KPMG

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Financial Statements

June 30, 2012

(With Independent Auditors' Report Thereon)

Submitted by

THE AUDITOR
STATE OF HAWAII

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

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Independent Auditors' Report

The Auditor
The State of Hawaii:

We have audited the accompanying statement of plan net assets – all trust funds of the Employees' Retirement System of the State of Hawaii (the ERS) as of June 30, 2012 and the related statement of changes in plan net assets – all trust funds for the year then ended. These financial statements are the responsibility of the ERS' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ERS' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the Employees' Retirement System of the State of Hawaii as of June 30, 2012, and its changes in plan net assets for the year then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 29, 2014, on our consideration of the ERS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 10 and required supplementary information on pages 38 through 39 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the ERS taken as a whole. The supplementary information included in schedules 1 through 4 for the year ended June 30, 2012 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The supplementary information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

July 29, 2014

Management's Discussion and Analysis (MD&A) of the Employees' Retirement System of the State of Hawaii (the ERS) provides highlights and comparisons of the financial position and performance of the ERS as of and for the year ended June 30, 2012. The MD&A is presented as a narrative overview and analysis in conjunction with the Letter of Transmittal, which is included in the Introductory Section of the ERS Comprehensive Annual Financial Report (CAFR). For more detailed information pertaining to the ERS' financial activities, the reader should also review the actual financial statements, including the notes and supplementary schedules.

Overview of the Financial Statements

The ERS is responsible for administering a defined-benefit pension plan for state government, local government, and public education employees in the State of Hawaii (the State). The ERS also oversees the short-term investments of the federal Social Security employer contributions for the State in the Social Security Contribution Fund (Contribution Fund).

The ERS' financial statements include fiduciary type funds that are used to account for resources held for the benefit of parties outside of the ERS. The primary fund is defined as a Pension Trust Fund as these assets are held for the benefit of its members and their beneficiaries for the payment of pension benefits, while the Contribution Fund is an agency type fund that is custodial in nature. Throughout this discussion and analysis, units of measure (i.e., billions, millions, and thousands) are approximate, being rounded up or down to the nearest tenth of the respective unit value.

This discussion and analysis is intended to serve as an introduction to the ERS' financial reporting, which comprises the following components:

- The combining statement of plan net assets provides a snapshot of the financial position of the ERS at June 30, 2012. This financial statement reflects the resources available to pay benefits to members, including retirees and beneficiaries, at the end of the fiscal year reported.
- The statement of changes in plan net assets summarizes the ERS' financial activities that occurred during the fiscal year from July 1, 2011 to June 30, 2012 (FY 2012). This financial statement measures the changes in the resources available to pay pension benefits to members, retirees, and beneficiaries for fiscal year 2012.
- The notes to financial statements provide additional information that is essential to a full understanding of the financial statements. The notes are an integral part of the financial statements and include detailed information that is essential to a full understanding of the data provided in the basic financial statements.
- The required supplementary information immediately following the notes to financial statements provides two schedules showing historical actuarial information concerning the funded status of the ERS and the employer contributions, along with related notes.
- The remaining supplementary information provides additional detailed information concerning the changes in operating funds established by legislation, and the operating and investment-related expenses of the ERS.

Financial Highlights

- As of June 30, 2012, plan net assets were $11.3 billion or a decrease of about $0.4 billion during the fiscal year then ended. This represents a decrease of approximately 3.1% from the $11.7 billion in plan net assets available as of June 30, 2011. The decrease of plan net assets in FY 2012 reflects the negative investment returns in the non-U.S. equity markets.
- During FY 2012, the ERS investment loss was 0.1% on pension plan assets due to investment losses in the international equity markets that overshadowed the positive returns in other asset classes.
- Additional pension legislation was passed in 2012 to help improve funding of the pension trust and to counteract perceived pension spiking issues. The ERS collects additional contributions for employees who were first hired prior to July 1, 2012, and retire after June 30, 2012 if the retiring employee has significant non-base pay increases included in their average final compensation. The additional contributions, collected from their last employer, are equal to the actuarial present value of the additional benefits earned due to the "excessive" non-base pay increases. For members first hired after June 30, 2012, legislation enacted eliminates most types of non-base pay from the definition of compensation that is excluded in determining both contributions made by and on behalf of these employees and the retirement benefits these employees will earn. A historical summary of legislation impacting the ERS actuarial valuations is located in the "Summary of Plan Changes" in the Actuarial Section.
- The funded ratio decreased to 59.2% as of June 30, 2012 from 59.4% as of June 30, 2011 while the corresponding unfunded actuarial accrued liability (UAAL) of the ERS increased to $8.4 billion from $8.2 billion, respectively. During 2012, the ERS' underfunded status increased primarily due to continued recognition of investment losses as a result of the severe downturn in investment markets during the fiscal year ended June 30, 2009. The recognition in investment losses was slightly offset with a liability experience gain primarily as a result of lower than expected salary increases in the year.
- Total member and employer contributions decreased by $40.8 million, or 5.3% during FY 2012. The contributions decrease during FY 2012 is primarily attributed to the completion in one-time Hybrid Plan Upgrade Payments in FY 2011. Normal employer and member contributions increased in FY 2012 due to an increase in covered payroll resulting from more active members and elimination of the furloughs of employees.
- Total retirement benefit payments increased by $55.3 million, or 5.8%, to $1,015.5 million in FY 2012 compared to $960.2 million in FY 2011. Pension benefits continues to increase due to 2.7% more retirees and beneficiaries (40,774 in 2012 compared to 39,689 in 2011), an increase in the average pension benefit for new retirees, and the annual 2.5% postretirement increase.
- Administrative expenses decreased by $1.7 million in FY 2012 to $11.6 million compared to $13.3 million in FY 2011. Administrative expenses for all years were within the ERS' budgeted amounts. The decrease for FY 2012 was primarily due to lower computer system maintenance costs and the elimination of the backlog in finalization of pension benefits.

(Continued)

Analysis of Plan Net Assets for Pension Trust

Summary of Plan Net Assets

June 30, 2012

(Dollars in millions)

		2012	2011	FY 2012 percentage change
Assets:				
Cash and cash equivalents, and short-term investments	$	516.5	480.8	7.4 %
Receivables		303.4	354.8	(14.5)
Investments		11,363.1	11,553.0	(1.6)
Invested securities lending collateral		923.9	963.2	(4.1)
Equipment		7.3	8.4	(13.1)
Total assets		13,114.2	13,360.2	(1.8)
Liabilities:				
Securities lending liability		923.9	963.2	(4.1)
Investment accounts and other payables		897.3	742.6	20.8
Total liabilities		1,821.2	1,705.8	6.8
Plan net assets	$	11,293.0	11,654.4	(3.1)

Summary of Changes in Plan Net Assets

June 30, 2012

(Dollars in millions)

		2012	2011	FY 2012 percentage change
Additions:				
Contributions	$	730.8	771.6	(5.3)%
Net investments (loss) income		(57.8)	2,040.0	(102.8)
Total additions		673.0	2,811.6	(76.1)
Deductions:				
Pension benefit payments		1,015.5	960.2	5.8
Refund of contributions		7.2	7.9	(8.9)
Administrative expenses		11.6	13.3	(12.8)
Total deductions		1,034.3	981.4	5.4
(Decrease) increase in plan net assets	$	(361.3)	1,830.2	(119.7)

Investments, Investment Income, and Investment Expense

The ERS is a long-term investor and manages its pension assets with long-term objectives in mind. A primary element of the ERS' investment philosophy is diversification among various asset classes. The ERS makes estimates of long-term market returns and establishes an asset allocation strategy taking into account the risks associated with each asset class.

The ERS investment portfolio had a slight loss during FY 2012 with a (0.1)% return on assets due to losses in the international equity markets. The real estate and private equity markets earned rates above the 7.75% total portfolio benchmark return while the fixed income and domestic equity markets earned positive returns.

The real estate and private equity asset classes earned a respectable 16.0% and 11.9% for the FY 2012, respectively. The fixed income, real return, and domestic equity asset classes had positive returns of 7.0%, 5.5%, and 0.7%, respectively, while the non-U.S. equities experienced a loss of 13.9%. During FY 2012 total net investment losses was $57.8 million compared to FY 2011 gains of $2,040.0 million.

The asset distribution of the ERS' investment securities for the Pension Trust, excluding pending trade settlements and securities lending collateral, at June 30, 2012 and 2011, is presented below at fair value. Investment balances between the asset classes will change over time based on market sectors' performance and our rebalancing efforts to maintain asset allocation targets. Changes will also occur for financial reporting since certain real estate and alternative investments are reported on the consolidated method of accounting using the value of the underlying investments since ERS is the majority owner of the business organization. Please refer to the Investment Section of the ERS CAFR for a discussion on asset allocation plan targets and investments by investment strategy.

Investments in short-term securities and cash are held by external investment managers for liquidity to settle pending trades and investments, and should not exceed 10% of the investments. Fluctuations will occur based on the trading activity and timing of the settlements. The allocation to equity securities, including alternative investments, increased during FY 2012, due to portfolio rebalancing, and changes in investment managers. The increase for fixed income securities in FY 2012 resulted from positive investment earnings in the asset class with a small increase due to rebalancing the investment portfolio. The increase in real estate assets for FY 2012 reflects continued positive investment returns in the asset class.

Asset Class

June 30, 2012

(Dollars in millions)

	2012	Percentage	2011	Percentage
Short-term investments and cash	$ 516.5	4.3%	$ 480.8	4.0%
Equity securities	6,299.1	53.0	7,356.8	61.1
Fixed income	3,225.5	27.2	2,503.0	20.8
Real estate	1,250.2	10.5	1,164.8	9.7
Alternative investments	588.2	5.0	528.4	4.4
Total assets	11,879.5	100.0%	12,033.8	100.0%
Less loans on real estate and alternative investments	288.6		302.1	
Total	$ 11,590.9		$ 11,731.7	

Investment expenses consist primarily of investment management fees paid to external investment advisor firms that oversee the ERS' investment portfolio. The decrease in investment expenses for management fees in FY 2012 relative to FY 2011 reflects lower returns of the real estate portfolio for the FY 2012. Incentive fees are created and accrued when the investment has excess returns above the asset benchmark during the year, and may be eliminated if the portfolio decreases in value. Incentive fees are only paid when an asset is sold if the total return for the asset exceeds a target return rate.

The ERS requires external managers to provide the ERS with a "most favored nations" contract clause that guarantees the ERS with the lowest management fees the managers offer their clients for investment accounts with similar investment mandates and similar account size. Certain investment managers may receive an incentive fee for superior investment returns while maintaining an acceptable level of investment risk.

Contributions

Total contributions from employers and employees decreased by $40.8 million to $730.8 million during FY 2012 compared to $771.6 million in FY 2011. The 5.3% decrease in FY 2012 was due to the elimination of one-time payments hybrid upgrade payments (HPUP) that were made in FY 2011. When disregarding the HPUP payments, both employer and employee contributions increased during FY 2012 due to an increase in the number of active members and an increase in the amount of covered payroll. Please refer to the Financial Section in the ERS 2012 and 2011 CAFR for more information.

Pension Plan Benefits and Expenses

Pension benefit payments are the primary expense of the ERS with payments totaling $1,015.5 million during FY 2012 and $960.2 million during FY 2011. Pension benefits continued to increase with additional number of new retirees, higher pension benefits for recent retirees, and the annual postretirement increase for ERS' retirees.

Refunds to terminating members continued to increase slightly due to an increase in members making contributions under the Hybrid Plan and taking a refund compared previously to most members not making contributions to the ERS as a member of the Noncontributory Plan.

The $1.7 million decrease in administrative expenses in FY 2012 resulted from higher computer maintenance costs in FY 2011 and the elimination of the backlog in finalization of pension benefits in FY 2012.

Pension Plan Changes

Legislation enacted by the 2012 legislature focused on improving the funding status of the ERS pension trust based on the definition of compensation.

Act 152/2012 SLH amends the definition of "compensation" for the purpose of calculating retirement benefits for all employees who become Employees' Retirement System (ERS) members after June 30, 2012 to include the following:

- Normal periodic payments of money for service, the right to which accrues on an hourly, daily, monthly, or annual basis
- Shortage differentials
- Elective salary reduction contributions under 125, 403(b), and 457(b) of the IRC of 1986, as amended (i.e., deductions for "deferred compensation" and "teachers' annuity)
- Twelve-month differentials for employees of the department of education

Act 153/2012 SLH requires the last employer to make additional contributions to the ERS for employees that first became ERS members before July 1, 2012 and retire after June 30, 2012, if the member has "excessive" non-base pay during the last 10 years or employment. The additional contributions are based on the increased costs of the actuarial equivalent increase in pension benefits the member will be paid in retirement compared to the pension benefits that would be paid if the member did not have excess non-base pay in their Average Final Compensation amount.

Pension plan changes, including legislative and Board of Trustees' actions, are summarized in the Introductory Section and Actuarial Section of the CAFR.

Actuarial Valuations and Funded Status

The ERS uses an actuarial reserve type of funding that is financed by member contributions, employer contributions, and earnings from invested assets. Member and employer contributions are based on the member's pension plan (contributory, noncontributory, or hybrid), pay and job classification. The ERS' investment rate of return actuarial assumption is set by state law at 7.75% per annum. Material differences in the actual amounts compared to the actuarial assumptions for a given year may have a significant impact on the ERS' funded status. Changes in significant assumptions between valuation periods, such as the actuarial investment return, may also have a significant impact on the funded status of a pension plan.

An independent actuarial valuation of the ERS' actuarial assets and liabilities is performed annually. As part of this valuation, the progress towards funding pension obligations of the retirement system is measured by comparing the actuarial value of assets to actuarial accrued liability. This measurement is expressed as a percentage and referred to as the funded ratio or funded status. The UAAL is that portion of the actuarial accrued liability (including the present value of benefits presently being paid to retired members) that exceeds the value of current actuarial assets expressed as an amount.

The funded ratio decreased to 59.2% as of June 30, 2012 from 59.4% as of June 30, 2011. The ERS' UAAL was $8.4 billion and $8.2 billion as of June 30, 2012 and 2011, respectively. The decline in FY 2012 from FY 2011 is primarily the result of investment losses in the fiscal years ended June 30, 2009 since ERS uses a four-year smoothing of investment market gains and losses to reduce volatility of the required contribution rates.

Under the percentage of payroll methodology for employer contribution funding, one of the primary purposes of the valuation report is to determine whether the adequacy of the current employer contribution rates is sufficient to amortize the UAAL within a specific number of years. The employee and employer contribution rates have been set by State law and are intended to provide for the normal cost plus the level percentage of payroll required to amortize the UAAL over a period not in excess of 30 years. Under the standards established by the Governmental Accounting Standards Board Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans* (GASB No. 25) that the ERS implemented in 1997, the amortization period used to determine the annual required contribution rates should not exceed 30 years.

The aggregate funding period of the UAAL, including the value of future employer and employee contributions, for the ERS as of June 30, 2012 and 2011 was 30.0 years and 25.0 years, respectively.

The 2010 valuation determined that the funding period (the length of time required to amortize the unfunded actuarial accrued liability (UAAL)) exceeded the maximum 30 year funding period required under Hawaii Revised Statues. The 2011 Legislature took corrective action in the form of two significant changes to ERS: (i) the new tier of benefits and increased contribution rates for employees hired after June 30, 2012, and (ii) a schedule of increasing employer contribution rates over the next several fiscal years. The results after reflecting all of these changes was a 25-year funding period as of the June 30, 2011 valuation, which satisfied the Hawaii Revised Statute (the funding period has remained at or below the 30-year threshold in all subsequent valuations). However, the GASB No. 25 Annual Required Contribution (ARC) has specific rules in how it must be determined. These rules include the fact that the amortization payment to pay off the UAAL is to be calculated as the amount to be contributed the next year with increases in future years tied to the assumed payroll growth rate. GASB No. 25 does not allow you to reflect the increasing employer contribution rates in future years nor does it allow you to reflect that the amount of the statutory contribution that goes toward paying of the UAAL in future years will increase as the percentage of the active population hired after June 30, 2012 increases (on average 4% more pay will be contributed towards paying off the UAAL for a non public safety employee under the new benefit and contribution tier). The result is that the GASB No. 25 ARC determined using the maximum 30-year funding period (GASB maximum) is greater than the statutory rates being contributed in fiscal years 2011-2013. However, as described above the GASB No. 25 ARC does not describe the true long-term financial picture of ERS.

Requests for Information

This financial report is designed to provide a general overview of the Employees' Retirement System of the State of Hawaii's finances. For questions concerning any information in this report or for additional information, contact the Employees' Retirement System of the State of Hawaii, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Statement of Plan Net Assets – All Trust Funds

June 30, 2012

Assets:		
Cash and cash equivalents and short-term investments (notes C(2) and F):		
Cash and cash equivalents	$	50,976,924
Short-term investments		465,520,294
		516,497,218
Receivables:		
Accounts receivable and others		16,422,239
Investment sales proceeds		240,036,021
Accrued investment income		41,816,085
Employer contributions		448,078
Member contributions		4,645,487
		303,367,910
Investments, at fair value (notes C(2) and F):		
Equity securities		6,299,148,317
Fixed income securities		3,225,508,641
Real estate investments		1,250,239,211
Alternative investments		588,194,316
		11,363,090,485
Other:		
Invested securities lending collateral (note F)		923,932,665
Equipment, at cost, net of depreciation		7,337,058
		931,269,723
Total assets		13,114,225,336
Liabilities:		
Accounts and other payables		54,735,143
Payable for securities purchased		553,877,713
Securities lending collateral (note F)		923,932,665
Notes payable (note C(2))		288,637,414
Total liabilities		1,821,182,935
Commitments and contingencies (notes F, G, and H)		
Net assets held in trust for pension benefits (note D) (a schedule of funding progress is presented on page 37)	$	11,293,042,401

See accompanying notes to financial statements.

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Statement of Changes in Plan Net Assets – All Trust Funds

Year ended June 30, 2012

Additions:		
Contributions (notes A(4) and E):		
Employers contributions	$	548,353,394
Members contributions		182,401,324
Total contributions		730,754,718
Investment income (note F):		
From investing activities:		
Net depreciation in fair value of investments		(341,279,085)
Income on real estate investments		116,314,983
Interest on fixed income securities		109,897,746
Dividends on equity securities		104,854,788
Alternative investment income		46,179,704
Interest on short-term investments		1,109,643
Miscellaneous		1,814,226
		38,892,005
Less investment expenses		100,302,009
Net investment loss from investing activities		(61,410,004)
From securities lending activities:		
Securities lending income		2,839,531
Securities lending expenses:		
Borrower rebates		(1,408,982)
Management fees		636,919
Total securities lending activities expenses		(772,063)
Net investment income from securities lending activities		3,611,594
Total net investment loss		(57,798,410)
Total additions		672,956,308
Deductions:		
Benefit payments (note A(3))		1,015,447,668
Refunds of member contributions		7,187,606
Administrative expenses		11,634,197
Total deductions		1,034,269,471
Net decrease in net assets		(361,313,163)
Net assets held in trust for pension benefits (note D):		
Beginning of year		11,654,355,564
End of year	$	11,293,042,401

See accompanying notes to financial statements.

Note A – Description of the ERS

1. General

The Employees' Retirement System of the State of Hawaii (the ERS) began operations on January 1, 1926, having been established by the Territorial Legislature in the preceding year. The ERS is a cost-sharing, multiple-employer public employee retirement system established to administer a pension benefits program for all State and county employees, including teachers, police officers, firefighters, correction officers, judges, and elected officials. The ERS provides retirement, survivor, and disability benefits with multiple benefit structures known as the contributory, hybrid, and noncontributory plans.

Employer, pensioner, and employee membership data as of March 31, 2012 are as follows:

Employers:	
State	1
County	4
Total employers	5
Pensioners and beneficiaries currently receiving benefits:	
Pensioners currently receiving benefits:	
Police and firefighters	3,245
All others employees	34,585
Total pensioners	37,830
Beneficiaries currently receiving benefits:	
Police and firefighters	210
All others employees	2,734
Total beneficiaries	2,944
Total pensioners and beneficiaries	40,774
Terminated vested members entitled to benefits but not yet receiving benefits:	
Police and firefighters	238
All others employees	6,671
Total terminated vested members	6,909

Current employees:	
Vested:	
Police and firefighters	4,091
All other employees	41,681
Nonvested:	
Police and firefighters	803
All other employees	19,024
Total current employees	65,599
Total membership	113,282

2. *The Financial Reporting Entity*

As required by U.S. generally accepted accounting principles, these financial statements present the ERS (the primary government) as a separate reporting entity from the State of Hawaii (the State). The ERS is not part of the State's financial reporting entity because it is a separate legal entity that is fiscally independent of the State. The ERS was established by Chapter 88 of the Hawaii Revised Statutes and is governed by a Board of Trustees (the Board) as discussed below. The ERS is comprised of the Employees' Retirement System and Social Security Contribution Funds.

The Board administers the ERS on behalf of public employees of both the State and county governments. Except for limited administrative functions, the State does not have the power to supervise or control the Board in the exercise of its functions, duties, and powers. The Board consists of eight members. The State Director of Finance is a statutory member of the Board. Four members of the Board are elected by members of the ERS and the other three members of the Board are appointed by the Governor. Decisions are made with the concurring vote of five members of the Board. The Board appoints the Administrator and Chief Investment Officer and engages actuarial and other services required to transact the business of the ERS.

3. *Plan Descriptions and Funding Policy*

Members of the ERS belong to the contributory, hybrid, or noncontributory plan. All assets of the ERS (in the Pension Trust) may be used to pay benefits to any member of the ERS. Contribution rates are determined by state law. Effective July 1, 2008, the employer contribution rate for employees in the Police and Fire category increased from 15.75% to 19.70%, and the rate for employees in the All Other category increased from 13.75% to 15.00%. Per legislation passed in 2011, the current 19.70% rate for Police and Fire will increase to 22.00% effective July 1, 2012 and will gradually increase to 25.00% for fiscal year 2016 and beyond. The current 15.00% rate for All Other Employees will increase to 15.50% effective July 1, 2012 and will gradually increase to 17.00% for fiscal year 2016 and beyond. These employer contribution rates are applied to the total covered payroll in each respective category to determine the required employer contributions. Administration of the Pension Trust is financed through contributions from the employers and employees (if applicable) and investment earnings.

Employees covered by Social Security on June 30, 1984 were given the option of joining the noncontributory plan or remaining in the contributory plan. All new employees hired after June 30, 1984 and before July 1, 2006, who are covered by Social Security, were generally required to join the noncontributory plan. Qualified employees in the contributory and noncontributory plan were given the option of joining the Hybrid Plan effective July 1, 2006, or remaining in their existing plan. Starting July 1, 2006, all new employees covered by Social Security are required to join the Hybrid Plan.

The three plans provide a monthly retirement allowance equal to the benefit multiplier% (generally 1.25% or 2.00%) multiplied by the average final compensation (AFC) multiplied by years of credited service. The benefit multiplier decreased by 0.25% for new hybrid and contributory plan members hired after June 30, 2012. The AFC is the average salary earned during the five highest paid years of service, including the payment of salary in lieu of vacation, or three highest paid years of service, excluding the payment of salary in lieu of vacation, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after this date is based on the three highest paid years of service excluding the payment of salary in lieu of vacation. For new members hired after June 30, 2012, the AFC is based on the five highest paid years of service excluding the payment of salary in lieu of vacation.

For postretirement increases, every retiree’s original retirement allowance is increased by 2½% on each July 1 following the calendar year of retirement. This cumulative benefit is not compounded and increases each year by 2½% of the original retirement allowance without a ceiling (2½% of the original retirement allowance the first year, 5% the second year, 7½% the third year, etc.). For new members hired after June 30, 2012, the post-retirement annuity increase was decreased to 1.5% per year.

The following summarizes the three plan provisions relevant to the largest employee groups of the respective plan. Retirement benefits for certain groups, such as police officers, firefighters, some investigators, sewer workers, judges, and elected officials, vary from general employees. All contributions, benefits, and eligibility requirements are governed by Chapter 88 of the Hawaii Revised Statutes. For a more detailed summary of benefits for general employees and a description of special provisions to other groups of employees, refer to the Summary of Retirement Benefit Plan Provisions contained in the *Introductory Section* of the ERS CAFR.

Contributory Plan

General employees in the contributory plan are required to contribute 7.8% of their salary and are fully vested for benefits upon receiving 5 years of credited service. Under the contributory plan, members may retire with full benefits at age 55 and 5 years credited service, or may retire early at any age with at least 25 years of credited service and reduced benefits. The benefit multiplier is 2% for employees covered by Social Security.

New general employees in the contributory plan hired after June 30, 2012 are required to contribute 9.8% of their salary and are fully vested for benefits upon receiving 10 years of credited service. These members may retire with full benefits at age 60 and 10 years of credited service, or may retire at age 55 with 25 years of credited service with reduced benefits. The benefit multiplier is 1.75% for employees covered by Social Security.

Police officers, firefighters, and certain other members that are not covered by Social Security contribute 12.2% of their salary and receive a retirement benefit using the benefit multiplier of 2½% for qualified service, up to a maximum of 80% of AFC. These members may retire at age 55 with 5 years of credited service or at any age with 25 years of credited service, provided the last 5 years of credited service is any of the qualified occupations.

New police officers, firefighters, and certain other members that are not covered by Social Security first hired after June 30, 2012 contribute 14.2% of their salary and receive a retirement benefit using the benefit multiplier of 2.25% for qualified service, up to a maximum of 80% of AFC. These members may retire at age 60 with 10 years of credited service or at age 55 with 25 years of credited service with reduced benefits, provided the last 5 years of credited service is any of the qualified occupations.

Hybrid Plan

General employees in the Hybrid Plan are required to contribute 6% of their salary and are fully vested for benefits upon receiving 5 years of credited service. Employees may retire with full benefits at age 62 and 5 years of credited service or at age 55 and 30 years of credited service, or may retire at age 55 and 20 years service with reduced benefits. The benefit multiplier used to calculate retirement benefits is 2%. Members in the hybrid plan are covered by Social Security.

New general employees in the Hybrid Plan hired after June 30, 2012 are required to contribute 8% of their salary and are fully vested for benefits upon receiving 10 years of credited service. Employees may retire with full benefits at age 65 and 10 years of credited service or at age 60 and 30 years of credited service, or may retire at age 55 and 20 years service with reduced benefits. The benefit multiplier used to calculate retirement benefits is 1.75%. Members in the hybrid plan are covered by Social Security.

Noncontributory Plan

General employees in the noncontributory plan are fully vested upon receiving 10 years of credited service. The employer is required to make all contributions for these members. Employees may retire with full benefits at age 62 years and 10 years of credited service or age 55 and 30 years of credited services or age 55 years and 20 years of credited service with reduced benefits. The benefit multiplier used to calculate retirement benefits is 1¼%.

No changes to the plan provisions of the noncontributory plan were made for new general employees hired after June 30, 2012.

Ordinary disability retirement benefits require a minimum of 10 years of service, whereas service-connected disability resulting from a job-related accident does not have any service requirement. Under all three plans, there is no age requirement.

(Continued)

Ordinary death benefits under the contributory, hybrid, and noncontributory plans require at least one year, five years, and ten years of service, respectively. Under all three plans, there is no service requirement for service-connected death benefits.

Schedule of Funded and Funding Progress

	June 30, 2012
Actuarial valuation date:	
Actuarial value of assets	$ 12,242,493,808
Actuarial Accrued Liability (AAL):	
Entry age	20,683,402,818
Unfunded AAL (UAAL)	$ 8,440,909,010
Percent funded	59.2%
Annual covered payroll	$ 3,889,976,195
UAAL percentage of covered payroll	217%

Multi-year trend information regarding whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits can be found in the required supplementary information following the Notes to the Financial Statements.

Additional information as of the June 30, 2012 actuarial valuation is as follows:

Valuation date	June 30, 2012
Actuarial cost method	Entry age normal
Amortization method	Level percent, open
Remaining amortization period as of June 30, 2012	30 years
Asset valuation method	Four year smoothed market
Actuarial assumptions	
Investment rate of return*	7.75%
Projected salary increases*	
Police and fire employees	5.0% to 19.0%
General employees	4.0% to 8.0%
Teachers	5.0% to 8.5%
*Includes inflation at	3.0%
Cost of living adjustments (COLAs)**	2.5%

** COLAs are not compounded; they are based on original pension amounts.

4. *The ERS as Employer*

As an employer, the ERS participates in its pension benefits program, through the State. The ERS provides benefits for all of its full-time employees through the contributory, hybrid, or noncontributory plan. Contributions are calculated as part of the State’s total contribution requirements and are reimbursed to the State’s General Fund as part of the fringe benefit rate on the ERS’ employees’ actual salaries.

The required pension contributions by all participating employers (in thousands) for the years ended June 30, 2012, 2011, and 2010 were $654,755, $582,535, and $536,237, respectively, which represented 16.8%, 14.9%, and 13.8%, respectively, of covered payroll. Actual contributions (in thousands) by all employers for the years ended June 30, 2012, 2011, and 2010 were $548,353, $538,693, and $547,670, respectively, which represented 83.7%, 92.5%, and 102.1%, respectively, of the required contributions for each year.

5. *Other Post Employment Benefits (OPEB)*

In addition to the retirement benefits provided by the ERS Pension Trust, the participating employers, pursuant to Hawaii Revised Statutes (HRS) Chapter 87A, provide certain healthcare and life insurance benefits for State and county employees and retirees. The Hawaii Employer-Union Health Benefits Trust Fund (EUTF) was established on July 1, 2003 to design, provide, and administer health benefits plans and a group life insurance benefits program for State and county employees and retirees.

Under HRS § 87 A-33, the participating employers pay the EUTF a base monthly contribution for the health benefits plans of certain retired employees, including those who were hired before July 1, 1996 and retired after June 30, 1984, with ten or more years of credited service.

Under HRS § 87 A-34, the participating employers pay the EUTF one-half of the base monthly contribution for the health benefits plans of retired employees who were hired before June 30, 1996, and retired after June 30, 1984, with fewer than ten years of credited service.

Under HRS § 87A-35 and HRS § 87A-33(a)(6), the participating employers pay the EUTF for the health benefits plans of retired employees who were hired after June 30, 1996 but before July 1, 2001: (a) one-half of the base monthly contribution if the employee retired with between ten and fifteen years of credited service; (b) seventy-five percent of the base monthly contribution if the employee retired with between fifteen and twenty-five years of credited service; and (c) one hundred percent of the base monthly contribution if the employee retired with twenty-five or more years of credited service.

Under HRS § 87 A-36, the participating employers pay the EUTF for the health benefits plans of retired employees who were hired after June 30, 2001: (a) one-half of the base monthly contribution for a self-only plan if the employee retired with between ten and fifteen years of credited service; (b) seventy-five percent of the base monthly contribution for a self-only plan if the employee retired with between fifteen and twenty-five years of credited service; and (c) one hundred percent of the base monthly contribution for a self-only plan if the employee retired with twenty-five or more years of credited service.

Under HRS § 87 A-37, the participating employers pay the EUTF a base monthly contribution (currently $4.16) for each retired employee enrolled in the EUTF group life insurance plan.

The net assets of the EUTF are not included in the ERS plan net assets. The EUTF issues a financial report that includes financial statements and required supplementary information.

Note B – Social Security Contribution Fund

The Social Security Contribution Fund (Contribution Fund) was established under Section 88-224 of the HRS for the following purposes:

1. To receive all federal Social Security employers' contributions from the State and interest and penalties on unpaid amounts
2. To receive any appropriations to the Contribution Fund
3. To pay amounts required to be paid to the Internal Revenue Service (IRS)
4. To invest and collect income on resources held by the Contribution Fund

All other non-State governmental agencies remit Social Security contributions directly to the IRS. Social Security contributions withheld from employees are remitted directly to the IRS by the employers. The Contribution Fund is considered an agency fund for financial reporting purpose. At June 30, 2012, the ERS held no amounts in the Contribution Fund as all amounts deposited into the Contribution Fund were paid directly to the IRS.

Note C – Summary of Accounting Policies

A summary of the significant accounting policies consistently applied in the preparation of the accompanying financial statements is as follows:

1. Basis of Accounting

Fiduciary funds are used to account for assets held by the ERS in a trustee capacity or as an agent for individuals, private organizations, other governments, and/or other funds. The fiduciary fund types used by the ERS are a Pension Trust Fund and an agency fund. Each of the fiduciary funds is considered a separate fiscal and accounting entity with a self-balancing set of accounts that comprise its assets, liabilities, equity, revenues and expenditures, or expenses, as appropriate. The accounting and reporting treatment applied to a fund is determined by its measurement focus. The Pension Trust Fund is accounted for on a flow of economic resources measurement focus. As an agency fund, the Contribution Fund is custodial in nature and does not measure results of operations.

The financial statements are prepared using the accrual basis of accounting under which expenses are recorded when the liability is incurred, and revenues are recorded in the accounting period in which they are earned and become measurable. Employer and member contributions are recognized in the period in which the contributions are due. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan. Investment purchases and sales are recorded as of their trade date. Administrative expenses are financed exclusively with investment income.

2. Cash and Investments

Cash includes amounts in demand deposits and invested funds held by ERS investment managers.

Investments are governed pursuant to Sections 88-119 and 88-119.5 of the HRS. The Pension Trust Fund may invest in real estate loans and mortgages; preferred and common stocks; government obligations; corporate obligations; certain other debt obligations (such as obligations secured by collateral of certain other authorized securities listed here, obligations issued or guaranteed by certain development banks, and insurance company obligations); real property; alternative investments; and other securities and futures contracts. The investment decision is further dictated by internal investment policies and asset allocation established by the Board. Use of leverage is restricted to certain asset classes in order to enhance yields of approved investments and/or to facilitate diversification of the portfolio. The use of debt must result in positive leverage where cash flow is in excess of debt service. Assets in the Pension Trust Fund may be invested in any of these assets, while investments in the Contribution Fund are limited to investment grade, short-term marketable securities.

Investments are reported at fair value. Unrealized gains and losses are included as investment income in the statement of changes in plan net assets. The net assets of the Pension Trust Fund and Contribution Fund (the Retirement Funds) are valued on a monthly basis using the following sources:

Publicly Traded Securities (Corporate stock, investment derivatives, and fixed income): Fair values are based on published market prices, quotations from national security exchanges, and security pricing services as of each month-end closing of the New York Stock Exchange.

Fixed income securities (including investment derivatives not publicly traded): Fair values are based on equivalent values of comparable securities with similar yield and risk.

Pooled Equity and Fixed Income Funds (not publicly traded): Fair value are based on the ERS' pro rata ownership percentage of the fund reported by the fund manager based on the fair value of the underlying assets that is determined by published market prices, or quotations from national security exchanges. The pooled funds' annual financial statements are audited by independent auditors.

Limited Partnerships: The fair value of investments that are organized as limited partnerships and have no readily ascertainable fair value (such as private equity, real estate, and tangible assets) are valued based on their respective net asset value (NAV), and are generally audited annually. The most significant element of NAV is the fair value of the investment holdings.

These holdings are valued by the general partners using valuation assumptions based on both market and property specific inputs, which are not observable and involve a certain degree of expert judgment. Because of the inherent uncertainties in estimating fair values, it is at least reasonably possible that the estimates will change in the near term.

Private Equity Limited Partnerships: The fair value of individual capital account balances is based on the valuations reported by private equity partnerships using the following methodologies to value the underlying portfolio companies:

- Valuations of publicly traded portfolio companies are based on active exchanges using quoted market prices as of the close of trading for each month-end.
- When a portfolio company investment does not have a readily available market price, but has a return that is determined by reference to an asset for which a market price is readily available, valuations are based on the closing market price of the reference asset on the valuation date, adjusted for factors that affect the fair value of the investment held.
- When the portfolio company investments are private holdings and are not traded on active security exchanges, valuation methodologies used consist primarily of income and market approaches. The income approach involves a discounted cash flow analysis based on portfolio companies' projections. The market approach involves valuing a company at a multiple of a specified financial measure (generally EBITDA) based on multiples at which comparable company's trade.

Real Estate and Alternative Investments Limited Partnerships and Limited Liability Companies: The ERS has a controlling interest in certain real estate and alternative investment partnerships and limited liability companies. These investment companies provide quarterly valuations based on the most recent capital account balance to ERS management. Individual properties are valued internally by the investment companies at least annually, in accordance with standard industry practice and are adjusted as frequently as quarterly if material market or operational changes have occurred. Properties are generally valued every one to three years by external third-party appraisers, depending upon the investment company. Structured finance investments receive quarterly value adjustments by the investment companies, generally applying the assumption that all such positions will be held to maturity. Alternative investments are valued using their respective NAV, and are generally audited annually. The most significant element of NAV is the fair value of the investment holdings. These holdings are valued by the general partners in conjunction with management, investment advisors, and valuation specialists. The valuation techniques vary based on investment type and involve a certain degree of expert judgment. The fair value for these investments could differ significantly if a ready market for these assets existed. Annual audits of most partnerships and limited liability companies include a review of compliance with the investment company's valuation policies. Real estate and alternative investments consists of the value of real property within the limited liability companies and limited partnerships.

Notes Payable: Notes payable are shown at estimated fair values. Notes payable consist of mortgage notes within the limited liability companies and limited partnerships that are secured by real estate of the respective company.

3. *Revenue Recognition*

Interest and dividend income is recognized when earned. Capital gains and losses are recognized on a trade-date basis. Purchases and sales of investments are also recorded on a trade-date basis.

Contributions are recorded when received.

4. *Payment of Benefits*

Withdrawals are recorded when paid.

5. *Securities Lending*

The Retirement Funds record collateral received under securities lending agreements where the Retirement Funds have the ability to spend, pledge, or sell the collateral without borrower default. Liabilities resulting from these transactions are also reported. Additionally, costs associated with securities transactions, broker commissions paid, and lending agent management fees are reported as investment expenses in the accompanying financial statements. The statement of plan net assets does not include detailed holdings of securities lending collateral by investment classification.

6. *Interest and Earnings Allocation*

Pursuant to Sections 88-21 and 88-107 of the HRS, the Board shall annually allocate interest and other earnings of the Pension Trust Fund to the funds of the Pension Trust Fund, as follows:

a. Annuity Savings Fund – Fixed at 4½% regular interest rate for employees hired before July 1, 2012 and 2% regular interest for employees hired after June 30, 2012

b. Expense Fund – To be credited with all money to pay the administrative expenses of the ERS

c. Pension Accumulation Fund – To be credited with any remaining investment earnings

7. *Risk Management*

The ERS reports liabilities, as discussed in note G, related to certain types of losses (including torts, theft of, damage to, or destruction of assets, errors or omissions, natural disasters, and injuries to employees) when it is probable that the losses have occurred and the amount of those losses can be reasonably estimated.

8. *Use of Estimates*

In preparing financial statements in conformity with U.S. generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported

(Continued)

amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investments in limited partnerships and other alternative investments tend to be illiquid and the underlying assets are generally not publicly traded companies. Because of the inherent uncertainty in valuing privately held securities, the fair value may differ from the values that would have been used had a ready market for such securities existed, and the difference can be material. Accordingly, the realized value received upon the sale of the asset may differ from the recorded fair value.

9. Recently Issued Accounting Standards

In June 2011, the Governmental Accounting Standards Board (GASB) issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. Statement No. 63 provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. However, it does not identify any additional items that should be recognized within these element classifications. Statement No. 63 only applies to items that have been specifically identified by the GASB as deferred outflows of resources or deferred inflows of resources. Statement No. 63 will be effective for periods beginning after December 15, 2011. The implementation of Statement No. 63 will result in a change in the presentation of the statement of plan net assets to the statement of plan net position and the term net assets is changed to net position throughout the financial statements. The implementation of Statement No. 63 will not have a significant impact on the financial statements for the fiscal year ended June 30, 2013.

In June 2012, the Governmental Accounting Standards Board (GASB) issued Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*. Statement No. 67 establishes new standards for financial reporting and note disclosures by defined-benefit pension plans administered through qualified trusts, and note disclosure requirements for defined-contribution pension plans administered through qualified trusts. One of the major changes in the new standard is the rate used to discount projected benefit payments. The new standard states the long-term expected rate of return on the investments of the pension plan should be applied only to available pension plan assets that are expected to be invested using a strategy to achieve that return. If there comes a point in the projections when plan net position and contributions related to active and inactive employees is no longer projected to be greater than or equal to projected benefit payments related to those employees and administrative expenses, then from that point forward the pension plan will be required to discount the projected benefit payments using a municipal borrowing rate—a tax-exempt, high-quality 20-year general obligation bond index rate. Statement No. 67 will be effective for periods beginning after June 30, 2013. ERS has not yet determined the impact of this standard on its financial statements and disclosures.

Also, in June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*. Statement No. 68 establishes new standards for accounting for pensions by employers whose employees are provided with pensions through pension plans administered through trusts, or equivalent arrangements, that meet the characteristics defined in the statements and addresses accounting and financial reporting issues of certain nonemployer entities that contribute to such plans. Statement No. 68 will be effective for periods beginning after June 30, 2014. ERS has not yet determined the impact of this standard on its financial statements and disclosures.

Note D – Description of Funds

Section 88-109 of the HRS requires the establishment and maintenance of specific funds within the ERS. The funds in the Pension Trust Fund and their purposes are described hereunder:

1. Pension Accumulation Fund

To accumulate contributions made by the State and counties, transfers of retired members' contributions plus related interest income from the Annuity Savings Fund, and income from investments. All pension benefits, including the pensioners' bonus, are paid through this fund.

2. Annuity Savings Fund

To accumulate members' contributions and related interest income. Upon a member's retirement, the accumulated contributions and related interest income are transferred to the Pension Accumulation Fund or refunded to the member upon termination.

3. Expense Fund

To pay all the expenses necessary in connection with the administration and operation of the ERS. The Board estimates the amount of money necessary to be paid into the expense fund for the ensuing biennium to provide for the expense of operation of the ERS, and pays that amount into the expense account from the investment earnings of the ERS, subject to review by the legislature and approval by the Governor.

Net assets held in trust for pension benefits as of June 30, 2012 are as follows:

Pension Accumulation Fund	$ 9,490,402,585
Annuity Savings Fund	1,793,095,824
Expense Fund	9,543,992
Total net assets held in trust for pension benefits	$ 11,293,042,401

Note E – Contributions

The ERS' funding policy provides for periodic employer contributions expressed as a percentage of annual covered payroll. The funding method used to calculate the total employer contribution required

(Continued)

is the entry age normal actuarial cost method. Employer contributions are governed by Chapter 88 of the HRS. The actuarially determined contribution rates may differ from the statutory contribution rates.

Employer rates are set by statute based on the recommendation of the ERS actuary resulting from an experience study conducted every five years. Since July 1, 2005, employer contribution rates are a fixed percentage of compensation, including the normal cost plus amounts required to pay for the unfunded actuarial accrued liability. From July 1, 2005 to June 30, 2008, the required contribution rates for employers were 15.75% for their police officers and firefighters, and 13.75% for all other employees. As of July 1, 2008, employers contribute 19.70% for their police officers and firefighters, and 15.00% for all other employees.

The employer normal cost is the level percentage of payroll contribution required to pay all benefits. Actuarial gains and losses resulting from differences between actual and assumed experience are reflected in the employer unfunded accrued liability.

Member contributions rates are statutorily established in accordance with Chapter 88 of the HRS, and are discussed in note A(3). Plan Descriptions and Funding Policy above.

Note F – Deposits and Investments

1. Deposits

The deposits are held in several financial institutions, including the custodian bank for processing investment transactions. Per State statute, deposits, held by banks located in the State, in excess of Federal Deposit Insurance Corporation (FDIC) coverage are guaranteed by securities pledged as collateral by the bank with the State Director of Finance. Uninsured and uncollateralized amounts are primarily cash held by the investment custodian for settlement of investment transactions. The float caused by outstanding checks in the operating funds is invested, thus causing a possible negative book balance. Deposits are presented in the basic financial statements at cost, which represents market or fair value. The float for outstanding checks is included in the liabilities section of the statement of plan net assets.

Custodial Credit Risk for Deposits is the risk that in the event of a bank failure, the ERS' deposits may not be returned to them. The ERS has not adopted a formal policy specific to custodial credit risk. The ERS' policy is to deposit cash in excess of operating requirements in income producing investments to maximize investment income.

At June 30, 2012, the carrying amount of deposits totaled approximately $50,976,924 and the corresponding bank balance was $54,923,881, all of which was exposed to custodial credit risk. The following shows the aggregate book and bank balances of all cash accounts:

Carrying amounts of deposit – book balance:		
Cash	$	50,976,924

Depository accounts:		
Total bank balances	$	54,923,881

2. *Investments*

As a long-term investor, the ERS has established through its investment policy that preservation of capital is the primary goal of the ERS. Preservation of capital is to be attained with a consistent, positive return for the fund by diversifying the investment portfolio. The ERS recognizes risk associated for individual securities or asset classes may be reduced through diversification. Investments will be prudent and consistent with the best investment practices, in accordance with the Board's asset allocation strategy, assigned investment mandate, and in compliance with Chapter 88, HRS, as amended. The following table shows the investments of the ERS by investment type as of June 30, 2012. Please refer to note C(2) above for a discussion of fair value on investments:

Cash and short-term investments:		
Cash and cash equivalents	$	50,976,924
Short-term bills and notes		111,333,036
Pooled and others		345,201,490
Debt securities:		
Asset-backed securities		36,470,719
Collateralized mortgage obligations		65,593,798
Commercial mortgage-backed securities		45,754,276
Corporate		957,244,763
Government		534,709,648
Government agencies		203,509,618
Index-linked government bonds		431,389,918
Residential mortgage-backed securities		877,721,314
Municipal/Provincial bonds		55,339,813
Pooled and others		18,000,536
Derivatives:		
Forwards – Cash and short-term investments		8,985,768
Options – Equities		(9,031,580)
Options – Debt Securities		665,763
Rights/warrants – Equities		32,478
Swaps		(891,525)
Equities		6,308,147,419
Real estate		1,250,239,211
Alternative investments		588,194,316
Total investments	$	11,879,587,703
Short-term instruments for securities lending collateral pool	$	923,932,665

(Continued)

3. *Credit Risk Debt Securities*

The ERS utilizes two fixed income mandates: (i) a "Diversified Manager" whose benchmark is 85% Lehman Universal/15% Lehman Multiverse ex-USD Hedged Index and (ii) an "International Mandate" whose benchmark is Lehman Multiverse ex-USD Hedged Index. The ERS expects its debt securities investment managers to maintain diversified portfolios within the mandate assigned by the Board using the following guidelines:

- Securities with a quality rating of below Baa (based on Moody's rating scale) or equivalent are considered below investment grade.
- Invest in money market instruments; commercial paper (rated A1/P1); certificates of deposits and bankers acceptance; U.S. Treasury bonds, notes, and bills; U.S. government and agency securities; municipal bonds; 144A private placements; bank loans; nonleveraged structured notes; convertible bonds; mortgages, collateralized mortgage obligations (CMO) and asset-backed securities (backed by pools of mortgages guaranteed by the U.S. government or its agencies or corporate issues rated at least Aaa); investment grade corporate debt issues, emerging markets debt, preferred stock, and common stock; sovereign debt instruments (issued by agencies of, or guaranteed by foreign governments); and certain foreign securities (corporate debt issues, asset-backed securities, CMOs, 144A private placements, convertibles, and supranational issues). The minimum issuance size is $150 million.
- Summary of concentration limits for debt securities are:
  - Specific Issue or Issuer of 5% (excludes supranationals, U.S. Treasuries, U.S. agencies, and sovereign debt and equivalently rated agencies of Organization for Economic Co-operation and Development (OECD) governments).
  - All fixed income manager portfolios are limited to (i) 15% in below investment grade securities with no more than 2% below a B rating; (ii) 10% in private placements; (iii) 5% in convertible securities; (iv) 10% in preferred stocks and common stocks (common stock holdings not to exceed 180 days); and (v) 10% in non-U.S. agency CMOs.
  - Diversified managers are limited to (i) 10% in emerging markets (local currency and debt); (ii) 30% of non-U.S. dollar denominated securities (excludes money market securities and money market futures); (iii) a 15% net foreign currency exposure (as measured by net amount of currency's outstanding long and short positions versus the U.S. dollar); and (iv) a 30% gross foreign currency exposure (as measured by absolute value of all country-level currency long and short currency positions versus the U.S. dollar).
  - International managers are limited to (i) 20% in emerging markets (local currency and debt); and (ii) 25% of U.S. dollar denominated securities (excludes money market securities and money market futures).

A table of the ERS' fixed income securities as of June 30, 2012 is below. Securities below investment grade of Baa and nonrates issues amounted to $377,078,555 or 11.7% of total fixed income investments. All short-term investments, not held in a pooled investment, are rated A1/P1 or better.

Credit Rating – Moodys, as of June 30, 2012

Ratings	Cash and cash equivalents	Asset-backed securities	Corporate bonds	Government bonds and agencies	Mortgage backed securities	Residential mortgage backed securities	Pooled and others	Total	Percentage total
Agency	$ —	—	—	12,390,824	—	776,977,751	—	789,368,575	23.7%
Aaa	111,333,036	10,615,978	11,734,716	930,015,279	29,352,986	97,474,364	—	1,190,526,359	35.7
Aa	—	7,414,522	46,876,091	80,929,820	3,108,144	—	2,501,815	140,830,392	4.2
A	—	7,792,781	247,616,756	127,781,562	11,142,444	—	—	394,333,543	11.8
Baa	—	2,538,527	386,215,038	45,330,247	9,278,511	1,567,692	—	444,930,015	13.3
Ba	—	155,579	103,719,654	11,008,868	14,704,094	—	11,822,134	141,410,329	4.2
B	—	274,923	72,578,829	5,874,151	11,652,666	—	3,874,338	94,254,907	2.8
Caa	—	1,234,318	5,595,205	—	5,525,328	—	—	12,354,851	0.4
Ca	—	2,403,672	—	—	3,204,093	—	—	5,607,765	0.2
NR	—	4,040,419	82,908,474	11,618,246	23,379,808	1,701,507	(197,751)	123,450,703	3.7
	$ 111,333,036	36,470,719	957,244,763	1,224,948,997	111,348,074	877,721,314	18,000,536	3,337,067,439	100.0
						Derivatives		(225,762)	
						Short-term investments		(111,333,036)	
							Total fixed income securities	$ 3,225,508,641	

4. *Custodial Credit Risk*

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty, the ERS will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. All securities, except certain pooled funds, are registered in the name of the ERS and are held in the possession of the ERS' custodial bank, Northern Trust. Pooled funds not held by the custodial bank, such as certain equity investments, are registered in the name of the ERS.

Custodial credit risk summary:	
Exposed to custodial credit risk	$ 68,261,180
Not subject to custodial credit risk	4,333,503,760
Not exposed – registered	6,560,686,425
Not exposed – securities on loan	917,136,338
Total investments	$ 11,879,587,703

5. *Concentrations of Credit Risk*

The ERS' debt securities managers are expected to maintain diversified portfolios by sector, quality, and maturity as discussed above in Credit Risk Debt Securities.

Equity securities shall be diversified by industry and in number. An investment manager may not hold more than 5% of an individual company's stock; if that company's securities represent less than 3% of the investment manager's respective benchmark. (If those securities constitute more than 3% of the respective benchmark, then the manager shall not hold more than the benchmark weight plus 2 percentage points.)

At June 30, 2012, there was no single issuer exposure within the ERS' portfolio that comprises over 5% of the overall portfolio, or an investment that exceeded the above manager guidelines, and therefore, there is no concentration of credit risk.

6. Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The ERS has not adopted a formal policy that limits investment maturities as a means of managing its exposure to fair value changes arising from changing interest rates. External investment managers are given full discretion within their operational guidelines and are expected to maintain a diversified portfolio between and within sectors, quality, and maturity.

Duration is a measure of a debt investment's exposure to fair value changes arising from changes in interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's full price. At June 30, 2012, the table below shows fixed income investment securities by investment type, amount, and the effective weighted duration for the ERS' total portfolio. Interest rate risk associated with swaps and other derivative instruments are discussed in the derivatives disclosure below:

Effective duration of fixed income assets by security type

		Fair value	Effective weighted duration (years)
Cash and short-term instruments:			
Bills and notes	$	111,333,036	0.3
Debt securities:			
Asset-backed securities		36,470,719	2.8
Collateralized mortgage obligations		65,593,798	2.0
Commercial mortgage-backed securities		45,754,276	4.3
Corporate		957,244,763	4.9
Government		534,709,648	7.2
Government agencies		203,509,618	5.0
Index-linked government bonds		431,389,918	9.7
Residential mortgage-backed securities		877,721,314	2.1
State or local governments		55,339,813	10.3
Pooled and others		18,000,536	N/A
Total	$	3,337,067,439	

7. *Foreign Currency Risk*

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. The foreign currency risk exposure to the ERS arises from the international fixed income and international equity investment holdings. Board policy limits the use of foreign currency as a defensive measure to protect the portfolio value of non-U.S. equity and non-U.S. fixed income investments. External investment managers authorized to invest in these securities are given full discretion regarding their respective portfolio's foreign currency exposures, including using currency forward contracts, as established by their investment mandate. Cross-hedging is only allowed in non-U.S. fixed income portfolios. Counterparties for foreign currency derivatives must be rated A or equivalent. Derivatives investments are discussed in more detail in note G.

The following table summarizes the ERS' exposure to foreign currency risk in U.S. dollars as of June 30, 2012: (Securities denominated in U.S. dollars are not presented.)

	Cash and short-term instruments	Debt securities	Derivatives	Equities	Alternative	Real estate	Grand total
Argentine peso	$ 6,258	—	—	—	—	—	6,258
Australian dollar	152,764	70,527,234	(1,255)	59,845,827	—	—	130,524,570
Brazilian real	—	798,641	—	24,677,854	—	—	25,476,495
British pound sterling	1,615,735	143,871,065	177,725	243,972,125	—	—	389,636,650
Bulgarian new lev	—	—	—	201,401	—	—	201,401
Canadian dollar	7,179,818	36,074,014	—	60,086,955	—	—	103,340,787
Chilean peso	10,732	—	5,832	3,077,425	—	—	3,093,989
Colombian peso	—	—	—	1,603,469	—	—	1,603,469
Danish krone	—	15,430	—	24,486,632	—	—	24,502,062
Egyptian pound	—	—	—	157,557	—	—	157,557
Euro	5,015,218	236,983,892	2,290,030	364,904,367	—	—	609,193,507
Hong Kong dollar	446,225	—	—	134,007,694	—	—	134,453,919
Hungarian forint	5,607	—	—	286,964	—	—	292,571
Indian rupee	5,072	—	—	13,447,576	—	—	13,452,648
Indonesian rupiah	2,569	—	—	7,211,985	—	—	7,214,554
Japanese yen	76,482,515	71,894,546	—	163,310,819	—	—	311,687,880
Malaysian ringgit	17,598	2,629,243	—	8,772,854	—	—	11,419,695
Mexican peso	766,119	14,903,995	148,438	9,614,486	—	—	25,433,038
New Taiwan dollar	—	—	—	34,456,868	—	—	34,456,868
New Zealand dollar	17,486	34,225,360	55,225	—	—	—	34,298,071
Norwegian krone	—	11,686,297	—	3,052,144	—	—	14,738,441
Philippine peso	5,844	—	—	3,828,567	—	—	3,834,411
Polish zloty	8,363	55,260,735	—	7,071,705	—	—	62,340,803
Singapore dollar	—	—	—	25,006,954	—	—	25,006,954
South African rand	19,626	31,477,832	—	24,369,806	—	—	55,867,264
South Korean won	33,424	—	—	60,608,496	—	—	60,641,920
Swedish krona	35,804	11,882,044	—	21,662,732	—	—	33,580,580
Swiss franc	1,536,326	—	168,574	132,187,969	—	—	133,892,869
Thai baht	24,332	—	—	12,007,310	—	—	12,031,642
Turkish lira	421	—	—	6,030,839	—	—	6,031,260
Various countries	—	—	—	1,434,329,263	—	—	1,434,329,263
Total	$ 93,387,856	722,230,328	2,844,569	2,884,278,643	—	—	3,702,741,396

8. Securities Lending

The ERS participated in a securities lending program administered by its bank custodian, The Northern Trust Company. Under this program, which is permissible under Chapter 88 of the HRS, certain equity and fixed income securities of the ERS were lent to participating broker-dealers and banks (borrowers). In return, the ERS received cash, securities issued or guaranteed by the U.S. government, and/or letters of credit as collateral. The ERS did not have the ability to pledge or sell collateral securities absent of borrower default. Borrowers were required to deliver collateral for each loan equal to: (a) in the case of loaned fixed income securities and loaned equity securities denominated in U.S. dollars or whose primary trading market was located in the United States, 102% of the market value of the loaned securities; and (b) in the case of loaned equity securities not denominated in U.S. dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities. The collateral is marked to market daily. If the market value of the collateral fell below the minimum collateral requirements, additional collateral was provided. At June 30, 2012, the ERS had no credit risk exposure to borrowers because the market value of collateral held by the ERS exceeded the market value of securities loaned. In addition, the bank custodians indemnified the ERS by agreeing to purchase replacement securities or return cash collateral in the event the borrower failed to return the loaned security or failed to pay the ERS for income distributions by the securities' issuers while the securities are on loan.

The ERS did not impose any restrictions on the amount of loans the bank custodian made on behalf of the ERS. Also, the ERS and the borrowers maintained the right to terminate securities lending transactions on demand. Northern Trust invests the cash collateral related to the ERS' loaned securities in a separate account, according to the ERS investment policies and procedures as discussed above in note C(2). As such, the maturities of the investments made with cash collateral generally did not match the maturities of the securities loans. The extent of such mismatch as of June 30, 2012 was 125 days.

The following represents the balances relating to the securities lending transactions as of June 30, 2012:

Market value of loaned securities by type of collateral received

	Fair value of underlying securities			Collateral received		
	Cash	**Noncash**	**Total**	**Cash**	**Noncash**	**Total**
Fixed income, U.S.	$ 472,550,848	234,941	472,785,789	479,296,485	235,354	479,531,839
Fixed income, global	30,654,040	—	30,654,040	31,241,877	—	31,241,877
Equities, U.S.	325,320,552	1,493,266	326,813,818	327,426,982	1,494,977	328,921,959
Equities, global	84,037,834	2,844,857	86,882,691	85,967,321	2,918,645	88,885,966
Total	$ 912,563,274	4,573,064	917,136,338	923,932,665	4,648,976	928,581,641

9. Derivative Financial Instruments

Derivatives are instruments (securities or contracts) whose value is dependent on such things as stock or bond prices, interest rate levels, or currency exchange rates. These are financial arrangements between two parties whose payments are based on or "derived" from the performance of some agreed-upon benchmark. As with any investment, derivative contracts are subject to various types of credit and market risks. Notably, these would include the possible inability of a counterparty to meet the terms of the contract, changes in the market value of the underlying collateral, changes in the interest rate environment, or fluctuation in foreign currency rates. The ERS enters into various derivative investment contracts to hedge, for the minimization of transaction costs and as a means of implementing value-added strategies to enhance returns as authorized by Board policy.

Generally, derivatives are subject both to market risk and counterparty risk. The derivatives utilized by the ERS typically have no greater risk than their physical counterparts, and in many cases are offset by exposures elsewhere in the portfolio. Counterparty risk, the risk that the "other party" to a contract will default, is managed by utilization of exchange-traded futures and options where practicable (in which case the futures exchange is the counterparty and guarantees performance) and by careful screening of counterparties where use of exchange-traded products is impractical or uneconomical. ERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, posting collateral, and exposure monitoring procedures. The ERS anticipates that counterparties will be able to satisfy their obligations under the contracts.

Derivative securities are priced and accounted for at their fair value. For exchange-traded securities such as futures and options, closing prices from the securities exchanges are used. Foreign exchange contracts are valued at the price at which the transaction could be settled by offset in the forwards markets.

The following tables summarize the ERS' investments in derivative securities and contracts held at June 30, 2012 and their associated risks. The various risks associated with these investments are included in the tables expressed in terms of market values, summarized by the type of contract as follows: credit, equity, foreign exchange, interest, and other. Due to the level of risk associated with certain derivative investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term, and such changes could affect the amounts reported in the financial statements. ERS could be exposed to risk if the counterparties to the contracts are unable to meet the terms of the contracts. ERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, posting collateral, and exposure monitoring procedures.

The notional amount is the nominal or the underlying face amount that is used to calculate payments made on that instrument or contract. Changes in the market value of all derivative contracts are recorded as net appreciation (depreciation) in fair value of investments in the statement of changes in plan net assets.

Summary of derivative risk types as of June 30, 2012:

		Fair value
Credit contracts:		
Swaps	$	(130,354)
Equity contracts:		
Options		(9,031,580)
Rights/Warrants		32,478
Foreign exchange contracts:		
Forwards		8,985,768
Interest rate contracts:		
Futures		—
Options		—
Swaps		(761,171)
Other contracts:		
Options		665,763
Total derivatives	$	(239,096)

The following table summarizes the ERS' investments in derivative securities and contracts held at June 30, 2012:

Asset categories			Notional values	Market value
Forwards	Currency purchases	$	—	8,985,768
	Total forwards		—	8,985,768
Futures	Interest rate contracts		229,825,750	—
	Futures total		229,825,750	—
Options	Caps and floors		—	—
	Options		—	(9,031,580)
	Options on futures		—	—
	Swaption		—	665,763
	Options total		—	(8,365,817)
Rights/warrants			—	32,478
Swaps	Credit default swaps		—	(130,354)
	Interest rate swaps		—	(761,171)
	Swaps total		—	(891,525)
	Grand total	$	229,825,750	(239,096)

Forward Currency Exchange Contracts

The ERS enters into various forward currency exchange contracts to manage exposure to changes in foreign currency exchange rates and to facilitate the settlement of foreign security transactions. A forward contract is an agreement to buy or sell a specific amount of currency at a specific delivery or maturity date for an agreed-upon price. Risks associated with such contracts include movements in the value of the foreign currency relative to the U.S. dollar and the ability of the counterparty to perform in accordance with the terms of the contract.

Futures

Futures represent commitments to purchase (asset) or sell (liability) securities at a future date and at a specified price. Futures contracts are traded on organized exchanges (exchange traded) thereby minimizing the ERS' credit risk. The net change in the futures contracts value is settled daily in cash with the exchanges. Net gains or losses arising from the daily settlements are included in the net appreciation in fair value of securities in the statement of changes in plan net assets – all trust funds. At June 30, 2012, the net notional value of futures contracts was $229,825,750.

Options

Options represent or give the buyers the right, but not the obligation, to buy or sell an asset at a preset price over a specified period. The option's price is usually a small percentage of the underlying asset's value. As a writer of financial options, the ERS receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option. As a purchaser of financial options, the ERS pays a premium at the outset of the agreement and the counterparty bears the risk of an unfavorable instrument underlying the option.

Swaps

Swaps represent an agreement between two or more parties to exchange sequences of cash flows over a period in the future. At June 30, 2012, the ERS had interest rate and credit default swaps, as allowed by Board policy. In the most common type of interest rate swap arrangement, one party agrees to pay fixed-interest payments on designated dates to a counterparty, who, in turn, agrees to make return interest payments that float with some reference rate. Credit default swaps are the most common global credit market derivative that allows flexibility as an active portfolio management tool based on its ability to customize the exposure to corporate credit such as credit spreads and default risks. Total return swaps combine both market risk and credit risk in a single product as the holder also receives capital gains or losses. Credit default spreads and total return swaps are also used to gain access to global markets that do not have the transparency or efficiency of the U.S. credit markets. Gains and losses from swaps are determined on market values and are included in the net appreciation in fair value of securities in the statement of changes in plan net assets – all trust funds.

Derivatives, such as interest rate swaps, total return swaps, and credit default swaps, are a tool or instrument used to manage interest rate, credit quality, and yield curve exposures of the investments. In certain situations, derivatives may result in a lower overall cost to the portfolio than owning individual securities underlying the derivatives. When evaluating securities, risk, and return are measured at the security and portfolio levels.

On June 30, 2012, credit ratings of the counterparty for ERS' investments in derivatives were as follows:

Derivatives Counterparty Credit Ratings – Moody's

		A1	A2	A3	Aa3	Baa1	N/A	Grand total
Bank of America		—	—	341,467	—	—	—	341,467
Bank of America N.A.	$	—	—	(715)	—	—	—	(715)
Barclays Cap Secs London		—	101,931	—	—	—	—	101,931
Citibank N.A. New York		—	—	(24,897)	—	—	—	(24,897)
Citigroup Global Markets, Cme		—	—	—	—	—	(1,004)	(1,004)
Cme_Barcus		—	—	—	—	—	(368,969)	(368,969)
Cme_Csfbus		—	—	—	—	—	(555,756)	(555,756)
Cme_Ubswus		—	—	—	—	—	41,926	41,926
Credit Suisse International, London		(21,426)	—	—	—	—	—	(21,426)
Csfb Europe Ltd		(24,173)	—	—	—	—	—	(24,173)
Csfb NY		81,214	—	—	—	—	—	81,214
Deutsche Bank AG New York		—	(162,892)	—	—	—	—	(162,892)
Deutsche Bank London		—	(24,294)	—	—	—	—	(24,294)
Deutsche Bank Securities, CME		—	—	—	—	—	(251)	(251)
Goldman Sachs Bank USA		—	(1,214)	—	—	—	—	(1,214)
Goldman Sachs New York		—	—	(3,657)	—	—	—	(3,657)
Greenwich Capital Markets Inc		—	—	—	—	(22,087)	—	(22,087)
Hsbc Bank USA, NA-CCC		45,821	—	—	—	—	—	45,821
JP Morgan Chase Bank/HSBCSI		—	—	—	402,448	—	—	402,448
Morgan Stanley & Co Inc. New York		—	—	—	—	(19,472)	—	(19,472)
Morgan Stanley Capital Services New York		—	—	—	—	(62,119)	—	(62,119)
Royal Bank of Scotland FIN MKTS Fixed		—	—	—	—	(36,127)	—	(36,127)
UBS Securities		—	88,484	—	—	—	—	88,484
Foreign Currency Forwards		—	—	—	—	—	8,985,768	8,985,768
Exchange Traded – Futures and Options		—	—	—	—	—	(9,031,580)	(9,031,580)
Not Available on Rights and Warrants		—	—	—	—	—	32,478	32,478
Total	$	81,436	2,015	312,198	402,448	(139,805)	(897,388)	(239,096)

On June 30, 2012, the segmented time distribution for ERS' investments in derivatives was as follows:

		Fair value	Years to maturity
Forwards:			
Foreign exchange contracts	$	8,985,768	Range from 0.0 to 0.6 years
Options:			
Caps and floors		(25,555)	Range from 7.7 to 8.3 years
Options		(9,031,580)	Range from 0.1 to 0.2 years
Swaption		665,763	Range from 0.1 to 1.1 years
Rights/warrants:			
Equity contracts		32,478	Range from 0.0 to 4.9 years
Swaps:			
Swaps		(865,970)	Range from 0.5 to 40.3 years
Grand total	$	(239,096)	

Note G – Risk Management

The ERS is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. As required by state law, the ERS participates in coverage with the State. The State retains various risks and insures certain excess layers with commercial insurance policies. The excess layers are consistent with the prior fiscal year. Settled claims for the State did not exceed the coverage provided by commercial insurance policies during the year ended June 30, 2012. Losses not covered by insurance are generally paid from legislative appropriations.

1. *Torts*

The ERS is involved in various litigation and claims, including claims regarding retirement benefits, the outcome of which cannot be presently determined. In the opinion of management, the outcome of these actions will not have a material adverse effect on the ERS' financial position.

2. *Property and Liability Insurance*

The ERS also purchased property and liability insurance for all real estate owned from outside carriers. During the past three fiscal years, no loss settlements exceeded insurance coverages.

3. *Workers' Compensation Policy*

The State has a self-insured workers' compensation policy. Workers' compensation claims are paid from legislative appropriations.

Note H – Commitments

In the normal course of business, the ERS enters into commitments with associated risks. The ERS adheres to the same credit policies, financial and administrative controls, and risk limiting and monitoring procedures for these commitments as for all investments.

The ERS has future financial commitments of up to $549,000,000 as of June 30, 2012, consisting of $136,000,000 in real estate investments, and $413,000,000 in alternative investments.

Note I – Deferred Compensation Plan

The ERS does not sponsor a deferred compensation program. The ERS' employees are eligible to participate in the deferred compensation plan sponsored by the State. The State-sponsored plan was created in accordance with Internal Revenue Code Section 457. The plan, available to all ERS employees, permits them to defer a portion of their salaries. The deferred compensation is not available to the employees until termination, retirement, death, or an unforeseeable emergency. All compensation deferred under the plan is held in trust by a custodian for the exclusive benefit of participants and beneficiaries.

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Required Supplementary Information – Unaudited

June 30, 2012

Schedule of Funding Progress

(Amounts in thousands)

Actuarial valuation date		Actuarial value of assets (1)	Actuarial accrued liability (AAL) (2)	Unfunded actuarial accrued liability (UAAL) (3) = (2)-(1)	Funded ratio (4) = (1)/(2)		Annual covered payroll (5)	UAAL as a percentage of annual covered payroll (6) = (3)/(5)
June 30:								
2012	$	12,242,494	20,683,403	8,440,909	59.2%	$	3,889,976	217.0%
2011		11,942,753	20,096,930	8,154,177	59.4		3,915,957	208.2
2010		11,345,618	18,483,669	7,138,051	61.4		3,895,662	183.2
2009		11,400,117	17,636,432	6,236,315	64.6		4,030,121	154.7
2008		11,380,961	16,549,069	5,168,108	68.8		3,782,103	136.6
2007		10,589,773	15,696,546	5,106,773	67.5		3,507,040	145.6

Schedule of Employer Contributions

(Amounts in thousands)

		Annual required contribution	Actual contribution	Percentage contributed
Year ended June 30:				
2012	$	654,755	548,353	83.7%
2011		582,535	538,693	92.5
2010		536,237	547,670	102.1
2009		526,538	578,672	109.9
2008		510,727	488,770	95.7
2007		476,754	454,494	95.3

(Continued)

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Notes to Required Supplementary Information – Unaudited

June 30, 2012

Note A – Description

The information presented in the required supplementary schedules was determined as part of the actuarial valuation at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation date	June 30, 2012
Actuarial cost method	Entry age normal
Amortization method	Level percent, open
Remaining amortization period as of June 30, 2012*	30 years
Asset valuation method	4-year smoothed market
Actuarial assumptions:	
Investment rate of return**	7.75%
Projected salary increases**:	
Police and fire employees	5.0% –19.0%
General employees	4.0% – 8.0%
Teachers	5.0% – 8.5%
Cost-of-living adjustments (COLAs)***	2.5% (not compounded)

* Remaining amortization period for Annual Required Contribution is 30 years.

** Includes inflation at 3.00%

*** COLAs are not compounded; they are based on original pension amount.

Note B – Significant Factors Affecting Trends in Actuarial Information

2011 Changes in Plan Provisions Since 2010

The following changes were made to the actuarial assumptions:

- The investment rate of return assumption decreased from 8.00% to 7.75%.
- The salary increase rates were changed to reflect a larger productivity component for Police & Fire. Small changes also made to service-based components for all groups. The overall impact increased assumed salary increase rates for all employees.
- The rates of mortality for healthy retirees and beneficiaries for most employee groups were decreased.
- The rates of mortality for disabled retirees were modified.
- The rates of mortality for active employees were increased.
- The rates of disability for active employees were modified.
- The rates of retirement for most employees were modified.
- The rates of termination for both males and females for each of the groups were modified.

Schedule 1

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Supplementary Information – Combining Schedule of Changes in Plan Net Assets – All Trust Funds

Year ended June 30, 2012

	Pension Accumulation Fund	Annuity Savings Fund	Expense Fund	Total
Additions:				
Appropriations and contributions:				
Employers	$ 548,353,394	—	—	548,353,394
Members	—	182,401,324	—	182,401,324
Net investment loss	(57,798,410)	—	—	(57,798,410)
Total additions	490,554,984	182,401,324	—	672,956,308
Deductions:				
Benefit payments	1,015,447,668	—	—	1,015,447,668
Refunds of member contributions	—	7,187,606	—	7,187,606
Administrative expenses	—	—	11,634,197	11,634,197
Total deductions	1,015,447,668	7,187,606	11,634,197	1,034,269,471
Other changes in net assets held in trust for pension benefits:				
Transfer due to retirement of members	115,881,386	(115,881,386)	—	—
Transfer of interest allocation	(76,176,900)	76,176,900	—	—
Transfer to pay administrative expenses	(10,828,223)	—	10,828,223	—
Return of unrequited funds due to savings in administrative expenses	—	—	—	—
	28,876,263	(39,704,486)	10,828,223	—
Net increase (decrease)	(496,016,421)	135,509,232	(805,974)	(361,313,163)
Net assets held in trust for pension benefits:				
Beginning of year	9,986,419,006	1,657,586,590	10,349,968	11,654,355,564
End of year	$ 9,490,402,585	1,793,095,822	9,543,994	11,293,042,401

See accompanying independent auditors' report.

Schedule 2

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Supplementary Information – Social Security Contribution Fund
Statement of Changes in Assets and Liabilities

Year ended June 30, 2012

Assets		**Beginning balance**	**Additions**	**Deductions**	**Ending balance**
Cash	$	—	—	—	—
Total assets	$	—	—	—	—
Liabilities					
Due to employers	$	—	192,770,384	192,770,384	—
Total liabilities	$	—	192,770,384	192,770,384	—

See accompanying independent auditors' report.

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Supplementary Information – Schedule of Administrative Expenses

Year ended June 30, 2012

Personnel services:		
Salaries and wages	$	4,279,557
Fringe benefits		1,548,322
Net change in unused vacation credits		62,070
Total personnel services		5,889,949
Professional services:		
Actuarial		163,594
Auditing and tax consulting		233,257
Disability hearing expenses		85,122
Legal services		330,575
Medical		372,769
Other services		589,760
Total professional services		1,775,077
Communication:		
Postage		180,944
Printing and binding		113,213
Telephone		75,484
Travel		46,821
Total communication		416,462
Rentals:		
Rental of equipment		68,315
Rental of premises		17,053
Total rentals		85,368
Other:		
Armored car service		11,063
Computer and office automation systems		7,040
Repairs and maintenance		1,301,723
Stationery and office supplies		35,562
Miscellaneous		85,519
Total other		1,440,907
Depreciation		2,026,434
	$	11,634,197

See accompanying independent auditors' report.

Schedule 4

EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

Supplementary Information – Schedule of Investment Expenses

Year ended June 30, 2012

Real estate and alternative investment expenses:		
Operating expenses	$	50,682,320
Mortgage interest		13,804,315
Total real estate and alternative investment expenses		64,486,635
Investment expenses:		
Investment manager/advisor fees		33,280,858
Bank custodian fees		100,000
Other investment expenses		2,434,516
Total investment expenses		35,815,374
Securities lending expenses:		
Borrower rebates		(1,408,982)
Management fees		636,919
Total securities lending expenses		(772,063)
	$	99,529,946

See accompanying independent auditors' report.