Management and Performance Audit of the Employees' Retirement System

A Report to the Governor and the Legislature of the State of Hawaii

Report No. 02-19
December 2002

THE AUDITOR
STATE OF HAWAII

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. *Financial audits* attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.

2. *Management audits*, which are also referred to as *performance audits*, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called *program audits*, when they focus on whether programs are attaining the objectives and results expected of them, and *operations audits*, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.

3. *Sunset evaluations* evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.

4. *Sunrise analyses* are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.

5. *Health insurance analyses* examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.

6. *Analyses of proposed special funds* and existing *trust and revolving funds* determine if proposals to establish these funds are existing funds meet legislative criteria.

7. *Procurement compliance audits* and other *procurement-related monitoring* assist the Legislature in overseeing government procurement practices.

8. *Fiscal accountability reports* analyze expenditures by the state Department of Education in various areas.

9. *Special studies* respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawaii's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.

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OVERVIEW

Management and Performance Audit of the Employees' Retirement System

Report No. 02-19, December 2002

Summary

During the 2002 legislative session, House Concurrent Resolution No. 130 requested that the State Auditor conduct a management and performance audit of the Employees' Retirement System (ERS). The Legislature was particularly concerned about the ERS' delay in terminating an under-performing investment manager that employs the former administrator of the ERS. To assist in this review, the State Auditor engaged the investment firm of New England Pension Consultants, Inc.

In our examination, we found that the ERS continues to fail in its efforts to provide quality retirement service to its members. The ERS has allowed both processing time and the number of retirees awaiting finalization of benefits to increase significantly. For example, we found that the current average finalization time has now increased to about 18 months. This is three times longer than the average finalization time reported in FY1997-98. In one example, we found that the ERS allowed a retiree's final benefit to languish for 14 years before informing the retiree that he needed to purchase additional service credits for $1,500 and to return $6,200 in ERS overpayments. While this case may be an aberration, having retirees wait an average of 18 months to finalize their retirement benefits is too long and unacceptable by any reasonable standard. Such delays become more acute when you consider that no interest is paid on any underpayment of a retirees' estimated pension. In our test sample, we found one retiree who was underpaid a total of $10,000 over two years. In addition, the number of retirees awaiting final pension calculation increased from 1,100 as of June 30, 1999 to 2,523 as of August 30, 2002—an increase of over 129 percent.

We also found that the ERS' main computer system, a 16-year-old Wang computer, is inefficient and ineffective, hindering the retirement system's ability to fulfill its mission. We found that the ERS management failed to properly manage and control the development and implementation of the Automated Retirement Information Exchange System (ARIES) project, resulting in reciprocal lawsuits between the ERS and its computer contractor. In addition, the computer monitor hired by the ERS to monitor the performance of the computer vendor was unable to manage the progress of the new computer system, resulting in more than $3.5 million in wasted resources. Until this legal conflict is resolved, the ERS' antiquated computer system will continue to be a detriment to its ability to improve operations.

We also found that the Board of Trustees failed to properly manage the beneficiaries' assets. We found that the ERS' investment consultant's objectivity could be suspect, since the consultant disclosed financial relationships with the majority of investment managers it has recommended to the board. These financial relationships can include providing consulting services to money managers on strategy and

marketing/sales implementation, software and database information on money managers' performance, and research findings. It is not uncommon for a consultant to charge a money manager in excess of $200,000 for such advice and services—the same people that pension systems pay the consultant to evaluate.

Finally, we found that the board's investment performance to be poor. Our analysis showed that the ERS' total return on investments over the past five years ranked below the bottom 15 percent nationally when compared with other retirement systems. In addition, the handling of an under-performing investment manager was questionable and may have cost the ERS as much as $128 million. Such questionable performance should compel the board to clearly define its role and that of the investment staff, and to balance its investment advisor's recommendations by considering a competitive selection process for investment managers.

Recommendations and Response

We recommended that the ERS reexamine its management procedures to ensure that it can efficiently and effectively oversee the administration's operations to provide quality services to its beneficiaries. We also recommended that the ERS properly plan and replace its obsolete computer system to better meet the needs of the system. Finally, we recommended that the board review its responsibilities and investment strategy to fulfill its fiduciary duties and improve its management of the ERS' investments.

The ERS did not dispute our recommendations, but noted that the recommendations did not provide sufficient detail and substance to make any improvements. The ERS disagreed with most of our findings but agreed with some of the issues in the report. Specifically, the ERS agreed with some of the issues related to its failure to provide its members with retirement benefits and information in a timely manner. The ERS also acknowledged that the current computer system is obsolete. However, the ERS expressed concerns over our publication of the material on the implementation of the ARIES computer system. However, we have proceeded to publish inasmuch as the material is public information and the ERS would have to contend with the lawsuits regardless of this audit report.

The Board of Trustees responded that it agreed that the long-term relative performance has been under its own benchmarks and accepts responsibility for this performance. However, the board responded that our report does not recognize the positive investment decisions made in the management of the retirement systems' assets.

Finally, the board responded that our report demonstrated some serious faults in its assessments and recommendations on the investment decisions of the retirement system's assets.

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A Report to the Governor and the Legislature of the State of Hawaii

Conducted by

The Auditor
State of Hawaii
and
New England Pension Consultants, Inc.

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 02-19
December 2002

Foreword

This audit of the Employees' Retirement System was conducted pursuant to House Concurrent Resolution No. 130, Regular Session of 2002. Our audit focused on the management and performance of the Employees' Retirement System in meeting the needs of its beneficiaries.

We wish to express our appreciation for the cooperation and assistance extended to us by the Board of Trustees and the staff of the Employees' Retirement System. We also wish to acknowledge the assistance of New England Pension Consultants, Inc. with certain aspects of the audit.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

Section 88-22, Hawaii Revised Statutes (HRS) establishes the State of Hawaii Employees' Retirement System (ERS) for the purpose of providing retirement allowances and other benefits for state and county public employees. This section grants the ERS the powers and privileges of a private corporation: to sue or be sued, transact its business, invest its funds, and hold all of its cash, securities, and other property.

During the 2002 legislative session, House Concurrent Resolution (HCR) No. 130 requested that the State Auditor conduct a management and performance audit of the ERS. The Legislature was anxious about whether or not ERS' assets are managed and invested competently and whether they are sufficient to meet the needs of current and future beneficiaries. The Legislature was particularly concerned about the Board of Trustees' delay in terminating 3Bridge, an under-performing investment manager which employs ERS' former administrator.

Thus, the resolution asked that the audit include a review of investment decisions made by the ERS' board. To assist with this review, the State Auditor hired the investment consultant firm of New England Pension Consultants, Inc. through a competitive procurement process. HCR No. 130 also requested we perform a follow-up management review of our previous audit, *Financial Audit of the Employees' Retirement System of the State of Hawaii*, Report No. 00-10, dated April 2000.

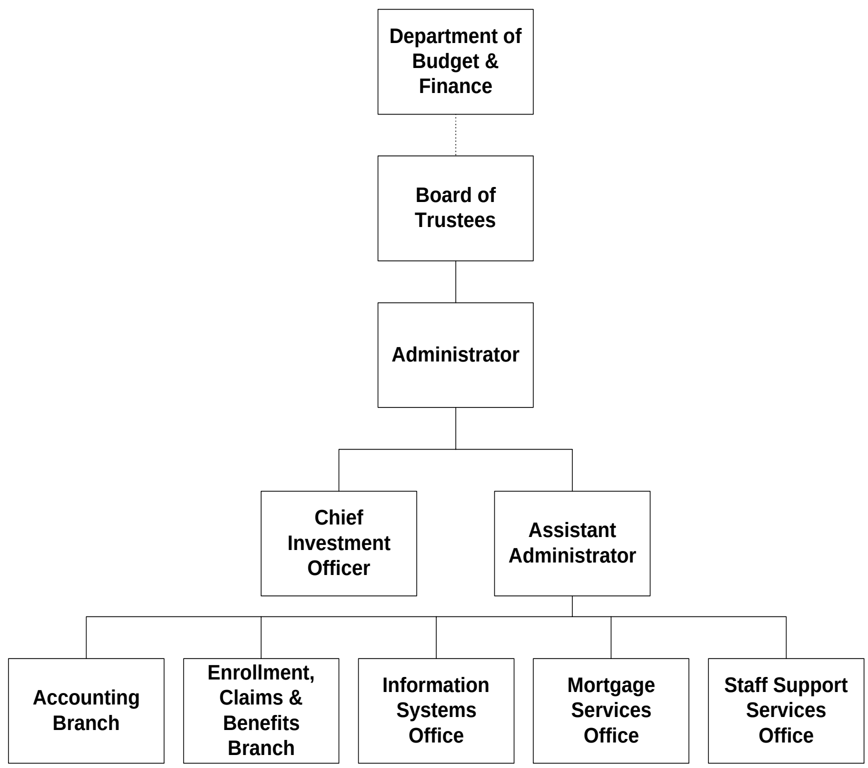
Background of the Employees' Retirement System

Hawaii's Territorial Legislature established the ERS by statute in 1925. Since January 1, 1926, the system has provided retirement, disability, and survivor benefits to state employees, teachers, professors, county employees, police officers, firefighters, judiciary employees, judges, and elected officials. As of March 31, 2001, the ERS' total membership of 93,068 was comprised of 59,992 active members, 3,416 inactive vested members, and 29,660 retirees and beneficiaries. Active members are currently employed as public employees, while inactive vested members are public employees who have met the requirements for retirement but are not currently employed as public employees. Participating employers include the State of Hawaii and the counties of Honolulu, Hawaii, Maui, and Kauai.

Mission and organizational structure

Section 88-23, HRS places governing responsibility for the ERS with its Board of Trustees. To assist it in administering the system's daily operations, the board appoints an administrator. It also appoints a chief investment officer to assist in monitoring the system's investment portfolio. Certain limited administrative responsibilities, such as coordinating the system's annual budgetary submission to the Legislature, are assigned to the state Department of Budget and Finance. The retirement system's organizational chart is shown in Exhibit 1.1.

Exhibit 1.1
Employees' Retirement System Organizational Structure



---- Attached for administrative purposes.
Source: Employees' Retirement System

Board of Trustees

The Board of Trustees provides policies and executive direction to the ERS. The board consists of eight members:

- The state director of finance, ex officio;
- Four members of the system (elected by the members and retirees, and consisting of two general employees, one teacher, and one retiree); and

- Three citizens of the State (not government employees, but appointed by the governor. One must be an officer of a bank authorized to do business within the State).

The trustees, excluding the director of finance, serve six-year terms. Trustees serve without compensation but are reimbursed for all necessary expenses and for any loss of salary or wages while serving on the board.

The board has fiduciary responsibilities, meaning that all actions must be taken for the sole benefit of plan participants. As fiduciaries, the board is responsible for preparing written investment policies, diversifying assets, using "prudent experts" to make investment decisions, controlling investment expenses, monitoring activities of all investment managers and investment consultants, and avoiding conflicts of interest.

ERS administrative staff

Under direction of the administrator, the Retirement Administration Office plans, coordinates, and directs ERS staff in supporting the Board of Trustees' policies and executive direction. The office consists of the administrator, an assistant administrator, chief investment officer (CIO), and two administrative staff. The Administration Office is supported by two branches and three offices, which have a total of 61 full-time employees.

The CIO, who reports to the administrator, oversees in-house investments and the commercial mortgage and member home loan programs. In addition, the CIO oversees performance of the investment management firms and rebalances the ERS investment portfolio to support its long-term asset allocation plan. The asset allocation plan is approved by the board and is used to determine the optimal allocation of funds among different asset classes.

The assistant administrator plans, organizes, coordinates, and directs daily activities of the organization. In addition, the assistant administrator reviews recommendations for improvements in policies, practices, and procedures, as well as serving as the project manager for development and implementation of a new computer system.

The Accounting Branch is responsible for budgeting, accounting, and safeguarding all assets in the system's investment portfolio; and for ensuring compliance with applicable state statutes, Title 6 of the Hawaii Administrative Rules, federal laws, and generally accepted accounting principles. The branch consists of 12 full-time employees.

The Enrollment, Claims and Benefits Branch, which includes neighbor island branch offices, consists of 39 employees (28 full-time and 11 temporary employees). The branch plans and coordinates the retirement program for state and county employees and retirees; conducts statewide pre-retirement counseling sessions; reviews medical board and hearing officers' decisions on disability cases; and participates in the development of program plans, rules and regulations, and policies and procedures.

The Information Systems Office is responsible for planning, developing, and maintaining an integrated, fully automated computer system with on-line inquiry and update capabilities. The purpose of the computerized system is to integrate the major sub-systems of the ERS and coordinate computer-programming activities with other state and county payroll and personnel systems, the Health Fund, bank custodians, unions, and other organizations. The office consists of seven full-time employees.

The Mortgage Services Office plans and coordinates investment activities of the Member Home Loan Program; develops program rules and regulations, policies, and procedures; coordinates procurement activities, including preparing requests for proposals for investment consulting, bank custody, actuarial, computer, medical, and other services provided to the system; and prepares contracts and contract amendments to reflect proper terms and conditions. The office consists of one full-time employee.

The Staff Support Services Office plans and coordinates records management activities for the system; maintains and operates data processing and telecommunications equipment; and participates in the development of program plans, rules and regulations, and policies and procedures. The office consists of eight full-time employees.

External investment experts support the board

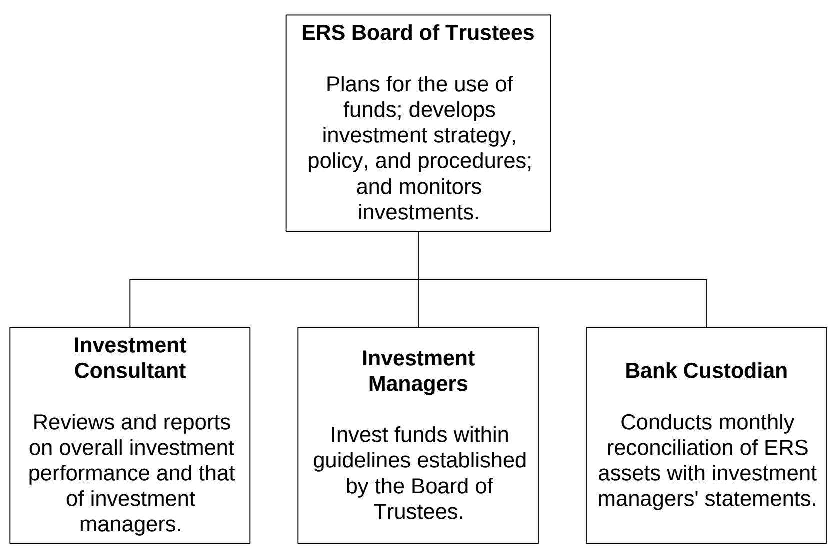
Because board members are not required to have investment experience, the ERS relies on external investment experts to help maximize earnings while preserving capital. These experts are the investment consultant, investment managers, and bank custodian.

The role of *the investment consultant* is to provide objective, independent third-party investment recommendations to the board. The investment consultant does not have decision-making authority, but functions in research, evaluation, and education on investments. The investment consultant also measures and evaluates overall performance of the ERS' assets. In addition, the investment consultant assists in the selection, monitoring, and evaluation of the ERS' investment managers.

The ERS also selects a number of *investment managers,* who are authorized to purchase and sell assets in accordance with strategy established by the board. The role of investment managers is to improve the ERS' assets through investment income from various asset classes such as U.S. stocks, U.S. bonds, foreign stocks, and real estate. The ERS' fundamental investment principles call for diversified investment manager styles–-that is, investment managers who are strong in their designated asset classes—and evaluation based on investment managers' impact on ERS' total portfolio. As of June 30, 2002, the ERS had contracts with 32 investment managers. Appendix A provides a list of investment managers contracted by the ERS as well as the contract effective date, asset class, and market value.

The *bank custodian* is responsible for safekeeping and custody of all security purchased or sold by the investment managers. Security transactions are reported to the ERS through a monthly reconciliation process of ERS' assets for each investment manager. Exhibit 1.2 shows the relationships between the board and its external investment professionals.

Exhibit 1.2
Relationship of External Investment Entities to the ERS Board



Source: Employees' Retirement System

Retirement benefit plan provisions

The ERS provides its members with retirement benefits through a contributory or noncontributory retirement plan. As of March 31, 2001, there were 11,108 active employees (19 percent) in the contributory plan and 48,884 active employees (81 percent) in the noncontributory plan.

ERS' contributory plan

Active members in ERS' contributory plan are primarily those employees hired prior to June 30, 1984 who have elected to remain in the retirement plan. Those in the contributory plan are required to contribute about 7.8 percent of their salaries to the ERS and *may* also be covered by Social Security. These active public employees are eligible for normal retirement benefits at age 55 following at least five years of public service *or* any age after at least 25 years of credited service. In addition, these employees receive a pension of two percent times the number of years of credited service. For example, an employee with ten years of credited service would receive a pension of 20 percent of his/her highest average annual salary (average final compensation) during any three years of credited service.

Employees in the following occupational groups, regardless of employment date, are required to be members of the contributory plan:

- Police officers,
- Firefighters,
- Judges,
- Elected officials,
- Legislative officers,
- State and county department heads and deputies,
- Attorney general investigators,
- Narcotics enforcement investigators, and
- Public safety investigators.

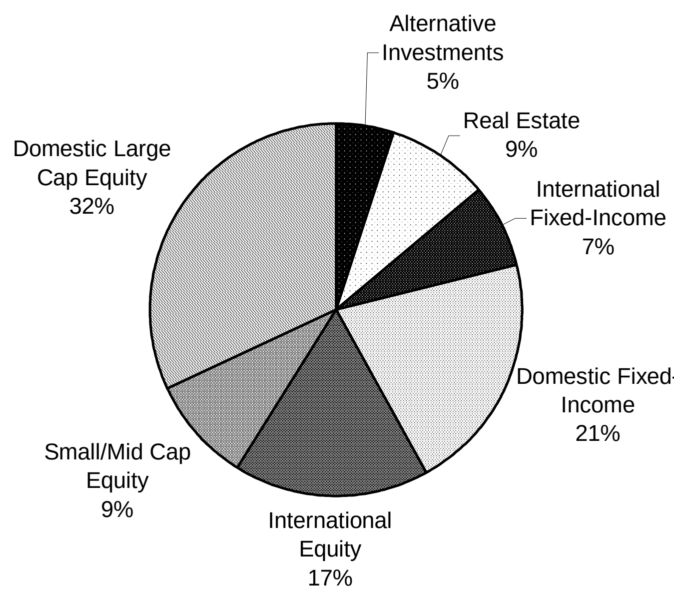
ERS' noncontributory plan

Members of the noncontributory plan do not make employee contributions to the ERS and *must* be covered by Social Security. The noncontributory plan covers most employees hired from July 1, 1984, as well as employees hired before that date who were eligible for the contributory plan but elected to join the noncontributory plan. These employees are eligible for normal retirement benefits at age 62 following 10 years of credited service *or* at age 55 after 30 years of credited service. These employees receive 1.25 percent of their average final compensation multiplied by the number of years of creditable service. Since FY1983-84, most new employees, except for the positions listed previously, are required to become members of the noncontributory plan.

Retirement system financial activities

The primary purpose of the ERS is to provide retirement, disability, and survivor benefits to qualified members and their beneficiaries. To achieve these goals with the appropriate level of risk, the board implements an asset allocation strategy that diversifies its investment portfolio among a range of different asset classes. Such asset classes include domestic equity, international equity, domestic fixed-income, international fixed-income, alternative investments, and real estate, among others. Exhibit 1.3 displays the board's long-range asset allocation strategy as of August 2002.

Exhibit 1.3
ERS' Long-Range Asset Allocation Target as of August 2002



Source: Employees' Retirement System

As stated previously, the ERS board relies extensively on external investment professionals' advice and assistance to help maximize the value of its portfolio. The overall performance of the ERS, using some of its performance benchmarks for the past four fiscal years, is displayed in Exhibit 1.4.

Revenues have significantly decreased

ERS revenues decreased significantly in FY2000-01 compared to the previous fiscal year. Such revenues consist of funds from member contributions, employer contributions, and investment earnings.

Exhibit 1.4
ERS Total Fund Performance, FY1997-98 to FY2000-01

	FY1997-98	FY1998-99	FY1999-2000	FY2000-01
Total assets *	$ 9.0 billion	$ 9.7 billion	$ 10 billion	$ 8.9 billion
Increase(decrease) from previous year *	$ 1.2 billion	$ .7 billion	$ .2 billion	$ (1 billion)
Annual return on investment	16.00%	10.28%	7.55%	-6.68%
Annual benchmark	17.40%	12.38%	8.85%	-8.81%
Difference	-1.40%	- 2.10%	- 1.30%	2.13%
Five-year performance	13.50%	14.66%	13.51%	8.80%
Five-year benchmark	13.90%	15.81%	14.32%	9.22%

* Difference due to rounding.
Source: Employees' Retirement System

Member contributions are received from public employees participating in the contributory retirement plan. Employer contributions to the ERS are determined by estimated actuarial valuation reports. The amount of an employer's contribution will vary depending on the amount of the system's investment income. An increase in investment income generally results in a reduction in employer contributions, while a decrease in investment income increases employers' contributions to the system.

During FY2000-01, member contributions decreased by about $2.9 million, or about five percent, from the previous fiscal year. The decrease resulted from a reduction in the number of members in the contributory retirement plan. As mentioned previously, most new employees hired after 1984 are not eligible to join the contributory plan, but must join the noncontributory plan.

Employers' contributions also decreased during the same period by about $14.2 million, or 63.7 percent. The decrease was due primarily to legislative actions requiring the retention of all investment earnings above ten percent in order to reduce employers' contributions to the ERS.

A major financial concern of the board is its unfunded accrued liability to current and future beneficiaries, which has increased over the past year. This liability has become more significant since ERS reported a 6.7 percent loss in its assets in FY2000-01 due to the poor financial market conditions. As a result, ERS' liability has grown from $543 million as of June 30, 2000 to $991 million at June 30, 2001. This significant increase in the fund's accrued liability generally means that greater employer contributions from the State and counties may be required in future years.

Expenditures have increased from the previous year

ERS program expenses result from recurring pension benefit payments, contribution refunds to new retirees and former members, and the costs to administer ERS' operations. During FY2000-01, refunds of members' contributions decreased by about $2 million due to a decline in the number of contributory members. However, benefit payments to retirees increased by about 6.8 percent to nearly $503 million. In addition, the costs to operate the ERS also increased significantly. Administrative expenses increased by over $700,000 (17.4 percent). The increase was primarily due to development and implementation costs for a new computer system, filling of vacant personnel positions, and actuarial services.

Our previous audit found flaws in management practices

In our *Financial Audit of the Employees' Retirement System of the State of Hawaii*, Report No. 00-10, we noted several serious reportable conditions involving system operations. We noted that the ERS failed to plan for delays in contracting for bank custodian and security lending services, which placed ERS assets at risk for five months and contributed to lost income of approximately $1 million. We also noted that management did not properly monitor or enforce remedies against the bank custodian for noncompliance with contract provisions. This laxity weakened critical controls and the safeguarding of more than $9 billion in investments held for members' benefits. We further indicated that the ERS failed to properly plan and implement its information system, resulting in untimely contract execution and additional costs.

In addition, our previous audit mentioned the insufficient planning and implementation of the ERS' "Data Purification Project." This project was designed to clean up past data maintained on manual ledger cards and to transfer the data to a computer system for improved accuracy and better timing of the pension benefits program. Finally, we noted that ERS management did not ensure timely and accurate pension payments to approximately 1,100 retirees. Many of these retirees received estimated pension payments that were significantly less than the final pension payment. In one case, a retiree was underpaid by as much as $15,000.

ERS management responded by agreeing with some of our findings and disagreeing with others. It provided explanations for its actions and stated that "many of the criticisms cited in the report were in areas in which the system had little control."

Objectives of the Audit

1. Assess the efficiency and effectiveness of the management of the Employees' Retirement System in meeting the needs of its beneficiaries.

2. Assess whether the Board of Trustees has fulfilled its fiduciary duties to safeguard the resources of the Employees' Retirement System.

3. Make recommendations as appropriate.

Scope and Methodology

This audit reviewed the ERS' management practices as well as investment decisions of the Board of Trustees. For the management of the ERS, the audit focused on FY1999-2000 to the present and previous fiscal years as necessary. We reviewed investment decisions of the Board of Trustees with assistance from the investment consultant firm of New England Pension Consultants, Inc. For this review, the consultant evaluated, as necessary, investment performance of the ERS for the past five years.

We evaluated the retirement system's compliance with applicable statutes, rules, and policies that define its responsibility to members and retirees of the system. Specific tests were performed to assess compliance with sound investment practices and management techniques. We also assessed management controls relevant to the objectives of the audit.

The ERS management review focused on findings from our previous audit report, *Financial Audit of the Employees' Retirement System of the State of Hawaii*, Report No. 00-10. We conducted interviews, reviewed documents, and performed tests on the retirement system's records. We also selected and reviewed relevant documents on the management of the retirement system to determine whether it met prescribed law and/or policy, whether the system was efficiently and effectively managed, and whether there was documentary evidence of ongoing performance monitoring.

Our review of the Board of Trustees required the services of a technical consultant. We procured the services of the investment firm of New England Pension Consultants, Inc. The consultant reviewed the board's organizational structure, strategic plan, investment policies and procedures, asset allocation plan, investment strategies, investment managers' performance, financial and investment reports, investment decisions, and other relevant documents. The consultant also reviewed the adequacy of the board's investment decisions, including investment expenses; criteria for selecting, hiring and retaining investment managers; and the rate of return of ERS' investment portfolio. Finally, the consultant compared ERS' investment decisions with retirement systems in other states and made recommendations to our office as appropriate.

Our work was conducted from June 2002 to October 2002 in accordance with generally accepted government auditing standards.

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Chapter 2

The Poorly Managed Employees' Retirement System Squanders Resources, Provides Inadequate Service to Its Members, and Endangers Members' Assets

The Legislature created the Hawaii Employees' Retirement System (ERS) to provide state and county public employees with retirement, disability, and survivor benefits. Since its inception in 1925, the retirement system has grown to over 90,000 members, and has experienced rapid growth in membership, benefit payments, assets, and pension payments for more than 30,000 retirees. With over $8 billion in assets, the system is mandated to manage and invest these assets effectively to serve current and future beneficiaries.

Using our previous work, *Financial Audit of the Employees' Retirement System of the State of Hawaii* (Report No. 00-10), as a springboard, we found that ERS operations not only have not improved, but in most cases have declined in efficiency and effectiveness.

We note specifically that ERS management has continued to fail in its efforts to provide members with retirement benefits and information in a timely and efficient manner. These deficiencies stem, in part, from ERS' outdated and obsolete computer system. Furthermore, the implementation of a new computer system has been stalled indefinitely due to a legal controversy, leaving the ERS with no option but to continue using its inefficient and antiquated computer system. Finally, the ERS Board of Trustees has failed in its most fundamental fiduciary role—to ensure the ERS administration improves on its service to members and on its oversight of the performance of its pension plan funds.

Summary of Findings

1. The Employees' Retirement System has failed to provide its members with retirement benefits and information in a timely and efficient manner. These deficiencies have resulted in ERS' failure to provide quality service to its beneficiaries.

2. The Employees' Retirement System's efforts to replace its antiquated computer system are plagued with poor planning, wasted resources, and questionable procurement and contract management practices. These deficiencies have ultimately resulted in a legal

dispute, leaving the ERS to work indefinitely with an inefficient and archaic computer system.

3. The Employees' Retirement System Board of Trustees needs to improve its management and investment strategy over its assets to ensure that sufficient funds are available for current and future beneficiaries.

The Employees' Retirement System Has Failed To Provide Its Members with Retirement Benefits and Information in a Timely and Efficient Manner

As noted in our previous audit, *Financial Audit of the Employees' Retirement System of the State of Hawaii*, Report No. 00-10, we found that the Employees' Retirement System continues to fail in its efforts to provide quality retirement service to its members. The ERS has allowed both processing time and the number of retirees awaiting finalization of benefits to increase significantly. In addition, active members have also suffered from such neglect, leading to unnecessary delays and the receipt of inaccurate service credit statements. Furthermore, the ERS has not used its resources efficiently to meet its workload demands. Instead it has chosen to rely on costly overtime as a "quick fix" solution to its workload problems, thereby risking and compromising the level and quality of counseling services available to its members.

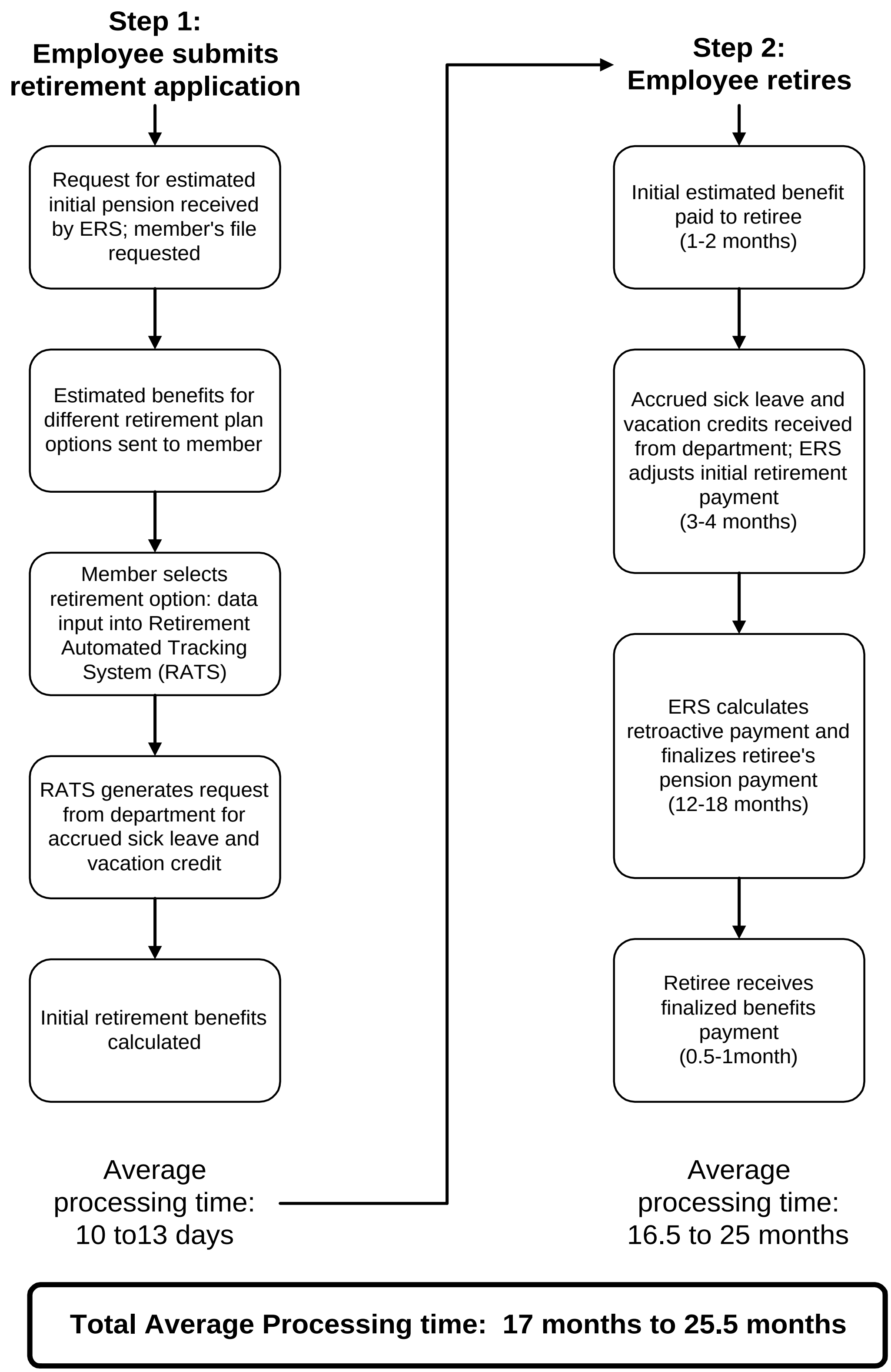
In our previous audit, ERS management responded that operating delays were caused by factors beyond its control. However, in our follow-up audit, we found that, in fact, with adequate monitoring and management, many of those delays were foreseeable and could have been addressed prior to the 2002 legislative session. Therefore, ERS should continue to be held accountable for its lack of improvement to the system and its failure to fulfill its mission of providing beneficiaries with quality service.

Process to finalize retiree benefits takes too long and is problematic to retirees

Since our last audit, we found that the process to finalize retiree benefits continues to be problematic. The process takes too long—both in the length of time elapsed before benefits are received, and in the number of procedures in place, which are ostensibly meant to reduce backlogs in approving retirees' final pension benefits.

ERS management is responsible for providing qualified retirees with timely and accurate pension payments. Initially, calculations are performed and payments are remitted to retirees based on an estimated pension calculation. Generally, after the estimated pension payment is calculated, retroactive adjustments are made to the estimated pension amount as necessary. Retroactive payments might occur as the result of bargaining unit agreements, post-retirement bonuses, or lawsuits. The process for finalizing a retiree's benefits is displayed in Exhibit 2.1.

Exhibit 2.1
Process to Finalize Retirement Benefits



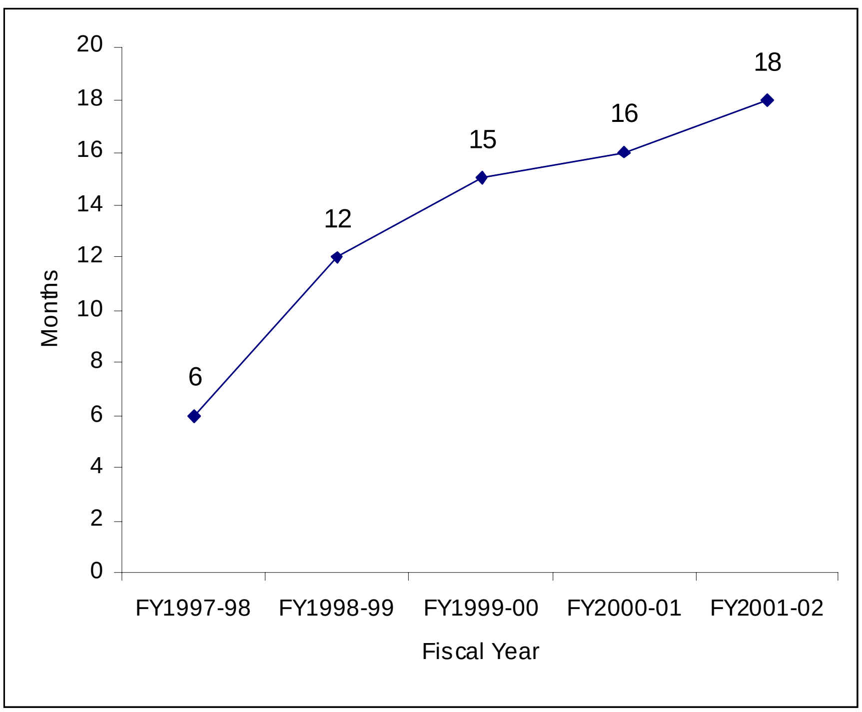
Source: Employees' Retirement System

Length of time to finalize retirement benefits has increased

Over the past several years, ERS' effort to process final retirement benefits for its members has deteriorated. The finalization process, which is designed to ensure that retirees receive all benefits that they are due, takes about 17 to 26 months to complete. In most organizations, including the federal government and large private corporations, retiree benefits are finalized within one to two months. However, we found that the ERS has had difficulties meeting its own benchmark of finalizing benefits within six to nine months.

The ERS reported to the Legislature that the average time to finalize benefits in FY1997-98 was only six months. By FY1998-99, finalization averaged 12 months. This was also supported by findings in our previous audit. Based on interviews with ERS officials, variance reports to the Legislature, and our review of 50 files, we found that the current average finalization time has now increased to 18 months. This is three times longer than in FY1997-98. Exhibit 2.2 displays the increasing average time to process a retiree's final benefits.

Exhibit 2.2
Average Time to Finalize Retiree Benefits



Source: Variance Reports to the Legislature, FY1997-98 to FY2001-02

ERS officials also reported that a number of factors have contributed to the increased time in processing payments: early retirement incentives that were utilized primarily in 1994, litigation leading to recalculation of thousands of teachers' benefits in FY1999-2000, and collective bargaining unit agreements that required calculation of retroactive payments on a monthly basis, some going as far back as three years. Regardless of alleged causes, the poor quality of service extended by the ERS to its beneficiaries is inexcusable.

The number of retirees awaiting benefits finalization continues to increase

In our 2000 audit, we reported that as of June 30, 1999, there were 1,100 retirees awaiting finalization of pensions. Since then, the number of retirees awaiting finalization has more than doubled. As of August 30, 2002, there were 2,523 retirees awaiting finalization—an increase of over 1,423 retirees, or 129 percent. Exhibit 2.3 shows the number of retirees awaiting final pension determination.

Exhibit 2.3
Number of Retirees Awaiting Final Pension Calculation

Retirement Date	Number of Retirees
FY1987-88	1
FY1994-95	2
FY1995-96	1
FY1996-97	4
FY1997-98	2
FY1998-99	28
FY1999-00	347
FY2000-01	771
FY2001-02	1,288
FY2002-03	79
TOTAL	**2,523**

Source: ERS records as of August 30, 2002

Exhibit 2.3 also illustrates that from FY2000-01 to August 30, 2002, 2,138 retirees, or about 85 percent of those awaiting benefits finalization, have been waiting for one to two years for their final benefit calculations. However, ten retirees had been waiting for more than four years—from FY1997-98 and earlier, and one retiree had been waiting nearly 14 years for a final pension calculation.

Management's failure to finalize pension benefits in a timely manner results in unwarranted burden to retirees

Significant delays in finalizing retirement benefits can place an unnecessary burden on retirees. For example, ERS notified one retiree in December 1988, one year after his retirement, that he needed to purchase service credits in order to be eligible for retirement with 25 years of creditable service. In the absence of any response from the retiree, the file languished until January 2002, almost 14 years later. At that time another letter was sent to the retiree indicating that he needed to pay a minimum of $1,500 to purchase service credits plus return $6,200 in ERS overpayments. What started out as a one-year service credit oversight snowballed into more than a decade of overpayments. Thus, a 69-year-old retiree now has to deal with a considerable financial burden as a result of ERS' negligence.

The consequences of these delays become more acute when the impact on retirees' incomes is considered. Our review of a random sample of 35 files, finalized between FY1999-2000 to FY2001-02, showed that the difference over time between estimated initial payments and final payments was significant. Underpayments ranged from $280 to almost $7,000 per retiree; one retiree was underpaid by more than $10,000. In that case, the retiree was underpaid by an average of $358 a month for over two years, primarily because the retiree's accrued sick leave credits (of about three years) were not promptly adjusted into the retiree's initial benefit calculation.

Even more distressing is the fact that the ERS retained the money that should have been paid to retirees and used it to generate investment earnings—without compensating retirees in interest for use of the money. An ERS official claimed that Hawaii Revised Statutes (HRS) prohibit interest from being paid on underpayments to retirees. However, we found that Section 88-107, HRS merely states that interest would be credited to active members' accounts, and investment earnings should be credited to the fund from which retirees are paid. The law does not specifically allow or prohibit the payment of interest to retirees. Thus, while underpayments generate earnings for the ERS, retirees never earn interest on underpayments, regardless of how long they wait for final benefit calculations.

Partially finalized benefits create more work for ERS and place unnecessary responsibility on retirees

ERS attempted to stem the tide of benefit calculation backlogs by establishing a new process of classifying documents as either "closed" or "partially finalized" if a retired employee's department failed to respond with needed information to ERS after 30 days. We found this procedure creates more work, provides inaccurate reporting of delayed final benefits, and transfers the ERS' responsibility to retirees. For example, after 30 days, retirees (not the ERS) must take the initiative to obtain the needed information from the departments or agencies they previously worked for.

If departments provide requested information after the 30-day period, then a retiree's file is re-opened and benefits are re-calculated. This creates more work for ERS staff, who are essentially repeating the finalization process.

Furthermore, while the partial finalization (closing) process enables the ERS to deflate the actual number of backlogged cases, in reality the process not only creates unnecessary work for ERS staff and retirees, but creates an artificial and misleading number of open cases to the public and Legislature. In addition, the procedure fails to address the ERS' basic responsibilities to provide timely and accurate benefit payments to retirees. A comparison of the former finalization procedure to the new, artificial "closing" system established by the ERS is displayed in exhibit 2.4 below.

Exhibit 2.4
Old Versus New Benefits Calculations Process

Old Finalization Process	New "Closing" Process
1. ERS requests additional information from retirees' department.	1. ERS requests additional information from retirees' department.
2. ERS receives response.	2. If no response received within 30 days, then: • File is determined to be partially finalized and closed. • Retiree must initiate information request from department.
3. ERS prepares final retirement benefits.	3. If response received after 30 days, then file reopened by ERS. • ERS prepares final retirement benefits.

Source: Employees' Retirement System

The Employees' Retirement System is responsible for most delays

In our previous audit, the ERS indicated that the increase in average finalization time was due to departments' delays in processing vacation and sick leave credits. The implication was that the audit unfairly accused the ERS of delays in the final payments processing for its retirees. However, our current analysis found that most departments approve the transfer of vacation and sick leave credits and responded to ERS staff's requests for additional information within one month.

The only significant departure from this timeline in our sample came from the Department of Education, whose internal auditing procedures require reconciling school records with state records. We found that this procedure adds an average of approximately 211 working days, or about seven months, to the finalization process. With the exception of the Department of Education, our sample indicated that ERS was responsible for most of the finalization delays, not the departments, as was previously reported by ERS.

The Employees' Retirement System's Data Purification Project was poorly planned and fails to provide timely and accurate information to active members

The ERS management has the responsibility of providing its members with annual statements showing their accumulated contributions, if applicable, and creditable service years upon request. To fulfill this obligation, the ERS in 1992 initiated the Data Purification Project to transfer pension information from ledger cards and personnel forms into an electronic database. The project was also intended to clean up past data and allow the ERS to improve on the accuracy and timeliness of its pension benefits program. The ultimate goal of the project was to provide all active members with annual statements of some basic retirement information, including years of creditable service.

However, after ten years, the goal of the Data Purification Project has yet to be achieved. The ERS is still unable to provide all active members with accurate annual statements that reflect their years of creditable service. This has resulted in a system plagued with inaccurate data, which significantly impacts the accuracy and timeliness of the final pension calculation and payments to retirees. After struggling with the planning and implementation of this project, the ERS was forced to expand its original two-year project into three phases: a Data Purification Project, Total Purification Project, and Online Service Credit and Calculation (OSCAR) Project. Exhibit 2.5 displays the major phases, project objective, and affected retirement dates of each project.

Exhibit 2.5
Phases of ERS' Data Purification Project

Project Phase	Objective	Affected Retirement Dates
Data Purification Project (DPP)	Transfer information from paper files to computer database	1958-1989
Total Purification Project (TPP)	Update Wang personnel records to which DPP records were to be appended	1989-1996
Online Service Credit Calculation and Reconciliation (OSCAR)	Generate worksheets based on payroll and personnel data; provide basis for annual member statements	1996-current

Source: Employees' Retirement System

Inadequate planning has delayed the project's completion

Our previous audit found that ERS' management had failed to properly plan the Data Purification Project. Little has improved since our last audit: we again found that the Data Purification Project continues to be poorly managed and, after ten years of effort, is still not completed. The goal of generating accurate annual member statements of credible service years continues to be a struggle for the ERS.

After completing the Data Purification phase of the project, the ERS found that annual member statements could not be generated as planned. During this phase, ERS failed to accurately update members' creditable service data from 1989, resulting in an additional five-year delay for the project. An ERS official reported that the original plan was to append results of the Data Purification Project–-spanning member and retiree records from 1958 to 1989–-to the current Wang computer system. However, upon completion of the Data Purification phase of the project, ERS realized that personnel records in the Wang computer system from 1989 had not been updated as planned.

Thus, instead of merely adding the Data Purification Project's data to the Wang computer system, a second phase, known as the Total Purification Project, was added as a means to update members' personnel records from 1989 to 1997. If the administration had planned properly, the

Wang computer system would have been regularly updated and ready to assimilate the Data Purification Project's data. Instead, the process to update the Wang computer system personnel records added five more years to the project (1994 to 1999).

In 1999, the Data Purification Project began its third phase, when the project was renamed the OSCAR (for Online Service Credit Calculation and Reconciliation) computer system. OSCAR was *not* intended to replace the Wang computer system, but was designed to computerize the calculation of service credits and pension benefits for members and also serve as the basis for the 1999 Annual Member Statements mailed in January 2000. However, over 5,500 members reported inaccuracies on their 1999 statements, once again delaying completion of the project. While the entire project (three phases) has already taken more than four times as long as was originally planned, the ERS is still unable to provide all active members with annual statements that accurately reflect their years of creditable service.

Service credit errors in member statements continue

Despite ERS' significant investment in time and money in the Data Purification Project, it still failed to correct the current members' service credit data. In addition, the retirement system's failure to verify membership information will further delay the 2002 Annual Member Statements. Uncorrected errors in service credit data could have a "snowball" effect on future retirees if this problem is not addressed and the data not updated on a regular basis.

For example, in January 2000, the ERS mailed out the 1999 Annual Member Statements to about 63,000 members. Over 5,500 inquiries from members resulted, consisting of changes to names, Social Security numbers, service credits and other requests. In addition, the administration found that 649 active members did not have addresses in the system's records.

To validate the accuracy of member statements, we tested a sample of members' records and found that the Annual Member Statements had significant service credit errors. In August 2002, we reviewed ten files that had been corrected by ERS and eight files that were pending correction. Within both groups, service credit errors ranged from an excess credit of ten years to an omission of almost nine years of service credit.

Despite awareness of such errors, ERS still has no assurance that corrections made to members' statements are accurate. In November 2001, the ERS mailed out the 2000 Annual Member Statements to 64,064 active members. An ERS official reported that because the 2001 statements were to be mailed out in six months and would presumably incorporate more corrections, ERS told members not to report any errors regarding their 2000 statement. Thus, members were not given the opportunity to inform ERS of possible errors in their statements, leaving doubts about the accuracy of these records. Therefore, after ten years, the goal of the Data Purification Project – to help ERS provide accurate and timely information to its members—has still not been achieved.

Management has failed to optimize its resources to meet workload demands

Effective organizations address human resource challenges through strategic workforce planning efforts as follows, by:

- Identifying their current and future staffing needs,
- Including the appropriate number of employees,
- Assigning staff across the organization, and
- Creating strategies for filling vacant positions.

In contrast, ERS' management ignored its own workload data and chose to use temporary staff, and incur significant costs in overtime, to address its workload demands. These temporary measures had a questionable impact on productivity and created additional administrative work for the ERS staff. In addition, with the shifting of workload, member counseling has fallen behind in priority to reducing the backlog of finalizing retirement benefits. Currently, only one retirement claims examiner is available on each island to answer member questions and take appointments. This has compromised the quality of information and customer service provided to members, retirees and their beneficiaries.

Excessive use of overtime increased Employees' Retirement System costs

In the business sector, overtime premiums usually mean increased operating costs without comparable increases in production output. Similarly, we found that for the past five years, ERS used an excessive amount of overtime to meet its organizational workload with no appreciable gains in addressing its backlog. Between FY1998-99 and FY2001-02, overtime increased six-fold, from $34,239 to $246,374, while regular salaries increased by only four percent. During FY2001-02, the ERS staff worked 9,579 overtime hours. ERS staff reported working from eight to 80 hours of overtime per pay period. Thus, while the workload increased, management failed to recognize the need to obtain an appropriate number of employees and decided to waste funds on expensive overtime premiums. As mentioned previously, this was also during the same period that finalization time for pension benefits started to increase.

To alleviate the increased workload, ERS elected to use temporary employees from other agencies. For example, six auditors from the Department of Accounting and General Services (DAGS) were trained and hired on an overtime basis in 2001 to help ERS finalize retirement benefits. These employees processed a total of 500 claims within three months. However, 250 claims (50 percent) were processed incorrectly and had to be recalculated by ERS personnel. In addition to DAGS auditors, two firefighters were also paid overtime to prepare files for claims examiners two to three days a week. The use of these temporary employees resulted in increased expenses for the ERS as well as increased work for its own staff. The benefits derived from the highly inefficient use of temporary employees are questionable.

Staffing for counseling services is inadequate

Retirement education programs play an important role in helping employees make well-informed retirement planning decisions. One-to-one counseling represents the most effective means of communicating information on retirement benefits to members, with the advantage of providing direct and immediate responses to members' questions. However, ERS' ability to provide effective one-to-one counseling is severely hampered by the lack of priority given to this function by management and the absence of a fully functioning computer system that would allow instantaneous access to accurate files and records of ERS members.

Federal agencies, such as the Air Force, Internal Revenue Service, and Department of Housing and Urban Development, facilitate employee access to benefit counselors who have immediate access to the employee's personnel records and retirement service credit information. In contrast, ERS' active members, at best, must wait one to two days for counselors to obtain hard copy records from the ERS file room before they can begin a counseling session. Members who walk into the ERS office without an appointment are most likely to be met by an administrative clerk, who can provide only basic retirement information but not answer specific questions. An ERS official acknowledged that clerks also have limited expertise and training to address individual questions by members.

To expedite the filing of retirement applications, ERS holds seasonal "filing sessions," or group counseling. These sessions are held during heavy retirement seasons, which are the end of the year for most state employees and in the summer for school employees. Retirement sessions typically begin with a 20-minute introduction consisting of general information. Attendees then break up in groups to meet individually with a retirement counselor and complete the necessary paperwork, which can take 15 minutes to one hour per person.

While group sessions allow the ERS to address a large number of members in one day, ERS officials recognize that active members might feel uncomfortable asking questions about their personal situation with others present. An ERS official also acknowledged that this format does not allow members to be candid or focused on the information being presented in the counseling session. Furthermore, members who need follow-up information or assistance will likely not meet with the same retirement counselor, thus requiring a new counselor to ask similar questions to understand the member's basic background information. While group filing sessions afford some degree of efficiency for the ERS, many members fail to receive the quality of information and service possible through one-on-one counseling sessions.

Management's Efforts to Replace Its Antiquated Computer System Are Plagued By Poor Planning, Wasted Resources, and Questionable Procurement and Contract Management Practices

A well-planned and properly designed computer system can seamlessly and efficiently integrate an organization's functions and activities with its mission and goals. In contrast, an information system consisting of fragmented computer programs can create process redundancies and other inefficiencies that can quickly cancel out any appreciable gains in productivity. Without a fully integrated management information system, ERS beneficiaries will continue to experience long delays in final pension payments and active members will continue to experience a high error rate in the calculation of members' service credit information.

We found that the ERS has been slow in its attempts to replace its archaic, obsolete, and ineffective computer system. While development of a new computer system was started several years ago, the project has been plagued by poor planning and questionable monitoring issues. After several years of development, the project is currently on hold as result of legal action between the ERS and the computer contractor. This will leave the ERS to operate with its antiquated computer system indefinitely.

Management failed to address the problems of its obsolete computer system in a timely manner

The ERS' main computer system is inefficient and ineffective, hindering the retirement system's ability to fulfill its mission. Productivity gains from computer systems occur when automation takes the place of time-consuming manual tasks such as calculations, tracking information, and consolidating of data into useful reports. However, ERS' obsolete computer system has failed to meet the needs of the organization and its members, and will continue to be a detriment to its operations until the current legal conflict over the development of a new system is resolved.

Antiquated computer system impedes operational efficiency

The administration's main computer system is an obsolete Wang minicomputer data processing system, originally acquired in 1986. The workstations that support the administrative staff function as "dumb terminals," meaning that they provide only static data. For example, in order to calculate the highest three years' salary needed for pension benefits, members' salary data from the Wang system must be transferred to a separate system (OSCAR), which performs the calculations.

We found that the Wang computer system is inefficient and impedes the operational effectiveness of the ERS. For example, we observed ERS personnel taking as long as 40 seconds to access a single application. ERS personnel also reported that the computer system was not always available to process retirement transactions because the system processes transactions through a "batch processing" method. In batch processing, input data are gathered and processed only periodically, in discrete groups. The biggest disadvantage of batch processing is that users are locked out of the system during processing. For example, ERS personnel reported that the computer system could be accessed only between 9:00 a.m. and 3:00 p.m. In contrast, online systems allow users to have direct access to the data stored in the system and to process data in real time.

In addition to limited system access during batch processing, sources for repair parts are nearly extinct, making maintenance of the Wang equipment a serious problem. For example, a major heat problem rendered the Wang system inoperable for about one week because all 12 fans used to cool the computer were out of order. Although the on-island contract maintenance vendor had refurbished parts available for the minimum of two fans needed to keep the computer system running, after the fans were installed, they were found to be completely defective. Following a nationwide search, refurbished fans were found in Texas; however, due to a tornado warning, all flights there were grounded and the fans could not be delivered. As a last resort, the on-island contract maintenance vendor rebuilt two fans out of various parts from the 12 broken fans. In the meantime, to prevent overheating, ERS operated the computer system only when the equipment was cool and shut it down when it started to overheat. The intermittent availability of the system left ERS staff hamstrung and unable to complete their tasks for about one week.

These delays undermine ERS' ability and efficiency to complete tasks in a timely manner. While computer systems should be a tool to help improve employee efficiency, ERS' current system is a major hindrance.

The computer system contains inaccurate data and is missing key information

We also found that inaccurate and missing data limit the usefulness of ERS' computer system. Since different computer applications are not fully integrated, ERS staff must re-enter members' basic information into multiple computer applications. Multiple entry of common information into computer applications is inefficient and provides more opportunities for human errors.

Although ERS retains information on active members when they enroll, basic member information is not linked to the Retirement Application Tracking System (RATS). The RATS system monitors and tracks the processing of retirement applications from initial application submission date to payment of a retiree's final pension benefit. We observed ERS personnel re-entering basic member information such as name, address, and Social Security number, into the RATS system even though such information is already available in the membership information system. Manual reentry of information from one database to another creates additional work for staff and makes the overall process inefficient and prone to error.

Finally, the computer system does not contain vital information such as retroactive pay, accrued vacation leave, and sick leave for active members. Instead, ERS must request this information from departments or counties only after an employee has submitted a retirement application. In addition, either ERS or the department that employed the retiree must manually recalculate retroactive pay based on union bargaining agreements, bonuses, lawsuits, and other "retirement benefit enhancements." These deficits in vital information contribute significantly to delays in processing initial and final pension benefits.

Implementation of new $14 million computer system has stalled, while resources continue to be wasted

Integrated computer systems allow for the seamless completion of tasks from one step to another. The decision to replace the aging Wang system with a new, fully integrated information management system was made in 1998. The overall goal of the project, known as the Automated Retirement Information Exchange System (ARIES), was to improve ERS productivity, responsiveness, flexibility, functionality, and effectiveness while minimizing operating expenses and the need for additional staff.

However, we found that ERS management has failed to properly manage and control the development and implementation of the ARIES project, resulting in reciprocal lawsuits between the ERS and its computer contractor. This lack of proper oversight has resulted in wasted resources and will further delay ERS' efforts to replace its obsolete 16-year-old Wang computer system. The ERS' goal of improving organizational efficiency and effectiveness will not be achieved as scheduled, and the ERS is faced with a potential loss of over $14 million. Exhibit 2.6 displays a timeline of the development and implementation of the ARIES project.

Exhibit 2.6
Major Events in the Development of the ARIES Project

Date	Event
Dec 14, 1998	• Computer monitor hired for $1.2 million to provide contract and technical support and oversight services for ARIES' development and implementation.
Jun 22, 1999	• Request for Proposal (RFP) released. • Completion date scheduled for October 12, 2002.
Oct 26, 1999	• Contract awarded to computer contractor for $10.8 million.
Mar 31, 2000	• Contractor's project workplan approved by ERS.
Jun 5, 2000	• Contract amended to reflect computer contractor name change. • Contract also amended to include a liquidated damage clause of $250 per day, up to a total of $200,000.
Aug 17, 2000	• Contract changed to reflect computer contractor's name change. • Projected completion changed from October 31, 2003 to October 15, 2002 to conform to the request for proposal provision. • Compensation and payment schedule increased by $1.9 million for additional options. Total cost of the contract is now $12.7 million.
Aug 2000	• Contractor's workplan revised and approved by ERS.
Apr 30, 2001	• Computer contractor develops new workplan and extends scheduled completion to December 23, 2002. ERS rejects workplan and time extension.
Jan 25, 2002	• Project stalls due to internal deficiencies and changes in project approach, technology, management reporting, and applications. • ERS has paid computer contractor $6.2 million for goods and services rendered thus far.
Jun 19, 2002	• ERS and computer contractor file lawsuits against each other. • ERS faced with additional legal fees. • Potential costs for the ARIES project: Computer contract amount $ 12.7 million Computer monitor 1.2 million Total $ 13.9 million

Source: Employees' Retirement System

Contract dispute delays implementation of the new computer system

Despite efforts by the ERS to plan the ARIES' development and implementation, we found that the project is currently stalled and pending the outcome of legal actions between ERS and the computer contractor. On June 19, 2002, the ARIES computer contractor filed suit against the ERS, alleging that the ERS materially breached the contract by:

1. Making a series of unjustified and unreasonable demands aimed at "preventing and frustrating contractor's performance under the contract" (sic);

2. Failing and refusing to participate in the requirements gathering process;

3. Failing to pay invoices as required by law;

4. Delaying or failing to approve various scope of work changes; and

5. Locking the contractor out of the project.

On June 21, 2002, ERS filed a reciprocal suit, claiming that the computer contractor defaulted or breached the contract on 17 alleged points. Some of these claims are that the computer contractor failed to:

1. Diligently perform its obligation to make or demonstrate meaningful progress to complete the project as scheduled;

2. Provide reasonable and relevant work plans, a requirements definition document, and data conversion study;

3. Correct significant functional deficiencies in the ARIES project;

4. Produce features that ERS paid for, such as the benefit calculator and enrollment demonstration; and

5. Implement a suitable accounting software package, with reasonable cost and implementation plans.

Pending outcome of this legal dispute, the ARIES project remains stalled. The delay will force the ERS to continue relying on its antiquated Wang computer system to support its operations. Since it appears that the original goal of the ARIES project will not be realized in the near future and the entire project could possibly be terminated, the ERS stands to lose in excess of $14 million on this project.

Computer monitor's performance is deficient

A good project manager ensures that a project is properly planned, scheduled, monitored, and controlled. The manager should be able to quickly recognize signs of potential project breakdowns, such as missed deadlines or costs that exceed budget, and make appropriate adjustments.

We found that ERS' contracted computer monitor was unable to adequately manage the progress of the new computer system, resulting in more than $3.5 million in wasted resources. ERS issued a request for proposal to hire a computer monitor in 1998 because it lacked the technical expertise to oversee development and implementation of the ARIES project. Based on its evaluation of the proposals received, the ERS contracted with a computer monitor for $1.2 million. Duties of the monitor were to:

1. Evaluate ERS' computer system requirements;
2. Assist in development of the new system specifications;
3. Prepare the request for proposal;
4. Assist in selection of a computer contractor; and
5. Serve as technical oversight manager for the project.

However, after several errors by the computer monitor, the ERS' management failed to question the computer monitor's performance. For example, the original computer contract called for use of the same hardware and software used by South Carolina's State Retirement System. However, the computer monitor and ERS did not find out until April 2001—17 months after the contract was awarded—that the computer contractor was not using the same program and code as South Carolina's system. As the technical expert for the ARIES project, the computer monitor should have detected these major departures from the contract provisions.

In another example, the monitor's apparent carelessness in signing off on different phases of the project will cost the ERS over $3.5 million. During FY2000-01, the computer monitor certified that he had reviewed the computer contractor's invoice for work completed, vouched for the quality, and determined that it was within the parameters of the ARIES project. However, both the monitor and ERS later discovered that after paying $6.2 million to the computer contractor, $3.5 million of the goods and services were unusable. ERS management reported that incorrect computer equipment was installed, network and computer monitoring tools were neither purchased nor installed, and computer equipment racks were missing. The monitor's failure to notice such glaring omissions is unacceptable and a waste of ERS' funds.

Because the original work performed by the contractor was rendered unusable, the computer monitor is also accountable for wasting thousands of ERS staff hours. By the time the contractor's errors were detected, ERS had spent approximately 20,000 hours of staff time assisting the contractor. In return, the contractor produced minimal documentation and unusable programming codes. Thus, the monitor's inability to prevent such mistakes casts serious doubts on the acceptability of the monitor's performance. However, even after these oversights, ERS elected to not terminate the monitor, and instead chose to extend the monitor's contract.

The ERS Board of Trustees was made aware of these problems and expressed its doubts about the performance of the computer monitor during its November 2001 board meeting. Nevertheless, ERS' management requested an extension of the computer monitor's contract and amended the contract amount by an additional $300,000 to assist with the litigation against the computer contractor and the anticipated completion of the ARIES project. To date, ERS has expended about $1.2 million on the computer monitor, even though the services received have been inadequate and highly questionable in many instances.

The Employees' Retirement System's procurement and contract management practices for the new computer system are questionable and waste resources

The *Hawaii Public Procurement Code*, Chapter 103D, HRS, covers all contracts initiated by state and county agencies. The intent of the law was to increase competition, ensure fairness, and establish greater uniformity in the purchase of goods and services. However, we found that attempts by ERS to modify the new computer system contract through the use of subcontractors were highly suspect and possibly in violation of the procurement code.

We found that the ERS wasted over $3.5 million on its new computer system contract when it failed to verify whether the goods and services it paid for were acceptable. ERS relied on its "impression" that something of value had been received when it paid its computer contractor for work that was either unacceptable or incomplete.

Computer contractor claims request for subcontractor violates the procurement code

During development of the ARIES project, the computer contractor claimed that the ERS violated the procurement code by directing it to release a request for proposal without open competition. The computer contractor alleged that ERS violated Section 103D, HRS when the ERS attempted to use the subcontractor provisions in its contract with the computer contractor to issue a noncompetitive request for proposal to only two computer firms.

The ARIES project computer contractor also claimed that in October 2001 ERS revealed it was in contact with two computer companies that could provide a "packaged solution" to its computerization efforts. The contractor reported that it was directed by the ERS to develop a request for proposal for this packaged solution, which was later reviewed and approved by ERS management and sent to only two firms for consideration. Although the contractor reported that these two computer firms declined to respond to the request for proposal, meaning that the ERS may not have violated the letter of the law, it certainly violated the spirit of the code by attempting to procure a major scope change to the existing computer contract without a fair and open competitive process.

Poor contract monitoring has squandered $3.5 million

Public officials are responsible for utilizing public resources efficiently, economically, and effectively to achieve the purposes for which the resources were provided. These officials are also responsible for establishing and maintaining effective controls to ensure that public resources are properly safeguarded from waste, fraud, and abuse. While the ERS has policies and procedures in place to help safeguard its assets, we found that poor monitoring of its major computer contract resulted in the loss of millions of dollars in state funds.

ERS has established procedures that require a review of goods and services received from the ARIES contractor. Before any payment is made to the computer contractor, ERS management and its computer monitor must both verify the acceptability of the goods and services and sign the authorization for payments.

By January 2002, the ERS had already paid the computer contractor a total of $6.2 million for goods and services received. However, we found that of this total amount, ERS paid $3.5 million for goods and services that had "no value and were not usable." Some of the goods and services identified as having no value included a detailed workplan, requirement definition documentation, data conversion study, and imaging software. In addition, ERS reported that the "contractor would have to start over again," further delaying completion of the ARIES project. ERS further reported that "the *acceptance* of the goods and services from the computer contractor had been made under *the impression* that something of value had been provided, but that *impression* had now proven to be just the opposite of the true situation." Thus, ERS' failure to properly monitor its contracts resulted in the squandering away of over $3.5 million in beneficiaries' assets on goods and services of basically no value.

The Employees' Retirement System Board of Trustees Failed to Properly Manage the Beneficiaries' Assets

The guidelines for "prudent investors" include construction of an investment portfolio based on the plan's objectives, diversification of assets, and the recommendation to hire an investment consultant to provide independent, third-party advice to the Board of Trustees. We found that while ERS has developed documentation meant to guide the board's investment decisions, the board has taken on administrative and other tasks that might be better delegated to ERS staff.

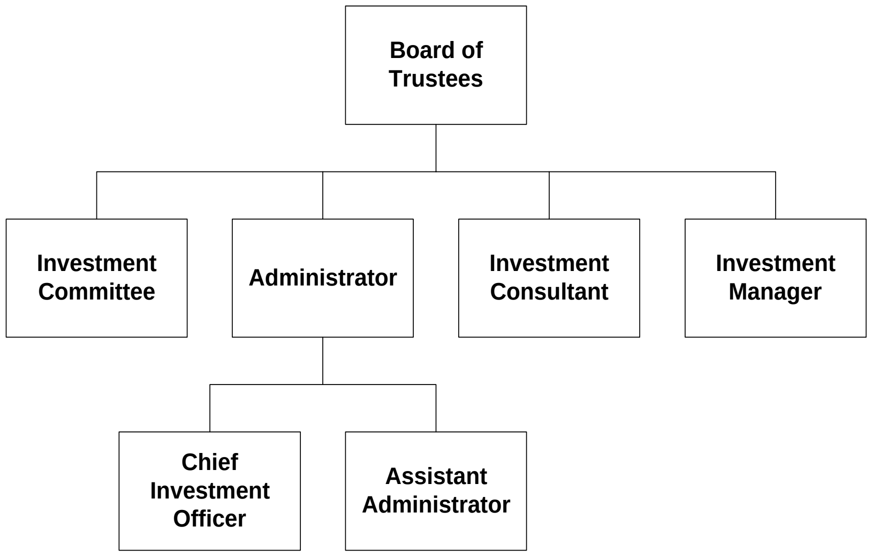
Because board members are typically not required to have investment expertise, since 1991 the board has relied heavily on the recommendations of its long-time investment consultant. While not uncommon, the consultant's objectivity could be suspect, since the consultant has disclosed financial relationships with the majority of investment managers it has recommended to the board. Compared to other retirement systems, ERS' total return, based on investment performance, ranks in the bottom 5 to 15 percent nationwide. Such questionable performance should compel the board to clearly define its role and that of the investment staff and consider open, competitive bidding for investment managers on a regular basis to minimize the impact of relationships on investment decisions and costs for such services.

The chief investment officer's responsibilities and reporting structure should be assessed

ERS defines the role of its chief investment officer (CIO) as the one who oversees investments and performance of investment managers, and who formulates, recommends, and implements investment policies and strategies. In most state retirement systems, the CIO reports directly to the board, the chairman of the board, the board's investment committee, or to an executive director, who in turn reports to the board.

For example, the CIO of the New Mexico State Investment Council reports to the governor, who is the head of the board. The CIO of the Oklahoma Public Employee Retirement System reports to an executive director, who reports to the investment board. In contrast, Hawaii's CIO is selected by the board but reports to the ERS administrator. This arrangement not only differs from common practice but is also fundamentally unsound, since the administrator is responsible for ERS operations and not investments. Exhibit 2.7 displays ERS' relationship with its CIO in the investment process.

Exhibit 2.7
CIO Relationship Within the Investment Process



Source: Employees' Retirement System

The process for selection, monitoring, retention and termination of investment managers needs improvement

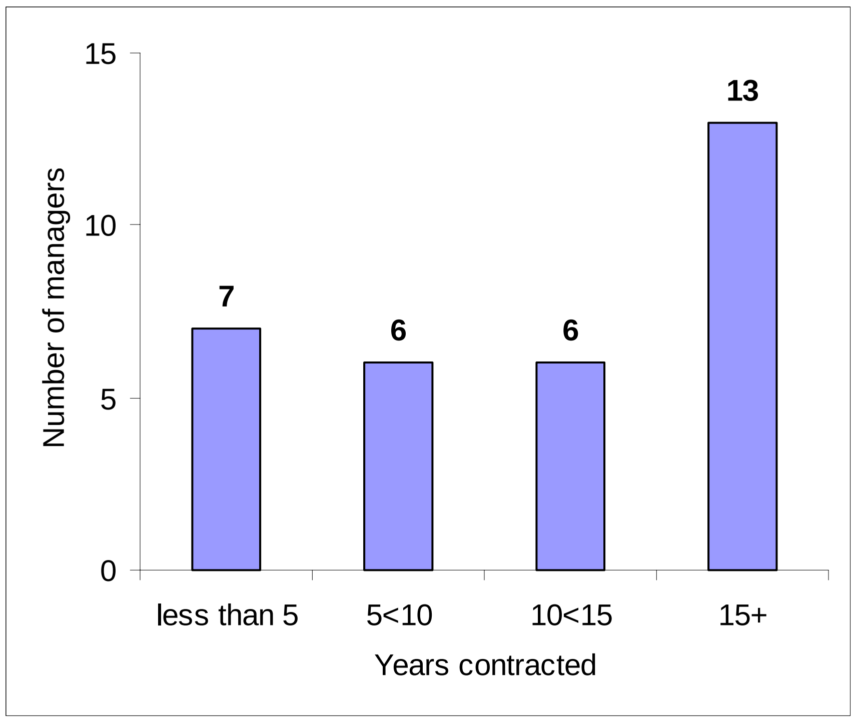
ERS measures investment managers' performance in light of stock indexes and peer groups, which is generally considered an objective standard. However, we found other pension plans also use competitive bidding to inform themselves of new services or technological advances in the investment industry. This practice also puts investment managers on notice that the managers need to continually improve performance and reassess fees to retain the systems' business.

Competitive bidding also provides clear criteria for terminating underperforming investment managers and identifies other investment managers with expertise in similar asset classes. Obtaining sufficient data this way facilitates a smooth transition from one manager to another.

In contrast, pension plans that do not use competitive bidding can be reluctant to change a clearly underperforming investment manager because it may not have readily available information about a replacement. Typically, finding a replacement means an exhaustive and sometimes costly search for a single manager. Competitive bidding allows retirement systems to review existing investment managers regularly, while also obtaining up-to-date information on the capabilities of others in the industry. Otherwise, investment managers can become entrenched within the system without demonstrating how they continue to earn the position over their peers.

For example, we found that ERS had retained 13 investment managers for more than 15 years. Of these, three managers were retained for over 20 years. Exhibit 2.8 displays the ERS' distribution of investment managers and the number of years the board has retained each manager.

Exhibit 2.8
Board of Trustees' Retention of Investment Managers as of June 30, 2002



Source: Employees' Retirement System

However, we note that the cost of transferring assets between investment managers can be significant, and the process requires more work for the board and investment consultant. Nevertheless, the cost of competitive bidding can be recovered or exceeded by enabling the system to negotiate significant reductions in fees with existing investment managers based on other bids, or by finding a formerly unknown manager who can significantly increase returns. Most importantly, it sends a clear message that the board is vigilantly pursuing its fiduciary duty to its members and not its investment managers.

The selection process for investment managers relies too heavily on recommendations from the investment consultant

Not all board members nationwide are required to have investment expertise. Thus, investment consultants assist boards with investment structure, selection, monitoring, and evaluating investment managers. Investment consultants have a fiduciary responsibility to their boards. The Hawaii attorney general has issued an opinion that while ERS' board can hire its investment consultant, it must not abdicate those responsibilities. However, we found that the board rarely deviates from its investment consultant's recommendations when selecting investment managers.

The investment consultant is responsible for selecting and recommending to the board investment managers who, when combined with the retirement system's total portfolio, support the board's stated investment goals. When a new investment manager is needed, the investment consultant recommends between four and six investment managers from its database, according to their perceived ability to meet desired qualifications. There is no requirement or practice of opening up the search process to managers outside the consultant's database. Board members then have the opportunity to select a subset of the candidates to interview in person before making their final decision.

Our review of board minutes and interviews with board members indicated that although discussions take place, the board invariably follows the recommendations of the investment consultant. Without another perspective from which to balance the investment consultant's recommendations, the board could fail to benefit from other, possibly better-performing investment managers.

The investment consultant may have a conflict in recommending investment managers to the board

The Prudent Investor Rule strongly recommends that boards of pension plans hire an investment consultant. ERS policies state that the investment consultant is responsible for providing independent, third-party advice to board members. However, we found that ERS' investment consultant has disclosed financial ties to the majority of investment managers it has recommended to the board.

Investment consultants primarily advise pension managers, but some consultants also earn additional revenues by acting as brokers or selling advice to investment managers. For example, these financial relationships can include providing consulting services to money managers on strategy and marketing/sales implementation, software and database information on money managers' performance, and research findings. It is not uncommon for a consultant to charge a money manager in excess of $200,000 for such advice and services—the same people that pension systems pay the consultant to evaluate. In addition to these financial relationships, pension consultants have been known to host conferences, where money managers pay as much as $50,000 to attend and mingle with the consultants' pension clients.

Our analysis of the investment manager searches performed for ERS shows that more than 85 percent of recommended candidates, and consequently 100 percent of the investment managers chosen, have disclosed financial relationships with ERS' investment consultant. The investment consultant further reported that since 1994, 44 investment managers were recommended to the ERS for six manager positions. Of these, 32 (73 percent) had a financial relationship with the investment consultant and 12 (27 percent) had no financial relationship. While not technically representing a conflict of interest, the motivation to recommend these particular investment managers warrants close scrutiny. The existence of such relationships should compel the board to supplement the consultant's recommendations with other criteria.

Exhibit 2.9
Investment Consultant's Relationship to Investment Managers

Asset Class	Date	Number of Investment Managers Recommended	Number of Investment Managers with Disclosed Financial Relationship to Investment Consultant	Investment Managers Selected by the Board with Financial Relationship to the Investment Consultant
Emerging Equity	May 1997	4	4	1
Small Cap -- Core	Dec 1999	6	5	1
Large Cap -- Growth	Dec 1999	6	5	1
Total		**16**	**14**	**3**
Percentage with relationship to investment consultant			**87.5 percent**	**100 percent**

Source: Employees' Retirement System

Adopting a competitive selection process for investment managers may be warranted

The intent of the *Hawaii Public Procurement Code*, Chapter 103D, HRS, was to advocate competition, fairness, and uniformity in the procurement process. Investment managers hired by ERS are currently exempt from this provision. Instead, they are hired through a selection process largely run by ERS' investment consultant. In contrast, many state retirement systems select investment managers through an open, competitive bidding process every few years. For example, in New Mexico's four major retirement systems, contracts with investment managers are re-bid on a staggered basis every four years; in Oklahoma's eight major retirement systems, contracts are re-bid every five years.

Knowing this in advance causes not only the retirement systems, but also the investment managers themselves, to re-evaluate their services and the costs involved to see whether they have kept up with industry norms, or whether other managers have developed similar or better services at lower rates. By not relying exclusively on the recommendations of their investment consultants, retirement systems are given a larger universe of investment managers from which to choose.

In contrast, ERS evaluates its investment managers in isolation, measuring their performance against indexes and peer groups, but not incorporating other possible advantages, such as lower costs, for the same quality of service from other managers. As stated previously, limiting the pool of possible investment managers to those recommended by its investment consultant is questionable.

The watch list review process is not consistently applied

ERS policies state that the board may place investment managers on a "watch list"—essentially a warning prior to possible termination—for a variety of reasons: personnel changes, violation of policy and investment guidelines, style deviations, underperformance, asset allocation changes and non-disclosure of material information. Guidelines include consideration of qualitative and quantitative factors affecting performance. However, when measured against these guidelines, we found ERS' implementation to be inconsistent.

Using criteria for the quarterly report as of June 30, 2002, we found that nine investment managers failed to meet performance criteria and should have been placed on the watch list. In contrast, ERS placed only five on its watch list. Of the remaining four, a warning letter was sent to one manager and no action was taken on three others. Additionally, one of the investment managers should have been on the watch list for three years and was rated in the bottom 7 percent of investment managers in the quarterly report. Inconsistently applied guidelines fail to hold the investment managers accountable for their performance and compromise the assets of the system.

The board's handling of an investment manager was questionable and may have lost beneficiaries millions of dollars

One underperforming manager, 3Bridge, received considerable attention during the 2002 legislative session. HCR No. 130 expressed concerns regarding its poor performance and the board's unwillingness to terminate this manager. In addition, House Standing Committee Report No. 961 and Senate Standing Committee Report No. 3500 of the same session questioned whether this reluctance to terminate the investment manager could be attributed to the manager's employment of ERS's former administrator.

In our interviews with ERS' board members regarding the 3Bridge situation, we found a pattern among board members who expressed a desire to "be fair" to the investment manager. As previously mentioned, some investment managers had been with ERS for over 20 years. In the meantime, 3Bridge's performance languished in the bottom 5 percent for its asset class, meaning that 95 percent of investment managers—virtually any other manager—could have produced better returns. When compared to the norm, the ERS' loss could have been as much as $128 million, but 3Bridge was allowed to remain on the watch list for two and one-half years before its termination in August 2002. As discussed previously, the board's close contact with individual investment managers appears to have delayed the termination of this significantly underperforming investment manager.

The board's poor investment performance rated below the bottom 15 percent nationally

Investment professionals use a percentile rank system to compare the performance of different funds. Percentile rank refers to the ranking of a fund's return on a scale ranging from one (the best) to 100 (the worst). The higher its percentile rating, the poorer is a fund's performance. Because the stock market can be volatile on a year-to-year basis, the investment industry typically applies this rank system to three- and five-year periods, in keeping with historically documented business cycles.

Our analysis showed that the ERS' total return ranked in the 84^{th} percentile among public funds for the three-year period ending June 30, 2002 and in the 88^{th} percentile for the five-year period ending June 30, 2002. This means that ERS performed dismally: 84 percent of other public funds performed better over the three-year period and 88 percent performed better over the five-year period.

The assessment of ERS' own investment consultant was even worse, with the ERS total fund return ranking in the 94th percentile in that consultant's public fund group for both the three- and five-year periods ending June 30, 2002. This poor performance, considered in light of questionable factors discussed previously, should compel the board to re-evaluate its investment practices. While competitive bidding is not a guarantee of superior investment returns, a more open process would dispel the impression that the board's selection of investment managers is less than objective.

Conclusion

Management problems at the ERS are widespread, affecting both the operation and investments of the system. In the last five years, ERS' failure to adequately plan is a recurring obstacle in its efforts to better support the needs of its membership. Unsuccessful attempts to improve on the processing of retirement benefits and the stagnant implementation of its computer system have both showed ERS' lack of foresight and focus on sustainable solutions. These failures will continue to seriously hinder improvements in service to the beneficiaries of the system over the long term.

Similarly, the Board of Trustees' failure to implement objective procedures to protect beneficiaries' assets is also alarming. As fiduciaries of the State's retirement funds, the board needs to be more vigilant against those who would pursue any agenda contrary to the State's interests. State workers deserve assurance that their contributions over the past several decades will be properly managed and their best interests will be served, rather than overshadowed by the interests of investment managers and consultants. In the absence of any substantial improvements within a reasonable time period, the Legislature may need to consider increasing its oversight of the board and administration.

Recommendations

1. The Employees' Retirement System administration should:

    a. Better manage staff resources and reduce the time it takes to process a retiree's final pension benefits;

    b. Terminate the new "closed" or partially finalized pension process for departments and counties that have failed to respond to the administration's inquiries in 30 days;

    c. Complete the Data Purification Project and verify that active membership service credit information is accurate to allow for the expeditious processing of retirement applications;

d. Properly plan, assess, and monitor its resources to ensure that ERS members receive adequate retirement counseling and service;

e. Replace the obsolete Wang computer system and properly manage and implement a new computer system; and

f. Seek an attorney general’s opinion or statutory changes to Section 88-107, HRS to permit the payment of interest for any underpayment of a retiree’s final pension benefits, using 90 days after the retiree’s retirement date as the start date for computing the interest.

2. The Board of Trustees of the Employees’ Retirement System should:

   a. Better define the duties, responsibilities, and structure of the chief investment officer (CIO);

   b. Delegate more of the on-going monitoring and review of investment managers to the CIO;

   c. Publicly advertise for the selection of investment managers and require the investment consultant to document criteria for the exclusion of qualified candidates;

   d. Periodically reevaluate managers by asset class against other qualified managers providing similar services, through a formalized request for proposal process; and

   e. Better monitor and adhere to the watch list procedures described in the Investment Policy and Procedures Manual.

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Appendix A
Employees' Retirement System Investment Managers Profile

Asset Class/Investment Manager	Service Contract Date	Market Value ($ 000) June 30, 2002	March 31, 2002	Increase/ (Decrease)
Domestic Large Cap Equity				
AllianceBernstein	January 15, 1985	$284,826	$347,868	$(63,042)
Bishop Street	April 20, 2000	27,884	32,621	(4,737)
Pacific Century	October 1, 1991	78,508	96,474	(17,966)
Putnam Investment	April 17, 2000	312,804	356,497	(43,693)
Hanson/3Bridge	January 12, 1987	145,749	164,068	(18,319)
Barrow Hanley	January 16, 1985	468,832	499,048	(30,216)
Delaware Investment Advisors	January 1, 1983	445,193	480,171	(34,978)
CM Bidwell	December 15, 1987	38,764	41,620	(2,856)
Mellon S&P Index	September 17, 1984	790,056	912,226	(122,170)
Total Large Cap Equity		**$2,592,616**	**$2,930,593**	**$(337,977)**
Small/Mid Cap Equity				
Denver Mid-Cap	September 23, 1994	$90,694	$101, 041	$(10,347)
Independence - Mid Cap	October 1, 1990	130,190	138,467	(8,277)
Oppenheimer - Mid Cap	October 7, 1994	122,465	135,045	(12,580)
Jennison	April 30, 2000	145,913	165,869	(19,956)
T. Rowe Price	July 5, 2000	158,218	170,639	(12,421)
Trust Co. of the West	October 14, 1994	77,202	94,113	(16,911)
Total Small/Mid Cap Equity		**$724,682**	**$805,174**	**$(80,492)**
Domestic Fixed-Income				
HCM/CIC	November 1, 1991	$167,795	$174,505	$(6,710)
Pacific Income Advisors	July 15, 1994	262,614	274,045	(11,431)
Bradford & Marzec	January 23, 1990	643,492	627,203	16,289
PIMCO	July 1, 1982	649,209	629,923	19,286
Total Domestic Fixed-Income		**$1,723,110**	**$1,705,676**	**$17,434**
International Equity				
Bank of Ireland	April 15, 1994	$353,419	$360,417	$(6,998)
Schroder Capital	January 12, 1987	385,926	407,490	(21,564)
Daiwa	July 1, 1981	937	1,013	(76)
Capital International	July 9, 1998	183,120	209,362	(26,242)
State Street EAFE	January 2, 1996	290,995	312,724	(21,729)
Total International Equity		**$1,214,397**	**$1,291,006**	**$(76,609)**
International Fixed Income				
Oeschle International	January 24, 1989	$350,367	$306,488	$43,879
PIMCO International	July 1, 1982	343,347	301,971	41,376
Total International Fixed Income		**$693,714**	**$608,459**	**$85,255**
Real Estate*				
PM Realty	September 20, 1999	$95,200	$95,200	$--
Clarion Partners	October 1, 1997	202,869	202,869	--
Heitman Capital Management	February 28, 1993	94,086	94,086	--
Invesco Realty Advisors	January 2, 1998	183,227	183,227	--
Total Real Estate		**$575,382**	**$575,382**	**$--**
Alternative Investments				
Abbott Capital	August 20, 1997	$171,897	$178,961	$(7,064)
Hancock Timber Resource	September 9, 1999	66,602	66,675	(73)
Total Alternative Investments		**$238,499**	**$245,636**	**$(7,137)**
Total Investment Manager's Assets		**7,762,400**	**8,161,926**	**(399,526)**

*Note: Only March 31, 2002 figures were available. In addition, the figures only include the assets for the four investment managers.

Source: Employees' Retirement System

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Response of the Affected Agency

Comments on Agency Response

We transmitted drafts of this report to the chair of the Board of Trustees of the Employees' Retirement System (ERS) and its administrator on November 29, 2002. A copy of the transmittal letter to the administrator is included as Attachment 1. A similar letter was sent to the board chair. A combined response from the board and the administration is included as Attachment 2. However, we have excluded the attachments and exhibit submitted with the ERS' response because of their volume. The attachments and exhibit, well in excess of several hundred pages, are available in our office for public review.

The ERS responded by agreeing to some of our issues and felt that others merit further investigation. However, the ERS disagreed with most of the conclusions in our draft report, maintaining that the report is based on factual errors and appear to lack due diligence. Additionally, the ERS did not dispute any of our recommendations, but noted that the recommendations did not provide sufficient detail and substance to make any improvements. The ERS also responded that our report did not recognize the progress made by the system to improve service to beneficiaries and protect the investments of the trust fund. Finally, the ERS provided a detailed and comprehensive explanation of its disagreement with our findings and recommendations.

The ERS maintained that our draft report contained inaccurate statements and conclusions regarding the agency's effectiveness and efficiency in fulfilling its mission. The ERS further responded that these issues were identified prior to the audit and that the retirement system has already acted to improve these services. However, the ERS cited *anticipated* improvements based on *newly initiated* plans, which were not fully evident during the time of our fieldwork. We contend that many of the management issues we identified were evident several years ago and could have been properly addressed then to minimize impact on beneficiaries.

The ERS also expressed concern that our statements and conclusions could have a detrimental financial impact on its members because of a pending lawsuit on the implementation of the Automated Retirement Information Exchange System (ARIES). However, the response from the ERS does not address specific legal complications that would result from the release of our report. We note that the ERS did not specifically disagree with any of the facts presented regarding the development and implementation of the new computer system. Inasmuch as the information is public record and the ERS must contend with the lawsuits, we proceeded to include our comments regarding ARIES in our report.

The ERS also agreed with our assessment that the current Wang computer system is outdated and obsolete. The ERS acknowledged that the replacement of the antiquated computer system has been a serious concern for the ERS for several years, and that replacing the system has taken longer than originally planned. The response further agreed that the implementation of the new system has been plagued with problems.

However, the ERS disagreed with our assessment that it failed to replace the obsolete computer system in a timely manner. Even with our understanding of the complexity of implementing a new computer system, we still concluded that efforts to replace the obsolete system should have started long before 1999. This delay will require the ERS to continue operating with an obsolete system until the lawsuit is settled.

The ERS also responded that the audit report falls short in its assessments and recommendations. This is surprising and a significant change from the trustees' positive responses to the same recommendations mentioned during our interviews with the trustees.

In addition, the ERS board agreed that the long-term relative performance has been below its own benchmarks and accepts responsibility for this performance. The board also recognized its performance shortfall when compared with other public funds and its own benchmarks. The board further acknowledged that the past shortfall was attributed to its aggressive investment strategy, historical reluctance to manage the asset allocation targets, historical reluctance to closely monitor investment managers, and reluctance to terminate under-performing managers on a timely basis. However, the board noted that performance improvements have taken place recently as a result of well-documented decisions regarding investment disciplines and strategies.

The ERS further provided justification defending the board's handling of 3Bridge, the underperforming investment manager that prompted the legislative resolution for the audit. In its response, the ERS cleverly combined the performance with the good performance of Hanson, a former company. However, our evaluation was of only 3Bridge from when it was first established two and one-half years ago. Thus, we stand by our conclusion that the delayed decision by the board to terminate 3Bridge resulted in the potential loss of $128 million in assets.

Finally, the ERS noted that we conducted a limited review of its office and its various processes. However, the provisions of House Concurrent

Resolution No. 130 of the 2002 Regular Session, which initiated this audit, defined the scope of our work. Our conclusions were based on the facts presented to us by the ERS, as documented in its own records and in compliance with Generally Accepted Government Auditing Standards.

We made some minor changes to the draft report for the purposes of accuracy and clarity.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

November 29, 2002

COPY

Mr. David Shimabukuro, Administrator
Employees' Retirement System
City Financial Tower
201 Merchant Street, Suite 1400
Honolulu, Hawaii 96813

Dear Mr. Shimabukuro:

Enclosed for your information are three copies, numbered 6 to 8 of our confidential draft report, *Management and Performance Audit of the Employees' Retirement System*. We ask that you telephone us by Tuesday, December 3, 2002, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, December 9, 2002.

The Board of Trustees of the Employees' Retirement System, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion Higa

Marion M. Higa
State Auditor

Enclosures

LINDA LINGLE
GOVERNOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

December 11, 2002

RECEIVED
DEC 11 11 59 AM '02
OFC. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion M. Higa
State Auditor
Office of the Auditor
State of Hawaii
465 South King Street, Room 500
Honolulu, HI 96813

Dear Ms. Higa:

Enclosed are the Employees' Retirement System's (ERS) Board of Trustees' and management's responses to the draft copy of the Management and Performance Audit of the ERS.

We implore the Office of the Auditor to exclude the portion of the report relating to the pending computer lawsuit as the incorrect statements and conclusions could have a detrimental financial impact on the members of the ERS and constituents the Auditor is charged to serve.

The ERS is responsible for the financial security of thousands of government employees. This is a responsibility that the ERS' Board of Trustees, management and staff take very seriously. This is why it is important that we need to correct and clarify the assessments, conclusions and recommendations contained in the Auditor's draft report. We want to assure our members, including the Legislature, that the ERS, contrary to the findings in the report, has made significant progress in providing services and protecting trust assets, and is looking to the future for the betterment of its members, retirees, and beneficiaries.

Sincerely,

Jackie Ferguson-Miyamoto

Jackie Ferguson-Miyamoto
Chair of the Board of Trustees

David Shimabukuro

David Shimabukuro
Administrator

City Financial Tower
201 Merchant Street, Suite 1400 • Honolulu, Hawaii 96813-2980
Telephone (808) 586-1660 / (808) 586-1735 • Fax (808) 586-1677

Executive Summary

The Office of the Auditor's draft report on the Employees' Retirement System of the State of Hawaii identifies some issues that we agree with and some that merit further investigation. However, we disagree with most of the conclusions in the report for several key reasons.

Auditors Report Has Serious Problems:

- **The report is based on many factual errors and appears to lack due diligence.**
- **The report demonstrates a lack of understanding of the complexity of the ERS' systems, processes and procedures.**
- **The conclusions contained in the Report about customer service are based on wrong information, ignores ERS successes and uses anecdotal evidence in an attempt to justify preconceived ideas.**
- **The Report unfairly fails to acknowledge positive trends in ERS performance and improvements in its systems and service.**

The ERS is one of the most complex public pension systems in the country. And faced with this complexity, one would hope that the Auditor's staff would have made an extra effort to fully understand the ERS. Unfortunately, their inability to review and understand all phases of the ERS resulted in questionable and inaccurate conclusions. Specific examples are detailed in our responses to each of the report Findings, and are summarized as follows:

Finding No. 1 – Conclusions About ERS' Customer Service are Based on Wrong Information, Ignore ERS Successes and Use Anecdotal Evidence in an Attempt to Justify Preconceived Ideas.

We acknowledge and agree with some of the issues identified in Finding No. 1, specifically, the importance of shortening the time necessary for finalizing benefits calculations and replacing the ERS' current WANG computer system. However, these issues were identified by ERS staff prior to the audit and the ERS is already acting to improve these services. What is more important are the inaccurate statements and conclusions in the draft report.

Problems with Finding No. 1.

- **The Report is wrong about ERS' efficiency.** The ERS has increased customer service output by over 88 percent since 1999.
- **The Report mistakenly attributes delays to ERS** – The ERS requires much more than just vacation and sick leave information, which was the only information referenced in the report, to finalize benefits.

- **The Report failed to recognize the ERS' long-term resource plan** which includes additional staff positions.

- **The Auditor is apparently unaware that new positions can only be approved by the Legislature.** Because of this, the ERS effectively used overtime and temporary help to respond to the immediate need.

- **The examples of problem cases identified in the report are anecdotal at best** – they do not accurately reflect the ERS systems.

- **The Data Purification Project demonstrated a more than 92 percent accuracy rate** – far better than the anticipated 85 percent rate despite having to input more than 13 million manual records.

- **The Auditor demonstrated lack of due diligence by misinterpreting State Law.** Contrary to the Report, annual member statements are not required by law.

Finding No. 2 – Auditor Lacks Expertise and Did Not Spend Time Required to Make an Accurate Assessment of Computer Upgrade.

We agree with assessment that the computer system is outdated and obsolete. However, we disagree with the Auditor's unsupported generalizations regarding the ERS' efforts to update the computer system. The ERS' response to problems with the computer system and deficiencies by the contractor hired to update the computer system has been responsible and in the interest of the beneficiaries. Incomplete information regarding the ERS computer upgrade was inappropriately included in the report, which could be taken out of context and jeopardize the ERS' position in litigation. Millions of dollars are at stake.

Problems with Finding No. 2.

- **The Auditor lacked expertise necessary to make accurate assessment.** The Auditor's staff has little or no direct experience in a major computer system upgrade.

- **The Auditor's staff lacked due diligence in its review** – In the time spent, it was literally impossible for the Auditor to review the more than 200,000 documents related to the project in order to draw any reasonable conclusions.

- **The Report has unsupported conclusions.** The draft Report provides no specific examples to support its conclusions regarding the computer upgrade process.

- **The Report is wrong about financial risk.** The ERS did not jeopardize ERS funds because of the required contractor performance bond and guaranty. Also, the ERS has not released all of the contract funds.

- **ERS acted responsibly.** The ERS demonstrated its due diligence in a timely and comprehensive manner once it determined that the contractor was not performing to expectations.

Finding No. 3 – Regarding Investment Decisions: Report Lacks Key Information, Incorrectly Interprets Policies and Procedures, Draws Unsupported Conclusions and Ignores ERS' Positive Performance.

The ERS Board strategy is working. The ERS has beaten its benchmarks for the last three years and is in the 47th percentile of all public funds for the fiscal year ended June 30, 2002.

While the Board agrees that the long-term relative performance of the ERS has been under our benchmarks and accepts responsibility for this performance, the report is inflammatory by not giving credit to the many positive decisions made in the management of assets over the last three years, a conclusion even a casual reading of Board meeting minutes would reveal. The Report also demonstrates some serious failings in its assessments and recommendations.

Problems with Finding No. 3.

- **The Report ignored lack of employer contributions and its impact on the actuarial soundness of the plan.** The finding fails to address the past Legislative actions that defrayed over $1.6 billion in the ERS' excess investment earnings thus jeopardizing the larger issue of sufficiency of funds for current and future beneficiaries. Actuarial soundness is achieved not only through prudent investments but also through consistent funding by the employer.

- **The Report excluded the investment consultant's favorable opinion.** The Auditor's own investment consultant has characterized the ERS Investment Policy and Procedures Manual as among the best, which makes the report's criticism even more confusing.

- **The Report is wrong about investment consultant's objectivity.** The Report seems to criticize the investment consultant's objectivity because it disclosed its various financial relationships with investment managers, yet also states that the relationships are "not technically representing a conflict of interest."

- **Auditor lacked due diligence regarding manager search process** - The Auditor seems to be only guessing about the ERS' manager search process. The Auditor draws conclusions without ever having contacted the ERS' investment consultant.

- **The Report is factually wrong regarding CIO.** The Auditor's criticism is based on the statement that the ERS Administrator is not responsible for both operations and investments, when, in fact, the Administrator has both responsibilities.

- **The Report grossly misinterprets the ERS watchlist guidelines** – The Report states that an additional nine managers qualify for watchlist status. Currently, based on the guidelines, there are no additional managers that qualify for watchlist status.

- **The Report is wrong about 3Bridge**. Contrary to the Report, the Board followed a prudent process in dealing with 3Bridge Capital.

- **The RFP process recommended in the Report is obsolete by current standards**. The Report's recommendation could result in higher fees and untimely manager selection. Only a handful of funds still use the Report's recommended method.

We understand the importance of what the Auditor attempted to accomplish. The ERS is responsible for the financial security of thousands of government employees. This is a responsibility that the ERS' Board of Trustees and employees take very seriously. And this is why it is equally as important that we help clarify the points raised by the Auditor, which are based on incorrect information.

DRAFT RESPONSE TO AUDITOR'S REPORT

December 11, 2002

Preface

The 2002 Legislature charged the Office of the Auditor ("Auditor") with conducting a management audit of the Employees' Retirement System of the State of Hawaii ("ERS") pursuant to House Concurrent Resolution No.130. The Board of Trustees ("Board") and Management of the ERS ("Management") welcomed the audit as an opportunity to dispel concerns raised by various news reports regarding the management of the ERS' investment portfolio. In addition, we viewed it as an opportunity to provide a more thorough and accurate picture of the progress that the ERS has made in recent years in both improving its administration of benefits and the management of its investment portfolio.

Unfortunately, the Report produced by the Auditor is a product that is rife with errors, misstatements, unsupported conclusions, flawed recommendations, inexpert analysis, and rhetoric aimed at grabbing headlines rather than providing thoughtful reporting and sound recommendations that would enable the ERS to make continued operational improvements.

This is not to say that the Report does not identify legitimate issues that we agree merit further inquiry and action by the Board and Management. However, because of the many factual errors, misinterpreted information, lack of comprehension by both the Auditor and its consultant of the ERS' systems, processes, and procedures, and the reliance on inflammatory language, the Report lacks the credibility one might expect from an important audit such as this.

The Report is a Product of Shoddy and Incomplete Research. Rather Than Reflect Appropriate Due Diligence, the Auditor Relies on Misleading Anecdotal Information That is Not Indicative of the True Factual Situation at the ERS.

What is most disturbing is the apparent lack of due diligence on the part of the Auditor. Instead of a thorough analysis of the ERS, the report demonstrates an obvious bias by using anecdotal, unique incidents rather than looking at the broad picture in an attempt to justify preconceived ideas about the ERS. Furthermore, the failure to conduct the proper due diligence led to unsubstantiated conclusions that the Board and Management failed to fulfill its fiduciary role.

The Report Reflects the Auditor's Failure to Comprehend the Operations of the ERS.

The ERS manages the pension accounts of more than 96,000 employees and retirees and tens of millions pieces of documentation and information that have accumulated over more than 75 years. It would require an enormous amount of time and expertise to effectively assess such a complex operation. However, after reviewing the Report, it was apparent that the Auditor's staff only had a rudimentary understanding of the ERS, which resulted in numerous errors and misstatements.

An independent actuary stated that the ERS is one of the most complex public pension systems in the nation. He attributed this complexity to the number and diversity of employee groups covered by the ERS. Moreover, there are numerous laws and numerous benefit calculations for these employee groups. Many other public pension funds cover one or few employee groups such as state employees, police officers, firefighters, teachers, judges, elected officials, etc. In other words, each group has its own pension fund including administration and staff support. The ERS, on the other hand, has all groups under its administration to provide better oversight and service, and to control costs.

Therefore, the Auditor's staff was faced with the challenge of learning as much as possible within a short time frame. And faced with this complexity, one would hope that the Auditor's staff would have made an extra effort to fully understand the ERS. Unfortunately, their inability to review and understand all phases of the ERS resulted in questionable and inaccurate conclusions.

The ERS Has Made Major Improvements in Providing Services to Its Members That the Report Ignores.

The ultimate goal of the ERS is to help ensure the livelihood of our members and provide the type of service they need and deserve. Over the past few years, the ERS has shown dramatic improvements in its service to its members. As will be detailed later, the ERS output of services has increased by more than 88 percent since 1999, and significant new services have been introduced including a new website, informational mailings and member statements.

We have been working diligently to improve our systems and service level, but we also agree that there are some issues that need addressing.

The Report cites two important issues that were identified by the ERS prior to the audit (finalizing pension benefit payments and replacing the WANG system). The ERS has been working hard to address these issues as well as other important ones through planning and reengineering efforts as will be described in this response.

We realize, however, that some of these efforts will take time to attain significant benefits since the ERS has more than 96,000 members, nearly one out of every ten people in the state. And, as previously stated, the laws governing the ERS provides for one of the most complex methods of calculating benefits in the country. We are trying to update and improve systems that have been in place for nearly 15 years, and it would be unrealistic to expect major changes to occur overnight. We would hope that any reasonable person would understand this challenge.

Nevertheless, we have been working on improving the ERS to meet its mission and achieve the values as identified by the Board and Management.

New ERS Initiatives include:

- Launching the ERS website;
- Issuing semi-annual member newsletters;
- Developing a strategic plan to implement short-term and long-term ERS goals and objectives;
- Performing a workload study resulting in 6 new positions;
- Developing reorganization plans to enhance the counseling area;
- Implementing performance measures to ensure improved employee results;
- And, revising important provisions in the Investment Policy and Procedures Manual. **In fact, the Auditor's investment consultant, New England Pension Consultants, said that the ERS Investment Policy and Procedures Manual was very comprehensive and one of the best manuals he's seen.**

The Report Reaches Mistaken Conclusions Based Upon Flawed and Misleading Factual Data.

A simple measure of success for the ERS is the fact that the total output of ERS services has increased by more than 88 percent since 1999. This seems contrary to the conclusion in the Report that the "ERS operations ... have declined in efficiency and effectiveness." But this is just one example of the type of questionable and inaccurate conclusions included in the Auditor's report.

If this conclusion were true, then how was the ERS able to produce the benefit-related operational results reported in the following table for the past 4 – 5 years? As can be seen from this table, the ERS was able to increase its output of major benefit-related operational activities from 12,950 in 1999 to more than 24,000 in 2002. These are important services to our members. For example, the completion of retirement estimates provides the member with valuable information on whether to retire now or in the near future. Retirement estimates alone increased by more than 52 percent from 1999 to 2002. This is hardly an indication of declining efficiency.

Since 1999, the ERS Has Increased Its Member Service Productivity by Over 88 Percent.

Description	1999	2000	2001	2002	Projected 2003
No. of New Enrolled Members or Transfers	3,886	4,370	5,171	6,095	7,000
No. of Times Members Counseled at Filing Sessions / Workshops / Appointments	2,347	3,082	2,838	3,398	5,000
No. of Retirement Estimates Completed	3,457	3,968	4,476	5,276	7,300
No. of Initial Pension Payments Processed	1,175	1,476	1,498	1,310	1,600
No. of Unused Sick Leave Credit Payments Processed	-	-	* 830	1,810	2,100
No. of Final Pension Payments Processed	751	637	862	1,394	1,800
No. of Military Service Bonus Claims Processed ^	-	-	-	2,320	144
No. of Disability Claims Processed	171	146	132	183	200
No. of Death	900	949	924	1,017	1,000

Claims Processed					
No. of Refunds	263	229	217	243	200
No. of Mainland ACH Processed	-	-	-	*1,272	600
Total Output of Major Services Provided	**12,950**	**14,857**	**16,948**	**24,318**	**26,944**
Permanent Positions	**53**	**53**	**55#**	**55**	**61##**

* - New process implemented.
^ - One time processing for newly enacted law.
\# - Two Information Systems positions added.
\## - Six new retirement claims examiner positions funded from October 2002. Filling of these positions approved in November 2002.

The increased number of services provided to its approximately 96,000 members, retirees and beneficiaries over the past 4 – 5 years reflect the Board and Management's ability to improve efficiencies with essentially the same amount of resources (53 - 55 permanent positions). Therefore, we are extremely disappointed that the Report misrepresents the facts and creates an environment that is demoralizing to the ERS staff that work diligently to service their members.

Response to Summary of Auditor Findings

In the three summaries of findings reported by the Auditor, we again find numerous inaccuracies and a clear demonstration of lack of understanding of the ERS. And in the case of Finding No. 2, we are appalled by the Auditor's disregard of the State's legal position by including inappropriate information and unsubstantiated conclusions included in the Report.

<u>**Finding No. 1**</u> – We acknowledge and agree with some of the issues identified in Finding No. 1 even though there are inaccurate statements and conclusions in the draft report that must be corrected.

<u>**Finding No. 2**</u> – We feel that the Auditor lacks expertise to make an accurate assessment of the computer system upgrade <u>or to make legal conclusions regarding the ERS' efforts to address problems associated</u>

with that upgrade. Rather than focus on the problems with the computer system, the Draft Report unfairly focuses on attempting to blame the ERS for allegedly failing to discover those problems without considering the efforts that the ERS has taken to remedy them. [Furthermore] incomplete factual information, inaccurate generalizations and unsupported legal theories were included in the report. Because of the ongoing legal action, reporting incomplete information and unsupported generalizations are irresponsible, and interferes with the ERS' ability to recover funds from the contractor it hired to upgrade the system.

Finding No. 3 – The finding fails to address the larger issue of ensuring that sufficient funds are available for current and future beneficiaries such as the legislative actions that defrayed over $1.6 billion in ERS excess investment earnings to reduce employer contributions. The Board has taken appropriate steps to ensure the sufficiency of beneficiary funds and fulfilled their fiduciary duty.

Finding No. 1 – Report's Conclusions Based on Wrong Information, Ignores ERS Successes and Use Anecdotal Evidence to Justify Preconceived Ideas

In finding No. 1, the Report states that the ERS has failed to provide its members with accurate retirement benefits and information in a timely and efficient manner. This is especially confusing considering the fact that the ERS accomplished a more than 92 percent accuracy rate in its first member statement mailing. The Report also does not seem to acknowledge the ERS' success in administering and processing tens of thousands of retirees' pension benefit payments despite facing numerous challenges that were beyond the ERS' control.

Therefore, in reviewing this finding, it was apparent that the Auditor's report lacks any perspective in its criticism of the ERS and relies on anecdotal evidence rather than overall performance.

For example, the Report states that benefits have not been finalized for ten of our members that retired between 1988 and 1998. But the report neglects to also mention that during that time, the ERS processed more than 13,000 retirees - **a successful completion rate of more than 99.99 percent**.

We acknowledge that the number of retirees on estimated pension benefits has increased, but the fact remains that the ERS took short-term and long-term steps to deal with the backlog. For our long-term approach, we performed a workload study considering all activities within the ERS, factored in the anticipated future increases with the baby boomers, and included other additional areas currently not done that would improve services to all members. The results of our study concluded that resources were insufficient to meet current and future needs.

The next step in the ERS' plan was to obtain legislative authorization for 6 new positions to compute retirement benefits for retirees. In its analysis, the ERS determined that the retiree group would increase from 30,330 in 2002 to over 42,000 in ten years. The 2002 legislature reviewed and analyzed the ERS' request and support, and recently agreed with the ERS that resources were needed to achieve its long-range plans.

Here is an example of where the Report criticizes the ERS for events outside our control. We will be filling the 6 positions by January 2003. To accomplish this, the ERS initiated the process in 2001 when the ERS performed the analysis that determined the need for additional resources. Like all other state agencies, the ERS submitted its budget request to the Department of Budget and Finance, then to the Legislature in January 2002 for approval. The Governor approved the budget request in June 2002 and signed the authorization to fill the positions in November 2002. Due to good planning, the required job descriptions were in place and the positions will be filled in January 2003 after interviewing all qualified applicants. Even though the process from the beginning up through filling of the 6 positions will take more than 1 year, it would have taken longer had the job descriptions been developed after receiving the Governor's approval.

The ERS followed up on its long-range plans with a reorganization analysis that included a review of all operational areas; duties; responsibilities; and interrelationships between branches, offices, employers, and members. The result of this review identified proposed structural changes that will occur over the next three to five years.

In the meantime, we realized that the backlog of finalizations was increasing and therefore we needed to take short-term measures to compliment our long-range plans. These measures included the formation of a project team, utilizing ERS employees from various branches, amending the Hawaii Revised Statutes to streamline the benefit calculation and processing of payments, changing procedures, implementing a more specialized process, automating manual tasks, and obtaining the assistance of other government employees. The result of these short-term initiatives reports a decrease in finalizing a pension benefit payment by an average of approximately one-half (1/2) hour per retiree pension benefit.

The Report incorrectly draws the conclusion that the use of temporary employees from other agencies "are questionable." The error rate from the use of these temporary employees was misstated. Approximately 25 percent was the actual error rate in the first few months of work and not 50 percent as identified in the Report. There were approximately 800 final pension benefit payments completed by these employees, and all of them were processed for payment. These temporary employees continue to assist with other finals processing that improves the ERS' output, including the completion of 600 retroactive pay adjustments and 30 prepped final pension benefits processed.

Auditor Draws Conclusions from Anecdotal Examples and Non-representative Samples.

We take exception to the Auditor's use of anecdotal examples to try to imply that those situations are typical of ERS customer service levels.

We acknowledge the problem created with the member who retired in 1988 and truly regret placing any member in that situation. However, steps have been taken to ensure that situations like this are prevented. Although this represents only one out of 30,330 retirees, the ERS' goal is to prevent any similar situation from occurring.

The audit report also identifies a retiree who was underpaid by $10,000, and the Auditor attributes this underpayment to "primarily because the retiree's accrued sick leave credits were not promptly adjusted into the retiree's initial benefit calculation." By the chart in Exhibit 2.1 of the audit report, instances like that should not occur as procedures have been implemented by the ERS to promptly process these adjustments after 3 months if not sooner. Had the Auditor's staff taken a representative sample from the population of unused sick leave credits processed, they would have discovered that a majority of the sick leave credits would have been included as years of service in the pension benefit computation within 3 months of receipt rather than the example contained in the Report. Again, we'd like to point out that the ERS had made significant improvements that question the conclusion in the Report that the ERS operations have "declined in efficiency and effectiveness."

The Auditor attempts to compare the time the ERS takes to finalize benefits to the one to two months it takes the federal government and large private corporations to finalize benefits. However, the Auditor has not cited their research to justify the comparison based complexity of plan provisions. We point out again that the ERS is one of the most complex retirement plans.

Auditor Missed Key Information Regarding Benefit Calculation Process.

In addition to an unfair characterization of ERS procedures, the Auditor's staff mistakenly assumed that the ERS requires only two pieces of information to finalize a benefit calculation when, in fact, the ERS requires nearly 100. This mistake led to a completely incorrect conclusion regarding the time required for final benefit calculations.

The ERS pointed out that final benefit calculations are often delayed because the ERS must wait for employee information from various State, city, and county departments. The Report states that this was not true because, except for the Department of Education, the departments provide vacation and sick leave information within 30 days. The 700 vacation and sick leave documents pending from the Department of Education represents 27 percent of the finals backlog dating back to retirees from 1998.

However, vacation and sick leave are not the only pieces of information we require to finalize a benefit calculation. We also need information such as breakdowns of salaries, salary overpayments, missing payments, descriptions of various leave without pay situations, workers compensation payments, per diem, percentage of full time equivalency (FTE), etc. Because of this, the ERS has faced situations where departments have taken years to provide all the information needed. In many cases, the ERS is still waiting for this information. For example, the ERS has not received information for over 100 requests to the Departments of Education and Health and the City and County of Honolulu for the past one to three years.

There were hundreds of others that have been recently received, but were outstanding for more than a year. Moreover, there are cases pending resolution of issues with the Department of the Attorney General, impact of which could have a widespread effect on specific groups of retirees. For example, the ERS was unable to finalize calculation of retirement benefits for more than 550 University professors until it received an opinion from the Department of the Attorney General. We had also sought an opinion from our deputy attorney general as to the proper treatment of large one-time salary payments received by thousands of employees. Hundreds of these employees have since retired, and the ERS is awaiting the opinion before these retiree pensions can be finalized.

Legislative session workers' payroll and personnel information is not sent to the ERS like other State and county employees. The legislature has been unable to work with the Department of Accounting and General Services to provide this information on the State Payroll System. This information is identified after the employee retires or files for retirement. In many cases, this service occurred more than ten to twenty years ago and will take time for the legislative staff to retrieve the information. So when the Reports states that the "length of time to finalize retirement benefits has increased," ERS staff is not working on a case continuously for over a year, but rather in many instances they are waiting for information from departments, or Attorney General opinions or guidance.

To the uninformed, this may seem to be a minor point, but this misunderstanding forms the basis of the Auditor's criticism of the ERS' ability to service our members in a timely manner. In addition, the conclusion reported by the Auditor that the ERS "is responsible for most delays" must be placed in its proper context. The Auditor reports that "our sample indicated that ERS was responsible for most of the finalization delays" yet there is no reporting of the sample tested to determine its pervasiveness. As previously described, there are thousands of retirees' pension benefits that were not finalized because the ERS was waiting for information from other departments. Thus, the Auditor's conclusion is puzzling. Was the sample large enough and properly gathered to be representative of the cause for not finalizing retirees' pension benefit payments timely or is it another case of drawing a conclusion from anecdotal examples?

ERS' Process Does Not Transfer Responsibility to Retirees

The Auditor mistakenly criticized the ERS' new efforts to improve the finalizing of benefits. The basis for the Report's criticism is based on incomplete and inaccurate information, again a lack of due diligence in research. The corrected table below depicts the correct process that has been in place since February 2002:

Exhibit 2.4
Report's Incorrect Versus ERS' New Benefits Calculations Process

Report's Incorrect Description of Process	ERS Process Effective February 2002
1. ERS requests additional information from retirees' department.	1. ERS requests additional information from retirees' department setting a 30 day deadline for reply
2. If no response received within 30 days, then:	2. If no response received within 30 days, then:
	• ERS contacts department by telephone; another memo is sent if necessary
• File is determined to be partially finalized and closed.	
	• If unable to obtain a timeframe for a reply, notations are made in file about the missing information and resulting computations

- Retiree must initiate information request from department.

- Letter sent to retiree explaining situation. **Letter does not transfer responsibility to retiree.** See Attachment III. Department is also copied on the letter to the retiree.

3. If no information received from the department two weeks after the letter is sent to the retiree, the file is determined to be partially finalized and closed.

3. If response received after 30 days, then file reopened by ERS.
   - ERS prepares final retirement benefits

4. If and when the information is received, then the file is reopened by ERS.
   - ERS prepares final retirement benefits

ERS also extends the deadline if the department needs a reasonable amount of time to complete the requested information. It is only upon failure to receive the required information from the department that the ERS will "partially finalize" and close the account. Since these accounts have been coded, the ERS will periodically schedule a print out listing of the "partially finalized" accounts and, again, attempt to obtain the information from the department.

The intent of the letter to the retiree is not to transfer responsibility, but instead, to provide the member with the status of his or her benefits and provide the retiree with their accurate pension amount based on information the ERS receives. In some cases, members were able to expedite the forwarding of information to the ERS resulting in a more timely finalization of benefits. We disagree with the criticism that this procedure creates more work, in fact, the opposite is true. Under this new procedure, the member may receive an increase in the benefit amount sooner than if the ERS were to keep the account open and wait for the department's response.

The Report attempts to emphasize that a little extra effort by the ERS to provide superior customer service by paying the member with the highest benefit possible based on the available information is inefficient.

Interest on Underpayments Merit Further Investigation

The ERS acknowledges that payment of interest for any underpayment of a retiree's final pension benefits, using 90 days after the retiree's retirement date is beneficial to the retiree and warrants further investigation with our deputy attorney general to determine its legality. In addition, discussion with the State and counties' finance agencies is needed to determine the financial impact on the Statewide budget.

Data Purification

Finding No. 1 continues by stating that the Data Purification Project was

Projects Proceeding Successfully

poorly planned and fails to provide timely and accurate information. After inputting over 13 million individual manual records, the ERS achieved a more than 92 percent accuracy rate. This is a success by anybody's measure and we disagree wholeheartedly with the conclusion contained in the Report.

Auditor Wrong in Assessment of Data Purification Project.

The first criticism of the project in the Report was based on a serious misinterpretation of Hawaii law.

The Report states, "Pursuant to Section 88-112, HRS, ERS management has the responsibility of providing its members with annual statements showing their accumulated contributions, if applicable and credited service years upon request. To fulfill this obligation…" This statement needs to be clarified. Section 88-112, HRS, specifically states that "A member shall be mailed an annual statement showing the member's accumulated contribution **upon request** (emphasis added)…" Furthermore, the Report incorrectly states that the statutes require the ERS to provide "credited service years upon request."

Hawaii law does not mandate the ERS to provide members with an annual statement nor does it even apply to Noncontributory members (Section 88-251, HRS) who have no accumulated contributions; however, the ERS has historically provided this service, sending Contributory members an annual statement with their contribution balance. The Data Purification Project was meant to help the ERS realize its ultimate goal of providing all members with an annual Statement (even though not required to) reporting contribution balances, credited service, beneficiary, and other information from the ERS files. This was part of the long-range plan for improving services to members.

The audit report goes on to say that "… after ten years, the goal of the Data Purification Project has yet to be achieved. The ERS is still unable to provide all active members with an accurate annual statement that reflects their years of creditable service."

This is another case where the Report lacks perspective.

The Data Purification Project involved the assimilation and purification of over 13 million payroll ledger records and 800,000 personnel documents over a 42-year period that were not consistently reported by employers, if reported at all.

Computer programs and sophisticated logic were developed from scratch to analyze this raw data and determine service credit. This resulted in 463,000 automated service credit adjustments. In January 2000, the 1999 Member Statements were issued to over 63,000 active and vested members of ERS. 5,564 members submitted service credit discrepancies/inquiries to ERS.

The bottom line is that, despite having to input millions of records for tens of thousands of members, the first time that the ERS produced the new statements we achieved an accuracy rate of more than 92 percent.

To say that the project failed to provide accurate information is misleading and just not true. Furthermore, not all of the 5,564 service credit inquiries required correction to the members' service credit balances; many were correct and merely needed clarification or an explanation, however each one had to be reviewed and processed with a written reply sent to the member. As a result, the true accuracy rate is greater than 92% initially reported or 58,000 statement balances. Moreover, 99% of the 5,564 inquiries were addressed by July 2002 with a balance of 75 inquiries remaining that will be completed within the next month.

The Auditor attempts to draw conclusions regarding the accuracy of member statements by testing a sample of 20 files out of the more than 63,000 statements issued. Aside from attempting to verify and draw conclusions on the accuracy of the member statements representing only .03 percent of those issued, the Auditor incorrectly reported the errors found in the test files. The Auditor's review covered only 18 cases, not the reported 20 (ten corrected cases and eight pending correction cases). The two errors identified in the report occurred in two of the ten corrected cases. The Auditor's statement that errors exist within both groups that were reviewed is incorrect.

The audit report further misleads the reader to believe that the ERS is maintaining a system that is "plagued with inaccurate data, which significantly impacts the accuracy and timeliness of the final pension calculation and payments to retirees." Just the opposite is true. Over 92% of our members have accurate/correct service credit data in our system. Service credit calculation has been automated. Consolidated worksheets are generated by the OSCAR system. The delay in the final pension calculation is not caused by discrepant service credit but by questionable salaries reported by employers such as retroactive pay adjustments and breaks in service that ultimately impact the accuracy of the average final compensation (AFC) calculation.

Other statements provided by the Auditor require explanation and clarity. According to the Report, "...the ERS was forced to expand its original two year project into three phases: a Data Purification Project, Total Purification Project, and Online Service Credit and Calculation (OSCAR)

Projects." The Data Purification Project (DPP) started in 1992. Computer programs were developed to automate the determination of service credit from January 1958 through June 1989 for active and vested members of the ERS.

This 'purified' data was supposed to be appended to the existing service credit in the WANG at the end of the project. Once DPP was completed, however, it no longer made sense to append the data to the WANG to create one database. The two sets of data would forever be 'out of sync' because the WANG programs were not as sophisticated as those in DPP. ERS made a decision to purify/adjust the WANG service credit data. The DPP programs had to be rewritten to accurately handle the WANG data on an ongoing basis. This effort occurred in TPP. Data from July 1989 through June 1996 was processed utilizing the new computer programs.

The OSCAR programs continued the efforts of DPP and TPP beyond June 1996. It also provided the retirement claims examiners with computerized consolidated service credit worksheets and member pay information from January 1958 and personnel documents – something they never had before; it enabled online manual adjustments to service credit; and the generation of the first annual Member Statement since the ERS began operations in 1926!. Again, we'd like to point out that the ERS had made significant improvements that question the Auditor's conclusion that the ERS operations have "declined in efficiency and effectiveness." The inaccurate phases of the projects as reported should be revised as follows:

Phases of ERS Data Purification Project

Project Phase	Objective	Scope of Project
DPP	Transfer payroll ledgers & personnel document information from paper files to computer database, determine service credit	1/1958 – 6/1989
TPP	Purify/adjust WANG-determined service credit	7/1989 – 6/1996
OSCAR	Generate consolidated service credit worksheets based on payroll and personnel data; provide basis for annual	7/1996 – current

Member Statements; purify/adjust WANG-determined service credit; enable manual online service credit adjustment

We also disagree with the conclusion contained in the Report that inadequate planning has delayed the project's completion. To reiterate: after DPP, annual Member Statements were not generated because of the need to purify/adjust the service credit data in the WANG to ensure that the data was 'in sync'. The "update" of members' creditable service could not occur until the WANG data was also purified.

The original plan to append the DPP data to the WANG was envisioned prior to the actual development of the DPP programs and the evidence of its worth. The consultant developed the DPP programs using Progress programming language on a personal computer independent of the WANG system. There was no interface to the WANG. Programs and logic utilized in DPP had to be rewritten to accurately determine service credit in TPP/OSCAR. (i.e., In DPP, base salary was not available so salary averaging logic used to determine whether or not credit should be given; in TPP/OSCAR base salary was available so salary averaging logic no longer necessary). This data was enhanced by the employer's computer systems after the DPP was undertaken. The ERS would not have been able to plan for these changes.

The ERS Addressed Workload Demands.

Contrary to that reported, the ERS is addressing its workload requirements and had not ignored its own workload data. As previously described, the ERS obtained legislative authorization for 6 new positions to address the current and increasing needs of retirees who are expected to grow to over 42,000 in ten years. Furthermore, the ERS conducted a reorganization analysis that identifies the proper structure under to which to operate and achieve its mission.

Temporary staff was used to assist with non-routine projects. They assisted with the processing of more than 3,000 additional retiree pension benefit payments in 1996 and 1997. In addition, these staff assisted with other non-routine projects such as the recomputing of pensions for retired teachers resulting from a court decision in 1998. More than 3,500 retiree pensions were processed. So, again the Auditor makes inaccurate conclusions that these temporary positions had "a questionable impact on productivity."

Another example of the ERS' prudent use of temporary workers is for the processing of over 9,000 claims and payment of a one-time $200 military bonus.

It would have been irresponsible of the ERS to create permanent positions for one-time or non-recurring activities.

The Auditor states that effective counseling is severely hampered by the "lack of priority" given to counseling. We strongly disagree. The Auditor mistakenly assessed the ERS' counseling services to its membership when indicating that counseling services has fallen behind in priority of the backlog of finalizing retirement benefits. This is not true since any member who requests an appointment is never denied an appointment for counseling!

ERS maximizes its resources to address the number of retirees remaining on estimated pension benefit payments, and provide counseling services to its membership. The ERS provides Group Filing Sessions during two peak periods, while providing other counseling activities outside of these periods. The ERS' peak periods are (1) June/July for the employees of the Department of Education and University of Hawaii, and (2) December for other employees who plan to retire at the end of the year. At these Group Filing Sessions, members are briefed as a group with general information of the retirement process and then counseled <u>individually</u> using information from the member's folder to provide the counseling services needed to address the member's questions about the features of the plans, payment periods, taxable impact, etc. The ERS has also held these sessions on Saturdays to accommodate the teachers', professors', and lecturers' work schedules.

These appointments do not include those who called or came in to the ERS for retirement counseling during the non-peak periods. These appointments also include those who file for disability retirement. The ERS staff has even traveled to members' homes and to various hospitals to take applications when the member was unable to come to the ERS. These services were provided during the evenings and weekends. Again, the ERS has never turned down any request for counseling services. As previously reported, the ERS had provided counseling services to its members for over 3,000 times during the fiscal year 2002.

In addition, the ERS staff contacts each member who mails his or her retirement application to the ERS. This is done to ensure that the member understands the option selected and to provide any other additional information needed by the member. ERS staff has also called members who live outside the State to provide phone counseling on their retirement benefits.

As for our neighbor island retirement claims examiners, any member who requests an appointment will get an appointment. All mail in applications are scheduled for phone interviews if the member is unable to come to the office. Our Hawaii representative whose office is in Hilo travels to Kona to counsel the members. Our Maui representative travels to Molokai and Lanai to serve of our membership regularly. Again all applications mailed in to our neighbor island offices will receive counseling at the office or by phone.

In addition, the ERS staff enrolls active members to retired status on their health fund medical coverage, which is administered by the Hawaii Public Employees Health Fund, and not the ERS. The ERS' proactive approach is to ensure that members have a "one stop" shop where all their retirement needs and requirements can be fulfilled. As a result, we continue to be puzzled by the inaccurate conclusion (in this case) that there is a "lack of priority" given to the counseling function.

FINDING NO. 2 – Auditor Lacks Expertise to Make Accurate Assessment of Computer System Upgrade and Inappropriately Discloses Sensitive Information.

The conclusions in Finding No. 2 are especially curious because, in addition to having no experience in a major computer system upgrade, it was literally impossible for the Auditor's staff to review the more than 200,000 documents related to the project in the time allotted in order to make a reasonable assessment.

However, we completely agree with the Auditor's description of the ERS computer system as "outdated and obsolete." This has been a serious concern for the ERS for several years, and the ERS has been involved in a difficult system upgrade. We also agree that the upgrade has taken longer than originally planned and has been plagued with problems.

This is why the ERS is currently involved in a legal action against the computer contractor and other related parties in the implementation of its new computer system.

Of concern to the ERS is the fact that the report inappropriately discloses sensitive information on the continued legal actions being pursued by the ERS against the contractor. Unfortunately, there were numerous incorrect allegations and conclusions about the project and the ERS' oversight consultant within the report that could jeopardize the ERS' and State's position in its actions against the contractor. Millions of dollars are at stake. The Auditor took a one-sided approach by including the contractor's incorrect allegations and conclusions and excluding majority of the ERS' position. This inappropriate approach by the Auditor led to a biased and unfair reporting of the situation that misleads the readers of this report, and could financially hurt ERS members and the State rather than helping them.

Since it was included in the draft report, the ERS must address the incorrect assertions and conclusions regarding the problems with the ARIES computer system. Attachment I (including Exhibits A through D) is the documentation provided by ERS' legal counsel that addresses the Auditor's assertions.

However, we also want to again point out that the Auditor's assessment is questionable at best because the Auditor's staff has little or no experience in large-scale computer system upgrades or direct project management in the implementation of multi-million dollar computer systems. In addition, the system upgrade produced in excess of 200,000 pieces of documentation, and it was literally impossible for the Auditor's staff to review all the necessary material in the time available to make a reasonable, informed conclusion.

Finding No. 3 – Audit Fails to Account for Recent Performance and Improvements Due to Board's Long-Term Strategy

Finding No. 3 states that the ERS Board of Trustees needs to improve its management and investment strategy over its assets.

The Board agrees that the long-term relative performance of the ERS has failed to meet our performance benchmarks and accepts responsibility for these lackluster results. Nonetheless, the long-term relative performance also reflects legacy issues that the Board has been actively working to correct – a fact totally ignored by the Report. Instead, by omission, the Report makes it seem as though the Board has been sitting on its hands and doing nothing to improve its investment management processes. The Report is very misleading in this respect as there has been considerable progress made by the Board over the last three years in improving the management of the ERS' investment portfolio.

This progress is demonstrated by the Board's adoption of well-crafted investment policies and guidelines that even the Auditor's technical consultant glowingly praised. Moreover, had the Auditor reviewed the Board's minutes they would have revealed the active implementation of those policies and guidelines by the Board and considerable management actions taken over the past three years. These include numerous terminations of investment managers and other actions such as watch-listing and warning letters taken to ensure compliance with the policies and guidelines. In addition, the Board has taken many other actions to reduce the fees and costs associated with the management of the investment portfolio.

Because of the glaring weaknesses in the Auditor's assessment we asked our investment consultant, Callan Associates, to respond to various issues raised in the Report. Callan's response is attached to this response as Attachment II.

The good news is that the ERS strategy combined with adherence to policies and the major changes in investment managers by the Board is working. The ERS has beaten its benchmarks for the last three years and is in the 47th percentile of all public funds for the fiscal year ended June 30, 2002. It is not objective to criticize the current position of the fund by citing only three and five year numbers while ignoring recent positive changes that are not fully reflected in the long-term results.

The Auditor's Own Technical Consultant Praised the ERS Investment Policy as Being Among the Best.

In 1995, the Board of Trustees adopted its *Investment Policy and Procedures Manual, which* is annually updated and serves as the guiding document for management of the investment portfolio. Despite this, the Auditor states: "We found that while ERS has developed documentation meant to guide the Board's investment decisions, this documentation consists merely of broad statements that are not linked to specific plans of action or lines of responsibility." In addition, on an annual basis, the ERS' consultant submits a detailed work plan that includes a review of the asset classes and managers to the Board.

The Board is surprised at this statement made by the Auditor, particularly if the sentence quoted from the Report refers to the *Board of Trustees Investment Policy and Procedure Manual.* As stated above, our surprise is due to the fact that the Auditor's technical consultant, Mr. Allan C. Martin of New England Pension Consultants, Inc., was unequivocal in his praise of the *Investment Policy and Procedure Manual* which he described as "one of the best he has ever reviewed."

In view of the unsolicited and unqualified praise of the Investment Policy and Procedure Manual orally communicated by Mr. Martin, the Board is astounded by the unspecific and unsupported statements made by the Auditor.

The Auditor also claims "the Board has been distracted from overall policy and goal setting, and has taken on administrative and other tasks that might be better delegated to the ERS staff."

Again, this broad and unsupported statement leaves the Board at a complete loss as to what is being referred to. As a volunteer Board, the Board relies heavily on the ERS staff and consultants. The Board retains discretionary decision-making authority over policy issues and material financial decisions. Where appropriate, the Board continues to delegate responsibilities to ERS staff in accordance with principles of prudent investment. In fact, the Board recently amended the Investment Policy and Procedures Manual to authorize the CIO to make portfolio rebalancing decisions consistent with our asset allocation strategy.

If the Auditor believes there are other tasks that the Board has taken on that should be delegated to the ERS staff, the Board would certainly be interested in learning what those specific tasks are.

Criticism of Reliance on Investment Consultant Unfounded

The Auditor criticizes the Board's reliance on its investment consultant in selecting investment managers. The apparent basis for this criticism is the contention that "the consultant's objectivity could be suspect, since the consultant has disclosed financial relationships with the majority of investment managers it has recommended to the Board."

The implication of the Auditor's comment is that our investment consultant's judgment and performance of services may have been deficient because of a conflict of interests. This alarming allegation by the Auditor is disturbing, especially since the Auditor admits on page 37 of her report that our investment consultant's financial relationships do not "technically [represent] a conflict of interest." If the Auditor were to support her report with some analysis that would indicate that the investment manager searches performed by our investment consultant offered up candidates who were not qualified or capable of performing consistent with the investment objectives of the ERS, it would be one thing. However, the only supporting basis for the Auditor's criticism is the observation that out of 16 investment managers recommended over an extended period, 14 were investment managers with some sort of disclosed financial relationship from which 3 were ultimately selected. This analysis fails to consider the materiality or lack of materiality of any disclosed financial relationship between the investment managers and the investment consultant. Although interesting, such an analysis falls short of being sufficient evidence of any impropriety to support the level of alarm suggested by the Auditor.

Moreover, the process employed by the Board in utilizing the services of its investment consultant to assist in investment manager searches remains the prevailing standard in the public pension field. Our investment consultant performs identical services for over 80 other Public Pension Funds throughout the country with assets of almost $800 Billion. Were the Auditor's criticism valid, then there are literally dozens of other Public Pension Fund Boards that could be accused of "failing to properly manage [their] beneficiaries assets" because of their reliance on the same investment consultant.

Auditor Criticism of ERS Organizational Structure Gross Misstatement and Unwarranted

The Auditor makes the observation that: "In contrast, Hawaii's CIO is selected by the board but reports to the ERS Administrator. This arrangement not only differs from common practice but is also fundamentally unsound, since the Administrator is responsible for ERS operations and not investments." The Auditor then cites an example from another fund where the CIO reports to an "Executive Director", an arrangement similar to ERS.

This criticism is curious at best. Currently, the ERS Board is specifically charged with the authority to hire the CIO pursuant to Hawaii Revised Statutes Section 88-22. Since that law was enacted, the ERS organizational plan has prescribed that the CIO reports to the ERS Administrator who is akin to an "Executive Director" and who in turn reports to the Board. Why that is "fundamentally unsound" is puzzling since the ERS Administrator's position description does charge him with oversight responsibility for both operations and investments.

Furthermore, as a practical matter, there is currently no impediment to the CIO's ability to communicate directly with the Board. In fact, the CIO regularly communicates with the Board and attends all Board meetings. The CIO is also the principal ERS staff member interacting with the Investment Committee of the Board.

It is troubling that the Report does not mention that in June 2002, the Board had already undertaken a review of the reporting line of the CIO and has since been evaluating a change to require a direct report to the Board with an indirect reporting line to the ERS Administrator. However, because there are issues regarding continuity and structure that need to be more carefully considered before effecting a permanent change the Board is proceeding deliberately. Nevertheless, for the Auditor to suggest that the current structure is "fundamentally unsound" is unwarranted and a gross misstatement.

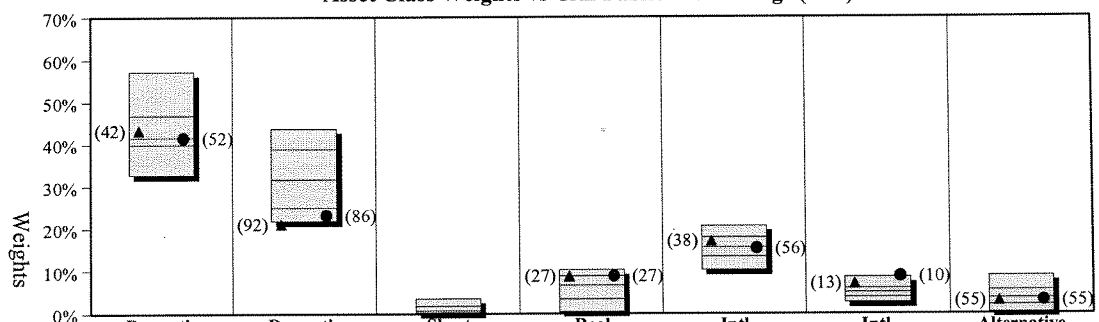
Audit Failed to Recognize Positive Performance Trends.

As stated above, the ERS has been consistently outperforming its strategic benchmark over the past three years, a continuing trend which means that the investment managers have been outperforming the market averages. In addition, the ERS ranked in the top half of all public funds in 2002, and the top third in the last quarter of this year.

Yet, the Auditor focused on the three and five year performance versus other public funds. This is a poor comparison because ERS objectives and investment strategies are different from the average public plan. These differences are a function of ERS' history and its unique funding situation.

As a result of individual objective and investment strategies, most public funds, including the ERS, perform quite differently than the average public fund. In fact, if you look at the chart below of large public fund asset allocations, most public funds are different than the median public fund in all asset classes except short-term/cash.

June 30, 2002
Asset Class Weights vs CAI Public Plan - Large (>1B)



	Domestic Broad Eq	Domestic Fixed-Income	Short Term/Cash	Real Estate	Intl Equity	Intl. Fixed-Inc.	Alternative Inv.
10th Percentile	57.19	43.76	3.50	10.23	20.60	8.52	8.88
25th Percentile	46.79	38.91	1.80	8.80	17.79	5.92	5.49
Median	41.60	31.65	0.70	6.58	15.49	4.93	3.64
75th Percentile	39.96	24.95	0.26	3.38	13.30	3.82	1.96
90th Percentile	32.74	21.80	0.10	0.41	10.21	2.61	0.27
Fund ●	41.44	23.07	-	8.68	15.17	8.67	2.98
Target ▲	43.30	21.00	-	8.70	17.00	7.00	3.00
% Group Invested	100.00%	100.00%	69.05%	61.90%	92.86%	38.10%	66.67%

This chart shows that there are significant ranges of allocation in each asset class adopted by individual public funds. The dots on the graphs are the ERS asset allocation exposures. It should also be noted that some large public funds do not have an allocation to real estate, international bonds or stocks, or alternative investments as the ERS does.

Therefore, if the ERS wanted to adopt a strategy that would make it relevant to compare its performance against other public funds, the Board would merely select the median allocation for each asset class. This, of course, is not how asset allocation policy is set. ERS has a unique set of funding preferences and legacy issues that has led it to have a unique allocation.

For example, due to the contribution risk (the skimming of past contributions by the state), the Board has elected to be slightly more aggressive in their investment strategy than the average public fund with bond exposures averaging about 5 points less than the median fund. However, the real story is the ERS' unique structure and asset allocation of the investment portfolio.

Real Estate – This allocation has been historically large relative to other public funds with the weight of the portfolio in non-performing local investments. The current real estate program is in the process of building a fully diversified program and "working out" the underperforming assets. However, real estate, and particularly local investments in the past, has been a major culprit in poor performance relative to other public funds over the years. The current real estate program underway will turn this around. However, it will take many years for the poor investments of the past to work their way out of the performance statistics.

International Equity – The ERS was one of the first public fund investors in international equity. The first investments were in Japan. They were very productive with initial returns in the 40% range. However, subsequent returns from that region over the past 15 years have been poor. The large Japanese exposure (Pacific Basin mandate) has had a significant negative impact on relative performance to other public plans for the last 15 years, a condition that has only recently been removed. A separate mandate to emerging markets is also different from most public funds.

International Bonds – The ERS has maintained a much higher exposure in non-dollar bonds than other public funds. This exposure has hurt performance historically as the dollar strengthened. However, with the current weakening of the dollar this is currently one of the best performing asset classes.

Active vs. Passive Management – During the bull market years, passive management outperformed active management. This is a regular cycle that recently has reversed itself. Typically, the larger the public fund, the more passive management is employed. This helped the performance of some of our larger public fund peers in the bull market, but the ERS underweight in passive management has helped ERS' relative performance more recently.

Other factors that have affected performance relative to other public funds and also relative to the benchmark have been:

- An historical reluctance to manage to the asset allocation targets and rebalance the portfolio.
- An historical reluctance to terminate underperforming managers in a timely basis.
- The historical reluctance to manage investment manager parity with respect to portfolio size.

The current Board and ERS staff have corrected these issues and are managing these critical factors going forward. The good news is that the ERS strategy combined with the new disciplines being used is working. For the year ended June 2002, the ERS ranked in the 47th percentile, the last ½ year in the 36th percentile, and the last quarter in the 34th percentile of the ERS consultant's large public plan database. These good rankings against other public funds will find their way into the long-range rankings eventually as the markets continue to favor ERS strategy and ERS managers continue to perform. The improvement of results relative to the strategy, which is much more accurately measured by the benchmark, is already reflected in our June 2002 performance report.

	Periods Ended June 30, 2002				
	Last Quarter	Last ½ Year	Last Year	Last 3 Years	Last 5 Years
ERS	-4.08	-3.25	-5.08	-1.70	4.00
Benchmark	-4.72	-4.49	-6.54	-2.48	4.07

While the ERS accepts the responsibility for these poor long-term results, why aren't the current Board, ERS staff and investment managers given some credit for the performance improvements that have taken place over the past three years as a result of our well-documented decisions regarding investment disciplines and strategies?

Report in Error Regarding Watchlist Criteria.

The Auditor's Report is in error in saying an additional nine managers fail watchlist criteria as of June 30, 2002. According to ERS guidelines no other managers qualify for watchlist status than the five who are already on the watchlist. Watchlist guidelines have been precisely followed by the ERS. The Auditor has grossly misinterpreted our guidelines. If the Report was more specific, the Board could explain the misinterpretations.

Board Followed Prudent Process in Dealing With 3Bridge Capital and Did Not Lose Millions of Dollars.

The legislative resolution prompting this audit was triggered in large part due to newspaper reports regarding the Board's handling of the investment management engagement of 3Bridge Capital. Because those newspaper reports failed to provide an adequate context in which to comprehend the Board's actions, the Board viewed the audit as an opportunity to ensure that a proper elucidation of the facts underlying their decision-making process was disclosed.

Instead, the Auditor rehashes the same information reported in the newspaper and sheds no new light regarding the reasons that belie the Board's action. Clearly, the Auditor squandered the opportunity to obtain and report on the full set of facts regarding an event that prompted the audit. As a consequence, we take it upon ourselves to relate those facts to provide a fuller context for comprehending the

Board's actions relating to 3Bridge.

The Auditor's criticism of the Board's handling of the 3Bridge situation shows a lack of knowledge of the history of the manager's tenure. Furthermore, the Auditor does not provide sufficient evidence and details in the report, and therefore fails to support her statement that "the ERS loss could have been as much as $128 million."

There are two logical approaches to determine what employing 3Bridge might have cost the ERS. The first way is to combine the $25 million the ERS withdrew in late 1997 together with the $275 million in total the ERS received from 3Bridge upon the reduction in assets and ultimate termination of the portfolio in 2002, and compare that against the $85 million invested with 3Bridge and its predecessor firm, Hanson. This would have resulted in a gain of $215 million.

The second approach is to compare the final market value of the 3Bridge portfolio ($118 million) against a simulated value of the firm's benchmark, the S&P 500 (net of fees and subject to identical cash flows). The benchmark would have had a final market value of $192 million. The difference between the two represents an opportunity cost of $74 million, not an actual loss of funds. In fact, as demonstrated in the first example above, 3Bridge was a profitable investment since inception.

3Bridge (formerly named Hanson) had been employed as a large cap value manager by ERS since the 1980's. In 1994, after a period of underperformance, 3Bridge/Hanson ranked poorly versus their large cap value peers. At that time, the Board showed patience with 3Bridge/Hanson and kept them on the ERS' roster of managers. That patience was rewarded as 3Bridge/Hanson was one of the best performing large value managers throughout the mid-late 1990's. In fact, as of December 31, 1999, 3Bridge/Hanson ranked in the top quartile of large value managers for the trailing ¼ year, ½ year, 1 year, 3 year, 5 year, 10 year, and 12¾ year (inception) periods. For the trailing 3 and 5 year periods (periods used by ERS as watchlist criteria) 3Bridge ranked 9^{th} and 12^{th} respectively.

3Bridge began a period of underperformance in 2000 as the equity markets shifted down. From the beginning, the Board displayed sound judgment when addressing the 3Bridge situation. The Board monitored the circumstances closely quarter by quarter, placing 3Bridge on the watchlist and holding several face to face meetings with 3Bridge's Chief Executive Officer. In addition, the Board directed the ERS' CIO to conduct an onsite visit at 3Bridge headquarters. The Board was aware of 3Bridge's history of rapid recovery and was confident in the firm's ability to return to competitive status.

As the underperformance continued, the Board took steps to reduce the performance risk by terminating half of the portfolio, while still leaving open the upside possibility of a 3Bridge recovery. The decision to reduce the portfolio is consistent with the Board's handling of underperforming investment managers in the past. The Board has a history of taking half of the assets from an underperforming investment manager to reduce current risk while leaving open the possibility of an upswing in performance. Most recently, this strategy has worked successfully with Delaware Investment Advisors, whose assets were halved in 2000, but is now one of ERS' best performing investment managers. In the end, as 3Bridge did not show sufficient improvement during 2002, the Board terminated the investment manager in August 2002.

All investment managers go through cycles of underperformance. In the case of 3Bridge, with a history of recovering from such cycles, it was entirely reasonable to monitor the situation for some signs of improvement. Frequent manager turnover or rash termination decisions are expensive and often unwise. Many times, they result in situations where a fund sells one manager at a low point and buys another at the peak of performance. At every turn, the Board showed prudence in their handling of 3Bridge; first by showing patience given their first-hand knowledge of the manager's history of cyclical performance, and second by terminating the advisor when improvement was not sufficient.

RFP Process Recommended by Auditor is Obsolete by Current Standards

We are surprised at the Auditor's hard sell of a regular public RFP process for investment managers to take place every three or four years. As pointed out by Callan Associates, this is a practice that has been abandoned by all but a few public funds. The availability of data on all institutionally viable investment managers, their performance and fees charged makes this practice obsolete and unproductive.

Many investment consultants have limited research staff and are unable to cover the universe of institutional managers. Instead, they work off select lists, a subset of the universe that they can comfortably research. When using a consultant like this, a public RFP would be useful.

The ERS investment consultant has the research resources to cover the entire industry. All institutionally viable investment managers are included at the onset of each ERS search. Our consultant's universe is regularly validated through their research efforts, searches for major institutional clients, and comparison with the actual results of their fund sponsor clients who utilize over 500 investment management organizations.

For investment management firms on asset based fees, the benefits of periodic RFP re-bidding are questionable. The cost of performance (fees) and the benefits of performance are continuously being compared and reviewed (re-bid) against the manager's competition in each quarterly investment performance review. The value added of a manager is actually re-bid against the competition every quarter and their fees are directly related to the performance (value added) of the funds they manage. Managers are being warned, placed on a watchlist and terminated based on a continuous "re-bidding" process in real time against their peers.

Initiating a regular RFP cycle would, in our opinion, create an opportunity where terminations and new hires might be delayed unnecessarily until the RFPs are initiated or worse yet, investment managers might be let go prematurely creating the opportunity costs of a missed recovery. It is also difficult to justify the cost, time and distractions of an RFP process with the RFP creating little more information than is already available from our consultant.

In the ERS' specific case, we fear that fees, might go up unnecessarily if periodic re-bid opportunities existed for some long tenured current managers. Some ERS managers have asset-based fees that were negotiated long ago. In some cases, these managers could now competitively demand higher fees if given the chance. The ERS recently had two situations where a demand for higher fees were made. We required both managers to stay at their previous fee levels. We believe the ERS should continue to receive the advantage of the fees they originally negotiated with these managers.

The bottom line is that we already know how competitive ERS investment management fee costs are through our consultants' periodic fee studies. We also know how competitive these fees have been through our consultants' quarterly performance reviews. What additional benefits would a periodic RFP process produce given the time and expense to manage such a process?

Furthermore, the ERS requires the investment managers to comply with its "favored nation" practice and this has resulted in lower management fees each year. The ERS' investment expenses are approximately 2 basis points lower than other pension funds average expenses.

The major problem with the public RFP process is that there is no easy way to validate the submissions. While the process sounds good conceptually, RFP responses can often be a maze of apples and oranges to decipher. Information can be inaccurate or just plain wrong. Information from our consultant's database has been scrubbed and verified for accuracy which allows for appropriate and useful comparisons in our decision making process.

We are puzzled by the Auditor's concern that 13 of our managers have been with the ERS for over 15 years. We view this as positive as changing managers frequently can cause timing risks. There is a tendency to buy a manager high (hire those with good recent performance) and sell a manager low (terminate those with poor recent performance). Good institutional practice supports consistency and continuity in promoting good long-term results. One doesn't achieve this with high manager turnover or timing the market with investment strategy changes. Good investment management organizations tend to remain so over long periods of time even though they will have good and poor performance cycles. The Board is looking for stability and consistency in their manager selections, not the latest "hot" managers.

Auditor Lacks Knowledge About Manager Search Process

Simply put, the Auditor's comments concerning the ERS manager search process are wrong and reveals an absence of due diligence.

There appears to be no knowledge by the Auditor of the search process employed by our investment consultant. In fact, as pointed out in Callan Associates' letter, Callan was never even contacted by the Auditor's staff or technical consultant. We believe this is a major oversight since suppositions and assumptions about our search process made their way into the Auditor's Report.

Our investment consultant is a major national firm. Their investment manager search database contains all institutionally viable investment management organizations (over 1,400 firms) and is open to any firm willing to submit a questionnaire. Each ERS search begins with establishing the specific criteria for the search qualifications as a basis for conducting the search. All investment managers in the database are initially considered but are screened by our consultant's Global Manager Research Group on this criteria. Our consultant's Manager Search Committee, comprised of senior management, regional managers and senior consultants, confer and approve a list of qualified candidates from the screens conducted by investment manager research. The ERS Board and staff are able to make requests for investment managers to be specifically considered and are involved in the decision- making process through its conclusion. Reports are compiled on semifinalists showing comparative data on each

investment firm. The Board interviews their selection of finalist investment managers and makes all hiring decisions.

There is No Conflict in Consultant Relationships

The Auditor suggests that our investment consultant "may have a conflict of interest in recommending investment managers to the Board." The basis for this contention is that the investment consultant has "disclosed financial ties to the majority of investment advisors it has recommended to the Board."

The statement by the Auditor is a curious one since she later concludes that the "disclosed financial ties" of the investment consultant do not "technically" represent a conflict of interest. Instead, she suggests that "the motivation [of the investment consultant in recommending] particular investment managers warrants close scrutiny." The Auditor then goes on to assert that the "existence of such relationships should compel the Board to supplement the consultant's recommendations with other criteria."

The Auditor's logic in suggesting the existence of a conflict of interest on the part of the investment consultant is very troubling. This section of the Report casts an unwarranted shadow on the credibility of our investment consultant. The ERS' investment consultant is a highly regarded investment advisory firm with an unblemished reputation for integrity. The characterization of the investment consultant in the Report undeservedly maligns its reputation.

The financial relationships which the Auditor claims to have "found" were disclosed by our investment consultant long before the Auditor's inquiry. There has been no concealment of any relationships. Furthermore, there is no basis to support any contention that the investment consultant at any time recommended to the Board any investment manager for selection that was not fully qualified and with a strong performance history.

The ERS' investment consultant provides advisory services to more public pension funds than any other investment consultant. In fact it utilizes the same investment manager search process for dozens of other Public Pension Fund clients. Are these dozens of other Public Pension Fund Boards failing to perform their fiduciary duties because they have relied upon the same investment consultant?

Using the Auditor's logic, one is left to question the credibility of the Auditor's own technical consultant. After all, New England Pension Consultants, Inc. was an unsuccessful competing bidder when the investment consultant was hired in 2000. Moreover, New England Pension Consultants, Inc. regularly competes with our

investment consultant for other engagements with other public pensions funds. Does that fact suggest that the Auditor's consultant has a potential <u>undisclosed</u> "conflict of interest" and that "the motivation [of the Auditor's technical consultant in arriving at its findings and conclusions] warrants close scrutiny."?

Recommendations are Too General and Lack Substance to Derive Any Benefits

The Auditor's recommendations fail to provide the details and substance to make any improvements to the ERS operations. Many of them only provide general statements that the areas need to be "better" or "replace" or "delegate." As previously stated, the ERS was looking to this audit as an opportunity for reporting on the progress and for finding ways to continue its operational improvements. We were disappointed that the recommendations lacked sufficient information and descriptions on ways to properly implement them. Could this be that the Auditor had a limited understanding of the ERS, and was therefore unable to provide the specificity needed to make substantive suggestions?

CONCLUSION

We understand the importance of what the Auditor attempted to accomplish. The ERS is responsible for the financial security of thousands of government employees. This is a responsibility that the ERS' Board of Trustees, Management and staff take very seriously and have incorporated our commitment into the ERS' mission statement and work diligently to accomplish:

> "....to provide superior services to members in a cost-effective manner through qualified personnel while maintaining the highest ethical standards."

And this is why it is equally as important that we help clarify the points raised by the Auditor, which are largely based on incorrect information. The ERS Board and Management have been vigilant in executing its fiduciary responsibilities by making significant progress in providing services and protecting of trust assets, and are looking to the future for the betterment of its members, retirees, and beneficiaries.