Facility on St. Croix	$8,000,000	8.25%
Expansion of Operations of an Inter-Island Airline Company	$4,800,000	14.25% reduced to 8.25% reduced to 6.25%
Pay-off Receivership and Renovations to a Hotel on St. Croix	$15,000,000	10.25%
Property Tax Revenue Anticipation Note to the V. I. Government	$13,000,000	4.91%
Line of Credit to a Life Insurance Partnership Investment	$10,000,000	15%
Renovations of Properties of a Fast Food Franchise in the Virgin Islands	$6,000,000	6.25%
Establishment and Construction of a Grocery on St. Thomas	$8,205,989	6.4%

The intent of implementing the Alternative Investment Program was not to offer discounted interest rates on loans; instead, it was a means to garner double-digit returns *(10% or*

more). This intent was disclosed in a Board of Trustees meeting held on January 23, 2014. The Administrator stated:

> *My recommendation is that we go back to the intent of this program and amend the interest rate that was adopted in December and set the rate no less than 10 percent. We are getting 15 percent right now on the credit facility. We need to stick to the intent of this program. We do not want to have….special situations, and all of that stuff. I remember the Governor saying that in front of me in 2008 with the "ethanol dehydration plant," he was totally against* ***(Company Name Redacted)*** *because he felt that we should have been double digits and he felt it was special interest. Totally against* ***(Company Name Redacted)*** *even though we get our money back in eight-point-something percent. I am recommending that we stick to our intent of this program and raise our interest rate to no less than 10 percent, double-digit.*

Following the Administrator's sentiments, the Board of Trustees approved a rate of no less than 10% effective January 1, 2014, for all alternative investments.

Recommendation

We recommend that the Board of Trustees of GERS:

2.1 Stop the practice of giving loans to non-members of GERS.

GERS Board of Trustees' Response

In their discussion, the GERS Board of Trustees stated that they did not agree with this finding. In reference to the $10 million line of credit given to the viatical, it was stated "Is the Inspector General saying that the GERS Board of Trustees made an illegal decision to grant the $10 million line of credit? If so we disagree. 3 V.I.C. § 717 grants GERS the legal authority to enter into this transaction."

Regarding the recommendation, the GERS Board of Trustees indicated non-concurrence, however, it was stated that "The Board suspended the Alternative Investment Program on September 18, 2015."

V.I. Inspector General's Comments

In response to the question, our answer is yes. The Code does not allow the GERS Board of Trustees to give loans to non-members. As we indicated in the report, a loan is not an investment. GERS does not have the expertise or the necessary structure to be giving loans to non-members, especially commercial loans. The Virgin Islands Government has several programs under the Economic Development Authority to assist businesses that are having difficulties in getting commercial loans from banks and other lending institutions.

Regarding the recommendation, we again maintain our position that GERS is not authorized to give loans to non-members, and to continue this practice is to continue violating the law. Although it was stated that the GERS Board of Trustees has suspended the Alternative Investment Program, GERS continues to provide loans to non-members. GERS recently provided an additional loan of almost $3 million to the entity mentioned in the report for the grocery store construction. We are concerned that GERS continues to provide commercial loans to non-members and that those entities are not qualified for the loans. As a result, we consider the recommendation as unresolved.

FINDING 3: VIATICAL

GERS entered into an extremely risky and questionable viatical investment that jeopardized about $42 million of its investment portfolio. This was done without performing the necessary due diligence and obtaining the necessary expert advice, before exposing the pension fund to this high-risk investment. As a result, GERS has already written-off 20% or $8.4 million of the remaining value. In addition, GERS also granted a $10 million line of credit to the same partnership that is handling the viatical. The majority of the proceeds were to pay past due and near term premiums for the policies.

Background

Title 3, Chapter 27, Section 717(b)(9)(A) of the Code authorizes GERS' Board of Trustees to invest in "viatical senior and/or life settlement policy contract investments". The Code section further defines the requirements for this type of investment. Code Section 717(b)(9)(B) limits this type of investment to 20% of total investments by GERS. It must be noted that Title 3, Chapter 28A, Section 766 does not provide for viatical investments.

Viatical investments are investments in life insurance policies, where a company/partnership pools investor/partner funds to purchase, at a discounted rate (20-30%), life insurance policies with high death benefit payments ($500,000 and up), from wealthy individuals with a limited life expectancy (usually 5 to 10 years). The investor's/partner's funds and funds received from collected death benefits are used to continue paying the insurance premiums for the insured individuals. Once an insured individual dies, the company/partnership would have to process claims and collect the death benefit. Upon collection, they would distribute the net proceeds, less expenses, to the investors/partners based on the percentage of the investor's/partner's investment.

An important fact about viaticals that should be noted here is that once an investment is made into a viatical agreement, the investor/partner cannot withdraw before the term of the agreement is completed. Any withdrawal will result in the loss of the investment. Also, the company/partnership must continue to make payments of the premiums on the life insurance policies that were purchased. Failure to remain current on the premium payments will result in the cancellation of the delinquent policies. If one or more investor/partner fails to make their share of premium payments, the other investors/partners must make up the difference. The partnership agreement can also require that a reserve account be established to ensure the payment of premiums for the active policies. This reserve account can be funded when a death benefit is collected. The funds received would be kept in the reserve account rather than distributed to the investors/partners.

Partnership

The viatical investment that GERS purchased was a Limited Partnership (Partnership), which came into existence on January 1, 2004. The Partnership changed its name in 2007 due to a trademark conflict with another firm. Based on documents reviewed, they received their initial investment from the International Brotherhood of Electrical Workers Local 98 Pension Plan (Local 98), of $5,000,000 on January 14, 2004, for two units of thirty-two units offered. The initial two units were offered for $2.5 million each, after which, the units sold for $5 million each. The Beaver County Pension Plan (Beaver County) purchased two units for $5,000,000 each on May 13, 2005, and December 28, 2005. On August 10, 2006, GERS purchased ten units for $50,000,000. Finally, on March 30, 2007, the Eastman Chemical Company (Eastman) purchased one unit for $5,000,000. Accordingly, only fifteen of the thirty-two units offered were sold.

Upon the receipt of GERS' capital payment in August 2006, the Partnership entered into "a bulk policy purchase agreement for a pool of policies." Audited financial statements and other documents provided to us for various years between 2007 and 2013 showed the Partnership, at one time, owned as much as 99 policies. The 2013 audited financial statement showed 79 active policies at a redemption value of $184,126,648. In addition, there were 8 inactive policies due to delinquent premium payments with a redemption value of approximately $13,584,000.

In 2008, a major restructuring of the Partnership portfolio was accomplished when a Limited Liability Corporation (Corporation) purchased the life insurance policies from the Partnership. The Corporation issued $40 million in 9% Preference Notes; $24 million in 9.5% Mezzanine Notes and Residual Notes. In return, the Partnership received $13.7 million in cash, $24 million in 9.5% Mezzanine Notes, 100% of the Residual Notes and sole membership interest in the Corporation. As a result of the transaction, the Partnership distributed $12,689,817 or $816,373 per unit to the partners. GERS, with 10 units, received $8,163,726 on June 18, 2008. Accordingly, GERS' equity position in the Partnership was adjusted to $41,836,274.

Investment Activities. As part of our inspection, we attempted to determine the events leading up to GERS' initial $50 million investment. Documents provided showed that the former Administrator and GERS' investment advisor were finalizing discussions on the Partnership investment in April of 2006. However, the current Administrator indicated that discussions had been ongoing since April 2005. We know that the act authorizing viatical investments became law on November 2, 2005, therefore, the investment in this Partnership had been under consideration for some time, before the November 2005 Act became law. On April 19, 2006, the GERS investment advisor voiced concerns regarding investing in viaticals. The advisor stated:

> *"Prior to reaching a decision on whether to invest in the [Partnership], the Trustees should consider the following questions:*
>
> - *Do you understand the nature of the investments?*
> - *Are there similar vehicles in the marketplace and how do they compare in*

terms of process, people and performance?

- *Is this type of vehicle a typical investment for a defined benefit retirement plan?*
- *Are the risks (e. g., liquidity, loss of principal, etc.) justified for the expected returns?*
- *What is the size of the potential investment and will it have meaningful impact on the overall results?*
- *How will an investment limit flexibility for future investments in the alternative investment asset class which was recently approved by the Legislature?"*

No documentation was provided to us to show that the Board of Trustees considered the questions raised by the investment advisor. On July 20, 2006, the Administrator confirmed the Board of Trustees directive to withdraw $50 million from three investment managers to become a limited partner in the Partnership. GERS' Board of Trustees Chairman signed the Partnership Agreement on August 10, 2006.

Shortly after GERS' membership in the Partnership, on August 27, 2006, an article appeared in the Pittsburgh Post-Gazette that was very critical of the Partnership. The general partner of the Partnership, on August 31, 2006, wrote a nine-page memorandum to the limited partners challenging the contents and assertions made in the news article. The negative effect of the news article raised concerns on the part of GERS' managers, and the concerns were brought to the attention of GERS' investment advisor. In a September 13, 2006, memorandum, the investment advisor made seven observations regarding the article and investing in viatical investments. The seven observations are summarized below:

- The Board of Trustees should have had an understanding of the investment process and the investment structure of the Partnership, including the appropriateness of this type of investment in a defined benefits plan, all of the risks associated with viatical investments and the lack of a performance track record.

- The due diligence process should be documented to support the Board of Trustees' decision to invest in the Partnership.

- The Board of Trustees should understand the fees associated with the Partnership and should be sufficiently satisfied that the added costs of this type of investment combined with the risk components (liquidity and loss of principal) are justified for the expected return.

- The Board of Trustees should know that this is a first-time fund and has no track record.

- There is uncertainty on the use of viaticals as an investment by a defined benefit plan.

- The uncertainty of investment professionals and issues raised by the article were reasonable and sufficient to not make the investment.

- The nature of the investment in viaticals, that is an investment seeking profits off death, raises issues of social responsibility.

The investment advisor stated that; "While we cannot comment on whether the interlocking relationships are legal or not and have no basis to suggest that the investment is not legitimate, we do believe that there is enough uncertainty and misrepresentation regarding the individuals and the investment itself to take action." Among other recommendations regarding questionable conflicting relationships, the investment advisor recommended that:

- Detailed information on each policy purchased by the Partnership should be provided.

- The contract should be reviewed for termination provisions. The relationship should be terminated even if it means a penalty on the $50 million investment.

In a September 13, 2006, internal memorandum to the legal counsel for GERS, it was indicated that the Partnership Agreement does not provide "….many options for withdrawals, redemptions, nor assignments. It strongly disfavors these actions, and it explicitly states that investors must be ready to hold this investment, which is risky for the long term." This interpretation of the agreement provisions was verified by the legal counsel for the Board of Trustees.

The acting Administrator of GERS contacted officials of the Partnership requesting various financial records of the Partnership including records of purchases, disposition and trading activities of the Partnership. In addition, based on documentation provided, GERS requested that the apparent $11.9 million in uninvested funds be held, pending resolution of the concerns. After receiving some documentation, notification that all funds had already been invested, and a meeting with the Partnership officials, in late October 2006 GERS officials felt that the major concerns were alleviated.

The investment advisor, however, still had concerns relating to the timing of the reported investment when compared to the date that GERS requested that no additional funds be invested. In addition, the amount of the advanced fees to the general partners was questioned. Finally, it was recommended that an example of a security transaction be provided to include all documents used in identifying the policy, all contracts associated with the purchase of the policy, and all documents illustrating the transfer of monies.

We were not provided with any documentation to show that the recommendations of the investment advisor were considered, or followed. Except for correspondence in 2007, requesting information from GERS' external auditors to determine the value of GERS' interest, we could not obtain any additional information relating to the activities of the Partnership during this time period.

On March 12, 2008, the GERS received a check from the Partnership in the amount of $594,000. This check represented a 66% distribution of a $900,000 death benefits policy that was received by the Partnership. On June 8, 2008, the Partnership informed GERS of the restructured purchase of the insurance portfolio by the Corporation, as previously mentioned, and the equity distribution of $8,163,726. As a result, GERS' equity position in the Partnership was reduced to about $42 million.

Except for Periodic Activity Reports and annual audited financial reports submitted by the Partnership, and requests by GERS' external auditors on the value of GERS' investment, there was no other significant correspondence between GERS and the management of the Partnership until 2010.

On November 1, 2010, the general partner of the Partnership contacted GERS' Administrator indicating the need for additional funds to meet the premium obligations and to preserve the assets of the Partnership. The correspondence further stated that failure to pay the premiums on a timely basis will adversely affect the unit valuation. Accordingly, each limited partner was requested to contribute $315,000 per unit interest in the Partnership. GERS, with 10 units was requested to contribute $3,150,000. After several weeks of correspondence, discussions and meetings, GERS' Board of Trustees decided not to provide the additional funding until further information was obtained and due diligence could be conducted. The general partner was so notified by correspondence dated November 22, 2010, and reinforced by additional correspondence dated November 27, 2010.

GERS' internal auditor and general counsel made a trip in March 2011 and reported in a one-page summary report the results of the trip. The report indicated that 70% of 96 policies were reviewed, but the files did not indicate the payment status of the premiums. The report also stated that Beaver County converted its partnership interest into $15 million of the mezzanine notes at 9.5% interest. It further stated that "[The Partnership] has $40 million in outstanding preference notes at 9% interest, $15 million in mezzanine notes at 9.5% interest, and about $6 million in premiums annually. When policies mature, payments are distributed to these obligations before distributions to limited partners." The internal auditor presented several options for GERS to consider as follows:

- "GERS may value its shares in [the Partnership] and solicit a sale
- GERS may transfer shares up to $24 million to mezzanine notes at 9.5% interest
- GERS may hold investments to imminent maturity."

Although no documentation was provided to show GERS' course of action, we saw no evidence of additional investment in the Partnership or changes in GERS' partnership status.

Line of Credit. On April 26, 2012, the Partnership notified GERS that cash flow needs were critical and "the fund will not be able to meet its obligations by the end of next week, May 5, 2012." Based on correspondence dated May 1, 2012, GERS and the Partnership had been negotiating a line of credit for some time, in order to meet the premium payment needs of the

Partnership. On May 4, 2012, GERS transferred $645,000 as an advance on the pending line of credit so that premium balances due on two insurance policies could be paid. An agreement was finalized on July 11, 2012, where GERS agreed to lend a total of $10 million for "…among other things, the payment of premium in respect of the Insurance Policies and certain other expenses of the Borrower." Interest is to accumulate at 15% per annum. The line of credit is expected to terminate on July 10, 2017. Interest payments are to be made periodically as funds become available; however, the entire principal and unpaid accrued interest are due on the termination date. Between May 4, 2012, and the final execution of the line of credit in July 2012, GERS made seven advance payments totaling $1,160,263. GERS received only one interest payment of $618,708.37 on November 26, 2013. In early 2015, the Partnership attempted to increase the line of credit amount by $3 million; however, GERS refused to provide additional funding. The entire $10 million was distributed by March 26, 2015. The following tables show the line of credit activity to date. The first table shows the drawdowns. The second table shows the one interest payment.

LINE OF CREDIT ACTIVITIES
DRAWDOWNS ON PRINCIPAL

Date	Amount
05/04/12	$645,000
06/11/12	40,000
06/19/12	267,063
06/25/12	89,000
07/05/12	64,200
07/11/12	30,000
07/13/12	25,000
07/30/12	3,000,000
04/03/14	3,000,000
09/25/14	2,500,000
03/26/15	339,737
TOTAL	$10,000,000

LINE OF CREDIT ACTIVITIES
INTEREST PAYMENTS

Date	Amount
11/26/13	$618,708.37

Recent Investment Activities. On February 4, 2013, GERS, at a cost of $100,000, requested a third party assessment of "…the fair value of GERS' investment in [the Partnership] as of September 30, 2012." The third party was to provide a written report. A July 2013 report was issued, with an opinion that as of September 30, 2012, the fair value of the GERS' limited interest in the Partnership was "speculative". A review of the detailed analysis revealed that from 2012 to 2018, income from expected life insurance proceeds will be consumed by premium payments and operating expenses, repayment of loans, and interest payments on the various notes. As a result, there will not be any remaining cash to distribute to the general or limited partners. Accordingly, the value has been classified as "speculative."

On June 19, 2014, the GERS Board of Trustees concluded that the entire investment will most likely be lost and decided "to write down [the Partnership], limited partnership by 20% in Fiscal Year 2014." As a result, the remaining value of GERS' investment in the Partnership has been reduced by about $8.4 million in Fiscal Year 2014. The GERS Administrator has indicated that the investment will be written down by 20% annually until it is completely written off.

In their December 31, 2014, Periodic Activity Report, the Partnership indicated that absent additional infusions of cash, the general partner has begun to sell policies to generate cash to meet the premium payments of existing policies and to pay other obligations of the Partnership.

Due Diligence

From the beginning, GERS' decision to invest in this form of alternative investment was questionable and not well researched. Documents reviewed and confirmation from the current Administrator, showed that this questionable investment had been discussed well before Act 6794 was passed in November 2005. In addition, the fact that the viatical provision of the Act was excluded from the alternative investment provision and limits, leads us to conclude that this was special interest legislation. There was no evidence to show that GERS' investment advisor's original concerns were addressed before GERS entered into the Partnership Agreement. Nor was there any evidence to show that a due diligence assessment of the potential investment was done. Instead, GERS purchased five times as many units, 10 units, when compared to the other partners who purchased no more than 2 units. GERS invested $50 million as opposed to the $10 million of the next largest partner.

Red Flags. There were numerous "red flags" throughout the years of this investment that should have signaled potential concerns about the viability of this investment.

- There is no evidence that the GERS Board of Trustees understood about the nature of viatical investments. The fact that the agreement could not be terminated after investing and the required commitment to keep the premium payments current was apparently lost to GERS officials and the Board of Trustee.

- There was no track record of the Partnership to gauge the success of the investment.

- Of the 32 units offered, only 15 units or 46.9% were sold. Yet the general partner insisted on meeting the goal of acquiring 100 policies. Records show that a total of 99 policies were acquired. With limited investment funds and no interest from others to purchase additional shares, death benefits collected are absorbed by the premium needs of the existing policies. As an alternative, the limited partners would be required to continue making contributions to meet these needs or additional funds would have to be borrowed.

- Premium payments and repayment of borrowed funds and interest would get priority preference over partnership distributions when benefit collections are disbursed.

- No confirmation requests were made by GERS to the various insurance companies issuing the life insurance policies.

- A review of the Partnership's Periodic Activity Reports from as early as 2008 showed the general partner's concern in raising sufficient funds to meet the necessary premium payments. Documents reviewed showed premium needs of $6 to $7 million annually.

- The Periodic Activity Reports also indicated that the expected mortality rates were not being met, in other words, people were living longer than expected. The December 31, 2008, audited financial statements report estimated the following 97 policies reaching their life expectancies (death) as follows:

    - 2009 7 policies
    - 2010 9 policies
    - 2011 15 policies
    - 2012 10 policies
    - 2013 15 policies
    - Thereafter 41 policies.

  Although, the 2008 report expected 56 death benefit collections from 2009 through 2013, the Periodic Activity Report for December 31, 2014, shows a total of only 12 death benefit collections from 2008 through 2014.

- The December 31, 2005, audited financial statements report issued on July 11, 2006, stated in "Note 4-SUBSEQUENT EVENT (UNAUDITED) - In August 2006, the Partnership sold ten Limited Partner units to third-party investors for approximately $50,000,000." We question if the report was issued on July 11, 2006, and GERS became

a partner a month later, on August 10, 2006, why that information was not included in the July report.

- The December 31, 2008, audited financial statements report showed GERS as a 66% partner in the Fund. The December 31, 2013, audited financial statements report showed GERS as a 76.9% partner. This is after Beaver County converted their interest into the 9.5% Mezzanine Notes, and Eastman also converted a portion of their investment into similar notes.

- On February 28, 2014, the Partnership requested a $3 million drawdown on the GERS line of credit in order to meet premium needs. Supporting documentation showed that the funds were needed to pay the premiums for the entire portfolio of 87 active policies. The documentation showed most premiums delinquent for 3-6 months.

- Of 12 death benefits for which $17.8 million was collected between 2008 and 2014, the GERS received a one-time distribution in 2008 of $594,000. In addition, in 2013, more than $618,000 in accrued interest was paid on the outstanding $10 million line of credit.

- The most recent audited financial report for December 31, 2013, indicated that approximately $7.1 million will be needed annually to meet premium needs. It was estimated that with the cash on hand, prepaid premiums and drawdowns from the GERS line of credit, 2014 premium obligations can be met. Future premium payments, however, will be contingent on additional funding either through more borrowing or collections on death benefits.

- The Partnership's Periodic Activity Report for December 31, 2014, concluded; "In the absence of additional credit for the payment of anticipated premiums and operating expenses, the conservative approach is to continue with efforts to sell these policies to generate cash. We would prefer not to sell these assets at reduced values but have no meaningful choice in the matter absent additional credit."

Only time will tell if GERS will receive any profits from this investment, a return of the remaining funds invested, or even the proceeds from the line of credit by the end of the Partnership agreement in 2017. Unfortunately, the only hope for a positive outcome from this investment is the death and subsequent collection of the death benefits from the majority of the remaining 87 policies before the termination of the Partnership.

Recommendations

We recommend that the Board of Trustees of GERS:

3.1 Ensure that legislation is enacted to include viatical investments as an alternative investment subject to the 10% maximum investment limit.

3.2 Establish written procedure to ensure that extensive due diligence is done to include third-party analysis of any potential alternative investment.

3.3 Ensure that all due diligence activities are fully documented to justify the ultimate decision of the Board of Trustees.

GERS Board of Trustees' Response

The GERS Board of Trustees disagreed that "it entered into an extremely risky and questionable viatical investment." They also did not agree with our statement that an additional $10 million was also in jeopardy of being lost. It was indicated that they did not concur with the first recommendation; however, they added that they will recommend amendments to the Legislature to include viatical investments as an alternative investment consistent with trends on the limits of alternative investments. The GERS Board of Trustees concurred in part and did not concur in part with the second and third recommendations. They indicated that written policies and procedures were already in place to ensure that adequate due diligence is conducted and that the Alternative Investment Management Program Policy adopted by the GERS Board of Trustees on May 20, 2010 will be adhered to and that documentation will be maintained in a central repository.

V.I. Inspector General's Comments

Apparently the GERS Board of Trustees still does not understand the nature of viatical investments. By definition viatical investing "…is extremely risky. The rate of return is unknown because it's impossible to know when someone will die. If you invest in a viatical settlement, you are basically speculating on death." We are extremely concerned about the viatical investment, the way the statute was created, the total disregard of the GERS Board of Trustees to address the concerns of their investment advisor, and their willingness invest such a large sum of GERS' investment assets, $50 million, in a new, extremely risky venture, when compared to the other investors, who limited their risk to $5 million. In addition, there were so many "red flags" that were either not see or ignored, but instead the GERS Board of Trustees were willing to invest another $10 million in an illegal line of credit. As a result, 20% of the viatical has been written-off, and as indicated by the Administrator, the balance will be written-off annually at the rate of 20% per year. As we stated in the report, only time will tell if GERS will receive any profits from this investment, a return of the remaining funds invested, or even the proceeds from the line of credit by the end of the Partnership agreement in 2017. Unfortunately, the only hope for a positive outcome from this investment is the death and subsequent collection of the death benefits from the majority of the remaining 87 policies before the termination of the Partnership.

Regarding the first recommendation in this section of the report, we are confused with the GERS Board of Trustees response. We recommended that viatical investments be included as an alternative investment subject to the 10% Code limit, similar to the first recommendation in the first Finding. The GERS Board of Trustees agreed with that recommendation, but indicated that they do not agree with the recommendation in this Finding. However, they did indicate that they

were going to request that the Code be amended to include viatical investments as alternatives. Based on their non-concurrence, we consider the first recommendation unresolved.

The GERS Board of Trustees response to the second and third recommendations stated that written policies and procedures were already in place to ensure that adequate due diligence was conducted. However, as part of our review of the Alternative Investment Management Program Policy, we noted that some of the necessary due diligence checks that should have been done with this viatical investment are not included in the Alternative Investment Management Program Policy. As a result, we consider both recommendations unresolved.

FINDING 4: DUE DILIGENCE

GERS entered into numerous agreements and investments without performing the necessary due diligence to ensure a reasonable rate of return. As a result, there is no assurance that the funds disbursed will produce the desired rate of return or even if the funds disbursed will be recovered.

Background

In lending and investing environments, due diligence procedures are conducted to safeguard assets and preserve the integrity of the entity providing the funding. For a retirement system, assets are safeguarded, and a system's integrity is preserved to promote the rights, benefits and livelihood of all present and future members and their beneficiaries. GERS and its Board of Trustees have even greater responsibility to the community. Based on its current membership, GERS has the potential to affect two out of every five (40%) households in the Virgin Islands. Industry standards for each type of investment dictate requirements for properly managing the investment portfolio and safeguarding assets. Also, commercial lending is a heavily regulated and dynamic industry that upholds rigorous standards aimed at predicting the likelihood of repayment.

Due Diligence

Of the 12 non-traditional investments, we found 7 loan agreements that were classified as special situations under the alternative investment type of private equity. Although we question the legality of loans, as detailed in Finding 2, we found that the processes to approve loans, notify potential borrowers, receive critical documentation, and ensure borrowers' experience, creditability and repayment ability were not uniform or diligent.

Both local and mainland commercial banking experts confirmed that documentation gathered and analysis conducted prior to loan approval are vital to establishing the entity's repayment ability and to assess the overall risk of making the loan. When we examined the physical files, we questioned whether documentation supporting loans were objectively examined to determine the following banking critical elements called the "5C's":

- Character – Have the owners handled their financial commitments for the business (and personally) in the past and paid back their loans?

- Capacity – Can the company really generate enough "cash flow" to pay back the debt requested?

- Collateral – Is there a secondary repayment source free and clear to be liquidated? According to a local bank, accepted collateral is usually in the form of cash, undeveloped land, developed property, inventory and accounts receivable.

- Capital – Is there enough capital in the business to sustain a downturn in the economy? This is normally addressed through personal guarantees from owners.

- Conditions – Are there specific economic conditions that may negatively affect the capacity or repayment ability? This is normally addressed through leases with committed future terms.

Although the GERS loans vetted by outside consultants addressed some of these elements, we did not find evidence that all loans were evaluated in a comprehensive manner. Furthermore, we found recommendations being changed from "do not invest" to "consider for a loan" without any changes in the elements used to evaluate the loan. These deficiencies in the loan origination process often lead to consequences that manifest later on during the life of the loan. For example:

Airline. On December 4, 2009, GERS extended a loan worth $3.3 million consisting of a $2 million convertible loan and a $1.3 million term loan. The proceeds went to an airline company to repair an aircraft, provide working capital and meet approved obligations to a local bank, a settlement agreement, the Virgin Islands Port Authority (Port Authority) and a private company. Although, this loan was approved, GERS officials had legitimate reservations that the loan approval process did not meet industry standards. These underlying reservations, in essence, questioned the company's ability to pay.

In an email dated June 8, 2009, to the Board of Trustees' Chairman, the Administrator detailed his concerns as follows:

- The company did not submit audited financial statements as requested;

- The most common ratios, current assets ratio and acid test ratio, revealed that the company was insolvent and could not pay its liabilities as they became due. A healthy current and acid test ratio should be 2.00 and above, but the company's ratio was 0.23;

- It could not be determined from the expenses in the income statement the amount of compensation paid to the officers of the company; and

- There was no collateral of substantial value if the loan was made.

When we questioned why the loan was granted, even though the airline did not provide audited financial statements, we were told that the reason was because the airline's former chief financial officer, who prepared the financial statements, was a certified public accountant.

Despite the reservations from the Administrator and the non-receipt of audited financial statements, the airline received its original request for a $3.3 million loan on December 4, 2009; then a modification that lowered the interest rate for $2 million (of the $3.3 million) on March 1,

2011, and an additional loan for $1.5 million on November 2, 2012. Although, the overall outstanding amount of $4.8 million was paid along with fees and interest on December 19, 2013, this loan was not administered with the proper due diligence to protect GERS' members and their beneficiaries.

Hotel. On December 8, 2009, GERS provided a $15 million loan to a hotel establishment for the purpose of paying off an existing mortgage in default and funding renovation costs. The financial consultant noted that due to the expedited nature of the transaction, the binder of required documents was not complete. These documents include critical financial and legal paperwork that are used to determine an entity's ability to pay.

This particular loan ended in default when the hotel establishment experienced cash flow problems and had only made two principal payments in the amounts of $62,500 in March 2011 and June 2011, respectively. This event forced GERS to fund activities and eventually took ownership of the establishment by May 2012. One expenditure, GERS had to pay was a hotel room tax liability in January 2013 for over $1 million for periods from 2005 to 2012. This liability was not disclosed in the December 8, 2009, closing documents.

In our opinion, if the financial advisor was not pressured to submit incomplete work, issues regarding unpaid taxes, future repayment ability, and character of the proposer(s) would have surfaced during the due diligence research. The results of such efforts would have allowed the Board of Trustees to make a more insightful decision regarding this investment.

For this particular investment, the instances of GERS making unexpected expenditures are frequent and could occur up to four times per month. In fact, GERS has made hundreds of additional disbursements directly to the hotel or on behalf of the entity totaling more than $12 million. Accordingly, GERS has expended more than $27 million for this hotel establishment (a $15 million loan and $12 million in additional funding), as of June 2015.

Fast Food Chain. On September 24, 2013, GERS approved a $6 million loan to a local fast food chain with stores in the Virgin Islands, as well as in Hawaii. According to the loan agreement, the proceeds were to be used to pay transaction costs, fund the Debt Service Reserve Fund, refinance existing inter-company debt, and to finance capital expenditures for store refurbishments to include the building of at least two new restaurants and a warehouse facility. The loan agreement warned that funds should be used for no other purpose without the prior written consent of the lender (GERS). The closing documents showed that the borrower received all of the funds, a net of more than $5.7 million at closing, on September 30, 2013. As will be shown in Finding 5, several of the anticipated uses of the funds have not materialized to date.

Grocery. On June 30, 2014, GERS provided an $8.2 million loan to be used to construct a multi-level grocery. The application and qualification process took almost two years because the proposers had difficulty turning over documentation to prove favorable character, capacity, collateral, capital, and conditions. In fact, on July 17, 2012, the outside financial consultant wrote an investment memorandum recommending that GERS "do not invest" due to competition, repayment ability, and the proposers' limited experience in retail grocery operation. This

recommendation was later changed to "consider for a loan" with the identical concerns cited in the "do not invest" memorandum remaining. We did not find enough evidence in the file to prove that these issues were ever satisfactorily addressed and resolved. The Board of Trustees endorsed the project, citing that it will be the only locally owned grocery while ignoring the other structural issues with the loan.

We also noted that the financial documents submitted included aggressive estimates. Furthermore, bank account information on file to support the loan revealed that the existing business account was overdrawn by $185 in May 2013 and had a balance of only $47 in June 2013. These issues led us to question whether the entity actually qualified for this loan, possessed the ability to repay, and could survive under current market conditions.

Despite the obvious issues with this loan, the Board of Trustees moved to allow closing on June 30, 2014, where $2.3 million was disbursed, and the remaining $5.9 million was to be disbursed in accordance with a percentage of completion schedule. The construction completion date was set for November 30, 2015, but has since been delayed. Recently, an additional $2.7 million was loan to the developers of the grocery.

Recommendation

We recommend that the Board of Trustees of GERS:

4.1 Perform and fully document due diligence procedures that include thorough assessments and evaluations of potential investments.

GERS Board of Trustees' Response

In their response, the GERS Board of Trustees stated that they concurred in part and did not concur in part to the recommendation made in this section of the report. They disagreed that they entered into numerous agreements and investments without performing the necessary due diligence to ensure limited risk and a reasonable rate of return on the funds used. They indicated that they conducted due diligence evaluations on all agreements and investments prior to making decisions. It was further stated that the Alternative Investment Program policy provides for the due diligence procedure, assessment and evaluation of potential investments. However, the policy will be reviewed and amended as necessary, and documentation of the due diligence process will be kept.

V.I. Inspector General's Comments

We disagree with the GERS Board of Trustees statement that they conducted due diligence on all agreements and investments prior to making decisions. As noted in this section of the report, our inspection found several instances where the GERS Board of Trustees did not conduct sufficient due diligence on its investments including the loan provided to the owner of the hotel. Their lack of due diligence is what has caused GERS to now own the hotel and

continue to invest millions of its members' funds in the hotel to maintain the operations. In addition, we identified four instances were adequate due diligence procedures and controls, to include the advice of financial advisors and GERS management, would have prevented the GERS Board of Trustees from granting the illegal loans. Included in the lack of proper due diligence is the viatical investment discussed in the previous Finding.

Although the response indicated concurrence with part of the recommendation, we do have concerns with the comments and the response. The GERS Board of Trustees did not provide a date when the due diligence procedures review will commence or the specific persons who will be responsible for the detailed due diligence procedures and documentation. We consider this recommendation unresolved.

FINDING 5: MONITORING

GERS did not conduct sufficient monitoring and oversight activities of investments under the Alternative Investment Program to protect GERS' interest. GERS did not establish any procedures, policies, or benchmarks to ensure that funds were being utilized for the requested purpose of the investments. As a result, funds may have been used for purposes not agreed to or approved by GERS.

Oversight Structure

GERS lacked an organized system to monitor their investments under the Alternative Investment Program. They lacked a designated employee to oversee the operations and effectiveness of the Alternative Investment Program. For example, during the audit, we had to obtain the basic information such as folders, letters, and payment information regarding the investment from the Administrator. There was no central repository of information, and additional basic information had to be obtained from several different employees with no clear designation of who was responsible for what functions.

GERS did not maintain records to determine the accurate cost of each investment and the correct rate of return of each investment under the Alternative Investment Program. We found that requests made to determine the costs associated with projects under the Alternative Investment Program revealed a lack of an organized, uniform, and reliable control system to track and monitor each loan and investment. For example, GERS did not allocate fees that were charged for financial consultants, attorneys, other professional fees, surveys, appraisals, etc. to each investment. They also did not allocate the time expended by their personnel to each investment. This was significant because the employee time that was expended dealing with the project was normally for high-ranking employees such as the Administrator, Chief Financial Officer, Investment Analyst, Attorney, etc. Accordingly, there was no management process or methodology to determine the true and timely, success or failure of the investment and to determine the true rate of return. Therefore, it was difficult for GERS to quantify the actual success or failure of the Alternative Investment Program and determine whether the investment provided the desired rate of return.

Monitoring

GERS did not track the non-traditional investments to ensure that the funds were being utilized for their intended purposes. There was limited follow-up with the companies to which GERS provided funds to determine whether the funds were utilized according to their respective agreements. Further, there was no verification to ensure that the companies utilized the funding to improve operations and contribute to the economy of the Virgin Islands.

The following examples showed the lack of monitoring performed by GERS.

Airline. In their November 30, 2009 loan agreement, with the airline, the company was required to maintain a minimum Fixed Charge Coverage Ratio of 1.1:1 through December 30, 2011, and a Lease Adjusted Total Debt Ratio of 6.25:1 through December 31, 2010 and 5.5:1 to December 31, 2011. Thereafter, they were required to maintain a Fixed Charge Coverage Ratio of 1.5:1 and a Lease Adjusted Total Debt Ratio of 4.5:1.

In a July 23, 2010 memorandum, the GERS financial advisor wrote to the Administrator to inform him that the airline was in covenant default for both the first and second quarters of 2010 for the Lease Adjusted Total Debt Ratio and Fixed Charge Coverage Ratio.

On September 13, 2010, GERS issued a memorandum to the airline notifying them of the default and recommended that they seek an amendment to their loan agreement to modify their covenants to return to compliance. The airline was assessed an interest charge of $87,450 for the quarters ended March 30 and June 30, 2010. On September 22, 2010, GERS granted the airline a waiver of the entire interest amount. Again, GERS recommended that the airline negotiate an amendment to the loan agreement to modify the existing covenants.

On December 31, 2010, the airline received an amendment to maintain a minimum Fixed Charge Coverage Ratio of .5:1 through March 31, 2011, 1.0:1 through December 30, 2011, and 1.2:1 thereafter. They also received an amendment to maintain a minimum lease Adjusted Total Debt Ratio of 12:1 through December 31, 2010, 8.5:1 through March 30, 2011, 7:1 through December 30, 2011, and 6:1 thereafter. We found no record of any standards that were used by GERS to determine the ratios. This was handled by the GERS Administrator, the financial advisor, and the GERS Board of Trustees. At the completion of the amendment, GERS waived the amendment fee of $10,000, further depriving its members and the GERS of receiving additional income.

The airline continued to default on covenants during the remainder of the loan. Throughout this, there was no standard policy developed on how to handle the issues. Despite this, the airline received an additional $1.5 million loan in November 2012 to assist with capital infusion and meet obligations. The airline made one late payment in April 2013 and made no payments thereafter. During this period, we found no record of collection action besides a letter issued to the airline on May 20, 2013, stating that they were in default of the financial ratio covenants and another letter to the airline on June 18, 2013, that it failed to pay principal or interest. Also, as of October 21, 2013, the airline had an outstanding balance of $883,789 with the Port Authority for rent, operating fees, and finance charges.

The airline announced that it was moving its headquarters to Puerto Rico on December 18, 2013. At the time, GERS was considering providing the airline with an additional $3 million loan despite the delinquencies, covenant ratio defaults, and the debt with the Port Authority. There was no information found in the file to determine the methodology for determining how the airline was deemed qualified for a new loan despite the defaults and delinquencies on the loan payments.

The airline's move to Puerto Rico resulted in the repayment of the outstanding loan along with the required interest. In our opinion, the decision to move to Puerto Rico saved GERS from another poor loan decision.

Hotel. On December 24, 2013, an accounting firm issued a forensic audit report for GERS relating to a St. Croix hotel operation to which GERS provided a loan in 2012. The audit identified several high-risk transactions including, (1) payments for $1.2 million for a fire detection and sprinkler system in 2010 that was not operational; (2) twelve payments totaling $83,626 from the then hotel owner to three other entities also owned by the individual; (3) goods supplied to the hotel that were not in the line of business of the items supplied; for example, an electronics shop supplying towels. The audit also noted instances where landscaping services totaling $23,843 were procured from service providers in Florida and the invoices included travel costs from Florida to St. Croix and a custom waterfall for $8,195 that could not be located.

Further, the report noted significant scope limitations to include, (1) no supporting documents for a sample of 23 wire transfers totaling almost $7.6 million; (2) no aged accounts receivable listing from December 2009 to December 2010; (3) financial statements not certified accurate by senior management between December 2009 and March 2013; and, (4) no documentation on journal entries relating to GERS wire transfers from December 10, 2012 to August 26, 2013. These scope limitations questioned whether funds were expended on behalf of the hotel for their intended purposes and whether journal entries complied with Generally Accepted Accounting Principles (GAAP).

Despite these findings, we found no evidence that GERS took steps to address the concerns. Instead, GERS continued to fund various operations at the hotel and invested an additional $12 million, through June 2015, without ensuring that basic internal controls were developed and implemented to reduce or eliminate questionable transactions, minimize the risk to members, and maximize the rate of return on the investment.

Fast Food Chain. As previously indicated, GERS entered into a loan agreement with a fast food chain, providing a lump sum distribution of $5.7 million on September 30, 2013. In the company's presentation, the funds, in addition to refinancing company debt, were to be used to "Reimage all 8 restaurants in 2 years, build 2 new restaurants, establish a self-distribution service, with warehousing and logistics, and employ a total of 250 people in the Islands." We did not find any evidence in the file that GERS took measures to ensure inter-company debt was satisfied. Furthermore, since the funds were disbursed in a lump sum at closing, there was no surety that the funds were used to refurbish the facilities in the Virgin Islands or build the additional restaurants and warehouse facility.

We visited the 8 restaurants (4 on St. Thomas and 4 on St. Croix), and saw evidence of some renovations in five of the eight establishments, although we could not tell when they were done. We requested from GERS officials evidence to show the nature and cost of the various renovations done, and how the $5.7 million was used; however, none was provided.

Normally for loans involving refurbishing or construction work, the funds are made available based on a percentage of completion involving actual site visits to ensure the funds were used as per the agreement. There was no evidence that any of this was done for this loan.

Grocery. Regarding the loan to construct a grocery on St. Thomas, **t**he June 30, 2014, Terms of Reference relating to the $8.2 million loan indicated that after the $2.3 million initial draw down given on the closing date, the remaining $5.9 million would be drawn based on work completed and upon the inspection by " a GERS appointed architect and engineer". The construction was to be completed by November 2015 at which time repayment of the loan was to begin. However, due to some delays in the project, officials from the business have requested a time extension to March of 2016, to complete the project and three months after to begin the loan repayments. A November 12, 2015, Inspection Report for GERS, states that the March 2016 completion date is unlikely. A more realistic completion time is the summer of 2016. Adding the extra three months requested after the completion of the construction, GERS can not expect any payments on the loan until late 2016 or early 2017, about two and a half years after the initial $2.3 million drawdown.

We were informed that as of November 13, 2015, there is still an outstanding balance of $3 million to be drawn down on the loan. Business officials have also requested a net after cost of $2.7 million in additional funding due to site changes and start up costs. The proposal for the additional funding includes the following:

• Change Orders	$403,000
• Various Electrical Items including Generator	344,200
• Parking Lot	530,000
• Trash Compactor	75,000
• Elevator/Electrical/Generator Room	69,000
• Third Floor Bathroom	50,000
• Internal Audit Security System	25,000
• Solar Power Installation	250,000
• Start-up Costs	
o Security System/Office Equipment	195,941
o Working Capital Cash	400,000
o Business Insurance	35,000
o Start-up Personnel Costs	335,000
Total	$2,712,141

As can be seen by the November 2015 photo of the construction, the structure is far from being completed.

St. Thomas Grocery - November 6, 2015 (OVIIG Photo)

Recommendation

We recommend that the Board of Trustees of GERS:

5.1 Conduct sufficient monitoring of GERS' investments under the Alternative Investment Program to minimize risk to members and maximize returns.

GERS Board of Trustees' Response

In their response, the GERS Board of Trustees stated that they concurred in part and did not concur in part. They disagreed with the conclusion that they did not conduct efficient monitoring and oversight activities of investments under the AIP to protect GERS' interest. The GERS Board of Trustees further added that all investments have been monitored, with the exception of the fast food chain. Further, they added that they will review and revise their policies and procedures as necessary. Also, a designated person will be assigned to conduct adequate monitoring of the investments under the Alternative Investment Program.

V.I. Inspector General's Comments

We found the GERS Board of Trustees response to this finding divergent. In their response, the GERS Board of Trustees admitted that they did not monitor the investment in the fast food chain, yet disagreed with our findings that they did not conduct efficient monitoring. We affirm our position, as the GERS Board of Trustees has never prepared a corrective action

plan to resolve the issues from the forensic audit of the hotel, waived amendment fees to the airline after they violated covenants, and continued to provide additional funding to the grocery store after the initial loan for items that should have been considered in the initial proposal, and for start-up items that should be the responsibility of the business owners. It appears that the GERS is absorbing the entire risk in this venture, while the owners seem to have very little to lose.

Regarding the recommendation, the GERS Board of Trustees did not provide a date when the monitoring activities will commence. We consider this recommendation as unresolved.

Government Finance Officers Association

GFOA Advisory

Using Alternative Investments for Public Employee Retirement Systems and OPEB Establish Trusts

GFOA Advisories identify specific policies and procedures necessary to minimize a governments exposure to potential loss in connection with its financial management activities. It is not to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Background. Alternative investments are assets or investment strategies that are not included or practiced in the traditional investment classes of equities, fixed income and cash. They typically include hedge funds, private equity, venture capital, real estate, and real assets, although this investment category is fluid, and new products are constantly being developed. Alternative investments use techniques and instruments that are unavailable in traditional investment approaches. Investments may be made in either listed or unlisted companies, securities, or assets. These alternative investments generally have a low correlation with traditional asset classes, and may provide improved diversification and return enhancement. Alternative investments seek to capitalize on market inefficiencies and/or provide a hedge for other investments or interest rate positions. During volatile markets, some alternatives may provide additional diversification. Notwithstanding these potential benefits, public pension and other post employment benefits (OPEB) portfolios that use alternative investments should also consider the inherent risks associated with these types of investments. Further, systems should confirm whether alternative investments are permissible under applicable state law.

Objectives

Investors may utilize this asset class for several reasons:

- To diversify a portfolio using innovative strategies;
- To produce higher returns than may be available from other investments;
- To reduce portfolio volatility and risk through low or negative correlation of returns with traditional
- asset classes or by correlating returns with inflation.

Types

Although the investments discussed below are all classified as alternative investments, the characteristics of each are unique.

Hedge Funds
Less stringently regulated, privately managed pools of capital that typically employ sophisticated investment strategies, including the use of short-selling, long-short strategies (e.g., 130/30, 120/20)[1], leverage, derivatives, and other means of seeking alpha[2] and

hedging risk.

Private Equity
Funds that take an equity stake in a private company to push management to develop new products and technologies, expand working capital, make acquisitions or strengthen a company s balance sheet. Generally, these funds then sell their stake sometime in the future after investment goals have been achieved.

Venture Capital
Provides financing for new businesses with perceived long-term growth potential. This form of capital raising is popular among new companies, or ventures, with limited operating history, which cannot raise funds through a debt issue.

Real Estate
Investments directly in real estate properties.[3]

Real Assets
Investments in real assets, such as commodities, timber, oil, gas, infrastructure, art, metal and energy.

Risks

While alternative investments may serve many beneficial purposes, they also carry several inherent risks. As some alternatives are relatively new, historical return data may be limited. In addition, valid benchmarks for comparison of performance may be scarce. Illiquidity, the lack of ready trading markets, is considered to be the most common risk, and may eliminate the ability of investors to end an investment early regardless of its success, as well as determine a marketable value. Lock-up periods, required by many venture capital firms and hedge fund managers, obligate clients to commit their capital investment for a minimum period of time, typically no less than one or two years. Lack of transparency and regulation, combined with the use of leverage and other speculative techniques, provide an additional layer of risk to most alternative investments. Some alternative investments may carry substantial, additional risk, which may result in the loss of some or all of the investment.

The market compensates investors for these risks with a higher expected return. PERS and governments using alternative investments should carefully evaluate the associated risks in achieving the desired returns. Analysis of net return is critical as manager fees are typically much higher (1-2% of assets) plus a share of profits (typically 20%); and if investing in fund of funds,[4] there are typically additional, multiple layers of fees. It merits noting that fee structures continue to change with new investment products and changing market conditions.

Alternative Investing Due Diligence

The complexity or uniqueness of these investments makes them more difficult to understand and be accepted by trustees, staff, plan sponsors and the general public. Alternative investments may require additional staff expertise, increased due

diligence[5] and careful attention to controls. Manager selection is arguably the most critical factor in successful alternative investing. Key factors to consider include the manager's experience, risk controls, track record and strategies.

In selecting alternative investments, a number of judgments must be made, including:

- Whether available alternative investments are consistent with the return objectives, risk tolerance, time horizon and liquidity needs, and will enhance the current portfolio in achieving these policies and objectives;
- Whether investment managers can be identified who have the capacity to find and make desirable investments;
- Whether acceptable terms can be agreed on that align the interests of the system and investment managers to ensure a high probability that good investment decisions will be consistently made.

Recommendation. GFOA recommends that state and local governments exercise extreme prudence and appropriate due diligence be exercised in the use of alternative investments in public pension and OPEB portfolios. Alternative investments should be limited to achieving a measurable objective such as increasing risk-adjusted net return or reducing portfolio volatility and, if included in the portfolio, should be included as part of an overall investment strategy based on all of the following considerations:

- The existence of sound investment policies and objectives that address the unique return and risk characteristics of alternatives, and prudent limits on these investments.
- Clear articulation of the economic rationale and overall importance of the specific investment in the marketplace as well as in the portfolio.
- Identification of appropriate benchmarks for comparison of investment performance in terms of returns and risk, and through industry cyclical downturns or bear markets.
- Consideration of resources in terms of staffing, culture and managerial discipline, and the ability to measure and monitor performance, risks and costs.
- A commitment to expanded due diligence by trustees, fiduciaries and staff.
- Careful due diligence in the selection of a firm or manager whose experience and ability enables them to provide the desired risk-adjusted net returns while reducing overall portfolio volatility. This investment fiduciary should be committed to a high level of transparency, which allows for the evaluation of the investment, manager or fund.
- A clear understanding of the legal terms of the investment and the recourse, rights and obligations of the investors.
- An analysis of liquidity needs to determine whether an investment's cash flows are adequate.
- The ability to evaluate the effect of such investments on the overall portfolio, particularly with regard to liquidity and volatility

References.

Alternative Investing, Association for Investment Management and Research, 1998.

Investing Public Funds, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.

The Potential of Private Equity Asset Allocations, *Pension & Benefits Update*, GFOA, November/December 1999.

A Guide for Selecting Pension Investment Consultants: Writing RFPs and Evaluating Proposals, Rick Dahl, GFOA, 1999.

Alternative Investments Audit Considerations, A Practice Aid for Auditors, *The American Institute of Certified Public Accountants*, 2006.

Hedge Fund Basics for Public Pension Sparks Interest Among Members, *Pension & Benefits Update*, GFOA, July/August 2007.

Notes.

1 While some consider these long-short strategies equity investments, others consider them alternatives.

2 The term alpha may be defined as earnings above market returns.

3 Real estate investment trusts (REITs), which invest in real estate directly either through properties or mortgages, are securities that are traded like stocks on the major exchanges and therefore are not considered alternatives.

4 A fund of funds allows an investor to invest in a series of hedge funds and thus diversify by investing in multiple managers. A fund of funds also permits an investor to rely on the expertise of the fund of funds manager for additional due diligence and hedge fund selection.

5 Due to the increased risk of misstatement inherent with these investments resulting from incorrect valuation, part of the increased due diligence could be to obtain a reasonable understanding of the procedures that may be applied to them during the independent audit of the financial statements. Accordingly, those considering obtaining positions in such investments should review *Alternative Investments Audit Considerations, A Practice Aid for Auditors* issued by the Alternative Investments Task Force of the American Institute of Certified Public Accountants.

Approved by the GFOA's Executive Board, October, 2008.

GERS BOARD OF TRUSTEES' RESPONSE

EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

February 18, 2016

Mr. Steven Van Beverhoudt
V.I. Inspector General
Office of the V.I. Inspector General
2315 Kronprindsens Gade No. 75
St. Thomas, U.S. Virgin Islands 00802-6468

Re: V.I. Inspector General's Report
No. INR-01-GERS-15

Dear Inspector General Van Beverhoudt:

Reference is made to your letter dated January 7, 2016. The Board of Trustees of the Government Employees Retirement System ("GERS") has reviewed the above-referenced report and offer the following comments. Our responses will follow the same numbering sequence as provided in the report.

Conclusions

(i) While viatical and real estate investments are considered by the industry as alternative investments, they are not considered alternative investments by the Virgin Islands Code. GERS administers its investment portfolio based on the authority of the V.I. Code, not necessarily industry standards. The provisions of the V.I. Code will supersede the provisions of industry standards.

(ii) GERS disagrees with the conclusion that "GERS' current 'non-traditional investment' limits are higher than the industry standards."

First, the report uses "non-traditional investment" interchangeably with "alternative investment." The V.I. Code does not use the term "non-traditional investment." But based on the substance of the report itself, it states that the industry standard for alternative investment is between 15% and 23%. (See pages 8 and 10). The V.I. Code places a 10% limit on GERS. At all times, GERS' investment in alternative investments, as defined by V.I. Code, has complied with the 10% limit.

Second, GERS disagrees with the method used to determine whether GERS has exceeded the 10% limit. The report continues to include Havensight,

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EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

Estate Hoffman & Nullyberg and Estate Coakley Bay as "alternative investments." Based on V.I. law that is incorrect. Further, the report used the asset balance as of June 30, 2015 to determine the amount of asset available in order to calculate the 10% limit. Whether the 10% limit has been reached must be calculated at the time the investment is being made, not years after the investment has been made when the asset levels are lower.

(vii) The GERS disagrees that "it entered into an extremely risky and questionable viatical investment." GERS entered into a viatical investment as authorized by law. GERS was aware of the risk as it is for all investments. GERS performed the requisite due diligence. The Trustees deliberated on the investment after hearing the concerns of its advisors. Ultimately, a majority of the Trustees were convinced the investment was worth the risk based on all the information before the board. All GERS investment decisions are made pursuant to Board Resolutions which provide the basis or rationale for investments.

(viii) The GERS does not agree with part of the statement on page 6 of the report in regards to the viatical investment which states that "…in addition to being illegal, an additional $10 million line of credit to the same viatical is also in jeopardy of being lost." Is the Inspector General saying that the GERS Board of Trustees made an illegal decision to grant the $10 million line of credit? If so, we disagree. 3 V.I.C. § 717 grants GERS the legal authority to enter into this transaction.

(ix) GERS disagrees that "it entered into numerous agreements and investments without performing the necessary due diligence evaluation to ensure limited risk and a reasonable rate of return on the funds used." GERS conducted due diligence on all agreements and investments prior to making decisions. Each proposal was reviewed by a competent financial consultant/advisor and all closing documents were prepared and or reviewed by competent legal counsel.

(x) GERS disagrees with the conclusion that "it did not conduct efficient monitoring and oversight activities of investments under the Alternative Investment Program to protect GERS' interest." GERS performed monitoring and oversight of the investments made under the Alternative Investment Program ("AIP"). With the exception of Kazi Food, LLC, all investments have been properly monitored. GERS has specific knowledge that the funds that were disbursed have been utilized for the requested purpose of the investment. GERS

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GERS BOARD OF TRUSTEES' RESPONSE

EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

has not been provided with any evidence that "funds may have been used for purposes not agreed to or authorized by GERS." At no time during any of the investments was GERS' interest compromised.

(xi) GERS does not agree that it "did not establish any procedures, policies or benchmarks to ensure that funds were being utilized for the requested purpose of the investment." Since May 20, 2010, GERS has established an Alternative Investment Program policy which provides procedures, polices, objectives and benchmarks for the program.

For example, a forensic audit was conducted by a CPA Firm of transactions of Carambola Northwest LLC (Carambola Beach Resort and Spa) after the GERS took ownership in November, 2012, because of suspicious disbursements to related parties of Carambola Management LLC (management company). After the audit was completed and policies and procedures were put in place, an outsourced chief financial officer was engaged to review all disbursements prior to payment. Also, the Carambola Northwest LLC Board mandated that at least three quotes be obtained for procurements over a certain threshold. These measures were put in place to halt the practice of the management company processing of related party transactions. A new management company was installed effective December 1, 2015.

Further, the GERS Administrator had been in contact with the owner and director of finance of Kazi Foods prior to the Inspector General's report regarding the use of the funds. The loan agreement states that "The proceeds of the Loan shall be used by the Borrower solely **to pay transaction costs, fund the Debt Service Reserve Fund, refinance existing inter-company debt, and to finance capital expenditures for store refurbishments,** and for no other purpose without the written consent of the Lender. The Borrower was advised of the loan requirements in writing by the Lender on August 14, 2015. The Administrator met with the owner of Kazi Foods and the director of finance on September 29, 2015 on this matter. At no time during any of those investments was GERS' interest compromised.

Notwithstanding, our numerous disagreements with the conclusions enumerated on page 5 of the report and based on your request that we respond to each "recommendation" and not necessarily the findings or conclusions, we hereby comply with your request to respond to the recommendations as follows:

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GERS BOARD OF TRUSTEES' RESPONSE

EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

Finding 1: Alternative Investment Program

1.1 Concur.

Action required: The Board has reviewed this issue on many occasions with the Investment Officer, Board Counsel, and the Investment Advisor, and will concur with your conclusion that all investments other than the traditional stocks and bonds should be defined as alternative investments in the V.I. Code. The Board will recommend the appropriate amendment(s) to the Legislature.

Responsible individual(s): Board/Counsels/Investment Officer

1.2 Concur.

Action required: The Board will recommend an amendment to the Legislature to change the limit in investing in high-risk alternative investments not to exceed the industry standards with the proviso that all existing investments be grandfathered.

Responsible individual(s): Board/Counsels/Investment Officer

1.3 Concur.

Action required: The Board recommended amendments to the Legislature in Bill No. 31-251, which was passed on October 19, 2015, and signed into law by former Governor John P. deJongh Jr. Additional inconsistencies will be identified and appropriate amendments will be submitted to the Legislature.

Responsible individual(s): Board/Counsels/Investment Officer

Finding 2: Lending Authority

2.1 Non-Concur.

Action required: The Board suspended the Alternative Investment Program on September 18, 2015.

Responsible individual(s): Board

Finding 3: Viatical

3.1 Non-Concur.

Based on the industry trends, investments in alternative investments are surpassing 15%. Thus, the V.I. Code limit of 10% is less than the industry standards.

Action required: The Board will recommend appropriate amendments to the Legislature to change the definition to include viatical investments as an alternative investment consistent with trends on the limits of alternative investments.

Responsible individual(s): Board/Counsels/Investment Officer

3.2 Concur in part and Non-Concur in part.

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GERS BOARD OF TRUSTEES' RESPONSE

EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

Action required: Written policies and procedures are already in place to ensure that adequate due diligence is conducted. All monitoring procedures will be adhered to in accordance with the Alternative Investment Management Program Policy adopted by the GERS Board of Trustees on May 20, 2010. The Board will review the policy for further revisions as necessary.

Responsible individual(s): Board/Administrator/Investment Officer

3.3 Concur in part and Non-Concur in part.

Action required: The Alternative Investment Management Program Policy adopted by the GERS Board of Trustees on May 20, 2010, and any subsequent procedural and policy changes made thereto, will be adhered to and documentation of all due diligence will be maintained in a central repository (hard and soft copies).

Responsible individual(s): Administrator/Investment Officer

Finding 4: Due Diligence

4.1 Concur in part and Non-Concur in part.

Action required: The AIP policy already provides for the due diligence procedure, assessment and evaluation of potential investments. The Board will review and amend the policy as necessary. Adequate documentation will be completed of the due diligence process from the time the proposal is received through the evaluation by the financial consultant(s), recommendation to the Board, and the required monitoring during the life of the investment.

Responsible individual(s): Administrator/Investment Officer

Finding 5: Monitoring

5.1 Concur in part and Non-Concur in part.

Action required: The AIP policy provides the procedure for monitoring investments. GERS will review and revise its policies and procedures as necessary. In addition, a designated employee or an alternative investment manager (consultant) will be assigned to conduct adequate monitoring of the investments under the Alternative Investment Management Program.

Responsible individual(s): Board/Administrator/Investment Officer

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GERS BOARD OF TRUSTEES' RESPONSE

EMPLOYEES' RETIREMENT SYSTEM
OF THE GOVERNMENT OF THE VIRGIN ISLANDS

We are available to further discuss the report and our responses should you so desire.

Sincerely,

Wilbur K. Callender
Chairman

cc: GERS Trustees
Austin L. Nibbs, CPA, CGMA, Administrator
Pedro K. Williams, Esq., Board Counsel
Cathy M. Smith, Esq., General Counsel
Grasilda H. Dobbins, CPA, CGMA, Chief Financial Officer
Bruce Thomas, CFA, CAIA, Investment Officer
Charmaine Antoine, CPA, CGMA, Internal Auditor

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ADDITIONAL INFORMATION NEEDED TO CLOSE RECOMMENDATIONS

Recommendation Number and Status	Additional Information Needed
Finding 1:	
1.1 Resolved/Not Implemented	Provide a copy of the proposed legislation.
1.2 Resolved/Not Implemented	Provide a copy of the proposed legislation.
1.3 Resolved/Not Implemented	Provide a copy of the proposed legislation.
Finding 2:	
2.1 Unresolved	Provide legal evidence that loans are authorized by the Code, or evidence that the practice of giving non-member loans has been stopped.
Finding 3:	
3.1 Unresolved	Provide a copy of the proposed legislation.
3.2 Unresolved	Provide evidence that policies and procedures have been reviewed and revised.
3.3 Unresolved	Provide evidence that policies and procedures have been reviewed and revised.
Finding 4:	
4.1 Unresolved	Provide evidence that policies and procedures have been reviewed and revised.
Finding 5:	
5.1 Unresolved	Provide evidence that policies and procedures have been reviewed and revised.

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