OVERVIEW

Financial Audit of the Employees' Retirement System of the State of Hawaii

Report No. 00-10, April 2000

Summary

The Office of the Auditor and the certified public accounting firm of KPMG LLP conducted a financial audit of the Employees' Retirement System of the State of Hawaii for the fiscal year July 1, 1998 to June 30, 1999. The retirement system's membership consists of 27,950 pensioners and beneficiaries and 61,164 employees. The system's assets amounted to more than $11 billion. In FY1998-99, it paid out more than $480 million. The audit examined the financial records and transactions of the retirement system; reviewed the related systems of accounting and internal controls; and tested transactions, systems, and procedures for compliance with laws and regulations.

We found several deficiencies in the financial accounting and internal control practices of the retirement system. These deficiencies included the retirement system's failure to plan for contracting delays to execute bank custodian and security lending services contracts. The result was a loss of approximately $1 million in income to the retirement system.

We also found that the retirement system did not properly monitor and enforce remedies against the bank custodian. Certain provisions that safeguard these investments were not being performed by the bank custodian, and remedies for this noncompliance had not been enforced. Failure to enforce this remedy cost the retirement system $12,500 in reduced fees.

The retirement system also failed to properly plan its "Data Purification Project" to verify membership data, which resulted in untimely execution of contracts and extensions, and an unforeseen sole source contract. The system has not reduced the time it spends in verifying pension benefits even after spending approximately $740,000 on this project.

We also found that the retirement system failed to ensure that retirees received their final pension payments in a timely manner. We found that retirees have been underpaid as much as $15,000.

Finally, we found that the retirement system owes the State approximately $17 million in excess contribution overpayment, and that Act 100, SLH 1999, increased the system's unfunded accrued liability. The legislation will likely increase the future contributions from the State and counties.

Recommendations and Response

We recommend that the retirement system allow sufficient time to negotiate and execute contracts before existing contracts terminate. We also recommend that the board require management to closely monitor the bank custodian's performance and report to the board its findings on the bank's performance. In addition, we recommend that excess employer contributions be remitted to the state general fund in a timely manner.

We recommend that the retirement system work closely with the consultant to complete the data purification project's purpose of expediting the pension benefits processing. The retirement system needs to work closely with the state and county departments to obtain timely information to reduce the delays in processing the final pension payments. The retirement system should continue to monitor its unfunded liability and work with the Legislature to ensure the continued improvement of its financial condition.

The Department of Budget and Finance basically concurs with our findings and responded that it will work with the appropriate state agencies to monitor the collection of pension assessments.

The retirement system agreed with some of our findings and disagreed with others. The retirement system provided explanations for its actions and stated that "many of the criticisms cited in the report were in areas in which we had little control."

The retirement system believes that it has adequately acted on the bank custodian's nonperformance. The retirement system indicates that waiver of the discount penalty was made by staff and that staff also negotiated additional reporting and account structure requirements that were not included in the contract but which benefit the system. However, this response then raises the further concern that staff are making key decisions outside the contract, and whether the new terms were reviewed and approved by the administrator, board, and attorney general.

In addition, management feels that the system's investments were safeguarded since investment managers reconcile the bank custodian reports to the investment managers' reports. However, the issue of nonperformance is with the bank custodian and not the investment manager. The bank custodian is contractually obligated but did not perform all reconciliations required. Even when these reconciliations were performed, errors were noted by staff.

The retirement system also disagreed with our finding that the data purification project has not improved the pension benefit process. It indicated that benefits have been derived through the production of estimate letters to members who are considering retirement. In addition, those retiring under the early incentive retirement law in 1994 and 1995 were effectively processed by the use of data from the project.

However, we found that the system has not improved the pension benefit processing. Staff continue to manually verify the years of service, age, retirement date, accumulated sick leave, and others, irrespective of whether it is generated by the project.

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