



**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Financial Statements

June 30, 2013

(With Independent Auditors' Report Thereon)

Submitted by

**THE AUDITOR
STATE OF HAWAII**

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Table of Contents

	Page
Independent Auditors' Report	1
Management's Discussion and Analysis	3
Financial Statements:	
Statement of Net Position – All Trust Funds	11
Statement of Changes in Net Position – All Trust Funds	12
Notes to Financial Statements	13
Required Supplementary Information:	
Schedule of Funding Progress – Unaudited	38
Schedule of Employer Contributions – Unaudited	38
Notes to Required Supplementary Information – Unaudited	39
Supplementary Information:	
Schedule 1 – Combining Schedule of Changes in Net Position – All Trust Funds	40
Schedule 2 – Social Security Contribution Fund, Statement of Changes in Assets and Liabilities	41
Schedule 3 – Schedule of Administrative Expenses	42
Schedule 4 – Schedule of Investment Expenses	43



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Independent Auditors' Report

The Auditor
The State of Hawaii:

Report on the Financial Statements

We have audited the accompanying financial statements of the Employees' Retirement System of the State of Hawaii (the ERS) as of and for the year ended June 30, 2013 and the related notes to the financial statements, which collectively comprise the ERS' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of significant estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the net position of the Employees' Retirement System of the State of Hawaii as of June 30, 2013, and the changes in net position for the year then ended, in conformity with U.S. generally accepted accounting principles.



Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles 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.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the ERS’ basic financial statements. The supplementary information included in schedules 1 through 4 for the year ended June 30, 2013 is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The supplementary 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. Such 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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 19, 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* in considering the ERS’ internal control over financial reporting and compliance.

KPMG LLP

Honolulu, Hawaii
December 19, 2014

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

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, 2013. 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 net position provides a snapshot of the financial position of the ERS at June 30, 2013. 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 net position summarizes the ERS' financial activities that occurred during the fiscal year from July 1, 2012 to June 30, 2013 (FY 2013). This financial statement measures the changes in the resources available to pay pension benefits to members, retirees, and beneficiaries for fiscal year 2013.
- 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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis

June 30, 2013

Financial Highlights

- As of June 30, 2013, net position restricted for pension benefits was \$12.3 billion, or an increase of about \$1.0 billion during the fiscal year then ended. This represents an increase of approximately 9.0% from the \$11.3 billion in net position restricted for pension benefits as of June 30, 2012. The increase of net position restricted for pension benefits in FY 2013 reflects the rebound of the global markets following losses in the non-U.S. equity markets during FY 2012.
- During FY 2013, the ERS earned a positive return of 12.6% on pension plan assets following a slight loss of 0.1% in FY 2012.
- The 2013 legislation passed does not have significant impact on the ERS financial operations. The legislation passed seeks to strengthen the long-term foundation and stability of internal investment staff with the addition of 3 investment officers that will assist the Chief Investment Officer and advise the ERS Board with critical information needed to structure the ERS investment portfolio to meet its asset goals and reduce the System's unfunded liability. 'Mandatory' legislation was enacted to maintain the tax-qualified status of the ERS based on technical clarification for compliance with the Internal Revenue code: (1) to reinforce the benefit limitations imposed by the Internal Revenue Code, and (2) to clarify vesting rules for the accrued retirement benefits for ERS members. 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 increased to 60.0% as of June 30, 2013 from 59.2% as of June 30, 2012 while the corresponding unfunded actuarial accrued liability (UAAL) of the ERS increased to \$8.5 billion from \$8.4 billion, respectively. Like most pension funds that use a four-year asset smoothing to determine the actuarial value of assets, the ERS continued to be impacted by the severe downturn in investment markets during the fiscal year ended June 30, 2009. However, the ERS had an offsetting liability experience gain which was caused primarily by lower than expected salary increases. Thus, the UAAL grew less than expected based on this actuarial valuation as of June 30, 2013.
- Contributions from members and employers increased by a total of \$36.5 million during FY 2013, or 5.0% with the implementation of legislation passed in 2011 and 2012. Most of the increase is due to an increase in required contribution rates paid by the employers for all employee groups. Per 2011 legislation, the employer contribution rate will increase annually over the next three fiscal years and new members will pay a higher contribution rate. The historical summary of legislation impacting the ERS actuarial valuations is discussed in more detail in the "Summary of Plan Changes" in the Actuarial Section of the ERS CAFR.
- Total retirement benefit payments increased by \$45.1 million, or 4.4%, to \$1,060.6 million in FY 2013 compared to \$1,015.5 million in FY 2012. Pension benefits continue to increase due to 2.5% more retirees and beneficiaries (41,812 in 2013 compared to 40,774 in 2012), an increase in the average pension benefit for new retirees, and the annual 2.5% post retirement increase.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

- Administrative expenses increased by \$0.3 million in FY 2013 to \$11.9 million compared to \$11.6 million in FY 2012. Administrative expenses for all years were within the ERS' budgeted amounts. The increase for FY 2013 was primarily due to an increase in payroll costs.

Summary of Net Position

June 30, 2013 and 2012

(Dollars in millions)

	2013	2012	FY 2013 percentage change
Assets:			
Cash and cash equivalents, and short-term investments	\$ 378.1	516.5	(26.8)%
Receivables	506.3	303.4	66.9
Investments	12,210.3	11,363.1	7.5
Invested securities lending collateral	—	923.9	(100.0)
Equipment	9.4	7.3	28.8
Total assets	13,104.1	13,114.2	(0.1)
Liabilities:			
Securities lending liability	—	923.9	(100.0)
Investment accounts and other payables	792.3	897.3	(11.7)
Total liabilities	792.3	1,821.2	(56.5)
Net position restricted for pension benefits	\$ 12,311.8	11,293.0	9.0

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

Summary of Changes in Net Position

June 30, 2013 and 2012

(Dollars in millions)

	<u>2013</u>	<u>2012</u>	<u>FY 2013 percentage change</u>
Additions:			
Contributions	\$ 767.3	730.8	5.0%
Net investments income (loss)	1,331.2	(57.8)	2,403.1
Total additions	<u>2,098.5</u>	<u>673.0</u>	211.8
Deductions:			
Pension benefit payments	1,060.6	1,015.5	4.4
Refund of contributions	7.2	7.2	—
Administrative expenses	11.9	11.6	2.6
Total deductions	<u>1,079.7</u>	<u>1,034.3</u>	4.4
Increase (decrease) in net position	\$ <u>1,018.8</u>	<u>(361.3)</u>	382.0

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 earned 12.6% on investments during FY 2013 following a loss of 0.1% during FY 2012 due to the strength of the equity markets during the year. The benchmark for the ERS investment portfolio is 7.75%. Total net investment income during FY 2013 was \$1,331.2 compared to a net investment loss of \$57.8 million in FY 2012.

Domestic equity and real estate were the top performing asset classes with returns of 21.2% and 20.8%, respectively, followed by international equity at 12.1% and private equity with returns of 8.9% for the FY 2013. These were followed by the covered calls, fixed income and real return asset classes that earned 6.6%, 2.8% and 0.4%, respectively.

The asset distribution of the ERS' investment securities for the pension trust, excluding pending trade settlements and securities lending collateral, at June 30, 2013 and 2012 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 CAFR for a discussion on asset allocation plan targets and investments by investment strategy.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

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. These amounts reported on the financial statements also include cash requirements used by ERS to fund pension benefits and transition amounts between individual 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 2013, due to positive investment returns, portfolio rebalancing, and changes in investment managers. The decrease for fixed income securities and real estate investments in FY 2013 was due to changes in the long-term asset allocation targets adopted by the ERS' Board of Trustees in 2011.

Asset Class

June 30, 2013 and 2012

(Dollars in millions)

	<u>2013</u>	<u>Percentage</u>	<u>2012</u>	<u>Percentage</u>
Short-term investments and cash	\$ 378.1	3.0%	\$ 516.5	4.3%
Equity securities	7,801.9	62.0	6,299.2	53.0
Fixed income	2,630.7	20.9	3,225.5	27.2
Real estate	1,153.6	9.2	1,250.2	10.5
Alternative investments	<u>624.1</u>	4.9	<u>588.2</u>	5.0
Total assets	12,588.4	100.0	11,879.6	100.0
Less loans on real estate and alternative investments	<u>247.9</u>		<u>288.6</u>	
Total	<u>\$ 12,340.5</u>		<u>\$ 11,591.0</u>	

Investment expenses includes (a) investment management fees paid to external investment advisor firms that oversee the ERS' investment portfolio and (b) operational activities of certain real estate and alternative investments since these assets are reported on the consolidated method of accounting using the activity of the underlying investments since ERS is the majority owner of the business organization.

The increase in investment management fees paid to external investment advisors during FY 2013 compared to FY 2012 is due to the positive returns on the assets and an increase in overall asset values during the FY 2013. 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

Contributions

Contributions from employers and employees totaled \$767.3 million and \$730.8 million during FY 2013 and FY 2012, respectively. During FY 2013, total contributions increased by \$36.5 million, or 5.0%, as employer contributions increased by \$33.1 million, or 6.0%, and member contributions increased by \$3.4 million, or 1.9%. The increase in employer contributions is mainly due to an increase in contribution rates effective July 1, 2012, and to a lesser extent an increase in covered payroll and the number of active members during the year. Please refer to the Financial Section in the ERS 2013 and 2012 CAFR for more information.

Pension Plan Benefits and Expenses

Pension benefit payments continue to be the primary expense of the ERS with payments totaling \$1,060.6 million during FY 2013 and \$1,015.5 million during FY 2012. Pension benefits increased with an additional number of new retirees, higher pension benefits for recent retirees, and the annual postretirement increase for ERS' retirees.

Refunds to terminating members of the Hybrid and Contributory Plans remained relatively stable during the year.

The \$0.3 million increase in administrative expenses in FY 2013 is from an increase in payroll related costs (salaries and fringe benefits), auditing and tax consulting and depreciation which was partially offset by a decrease in other professional services and computer maintenance.

Pension Plan Changes

There was no significant legislation passed in 2013 that affects pension plan provisions. Pension plan changes, including legislative and Board of Trustees' actions, are summarized in the Introductory Section and Actuarial Section of the ERS 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

The funded ratio increased to 60.0% as of June 30, 2013 from 59.2% as of June 30, 2012. The ERS' UAAL was \$8.5 and \$8.4 billion as of June 30, 2013 and 2012, respectively. After an unfavorable year in FY 2012, the investment markets had an excellent year in FY 2013 resulting in a return of 12.60% on the market value of assets. However, all of the excess investment earnings from FY 2013 were offset against the prior year's deferred investment losses. The ERS investment losses from the fiscal year ended June 30, 2009 are still being recognized since ERS uses a four-year smoothing of investment market gains and losses to reduce volatility of the required contribution rates. The recognition of deferred investment losses was partially offset by a liability experience gain from actual salary increases being less than the current salary scale assumption.

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, 2013 and 2012 was 28.0 and 30.0 years, respectively. (The remaining amortization period for purposes of determining the Annual Required Contribution as of June 30, 2013 in accordance with GASB No. 25 requirements is 30 years.).

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 Statutes. 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 nonpublic 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Management's Discussion and Analysis

June 30, 2013

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 Net Position – All Trust Funds

June 30, 2013

Assets:

Cash and cash equivalents and short-term investments (notes C(2) and F):

Cash and cash equivalents	\$ 39,994,831
Short-term investments	338,077,516
	378,072,347

Receivables:

Accounts receivable and others	15,629,969
Investment sales proceeds	417,411,350
Accrued investment income	41,322,029
Employer contributions	26,209,898
Member contributions	5,762,579
	506,335,825

Investments, at fair value (notes C(2) and F):

Equity securities	7,801,878,074
Fixed income securities	2,630,703,273
Real estate investments	1,153,657,262
Alternative investments	624,110,754
	12,210,349,363

Other:

Equipment, at cost, net of depreciation	9,374,587
	9,374,587

Total assets

13,104,132,122

Liabilities:

Accounts and other payables	50,751,311
Payable for securities purchased	493,615,557
Notes payable (note C(2))	247,937,305
	792,304,173

Commitments and contingencies (notes F, G, and H)

Net position restricted for pension benefits (note D) (a schedule of funding progress is presented on page 38)

\$ 12,311,827,949

See accompanying notes to financial statements.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Statement of Changes in Net Position – All Trust Funds

Year ended June 30, 2013

Additions:

Contributions (notes A(4) and E):

Employers contributions	\$ 581,447,213
Members contributions	185,837,186
Total contributions	767,284,399

Investment income (note F):

From investing activities:

Net appreciation in fair value of investments	1,034,798,125
Income on real estate investments	121,303,816
Interest on fixed income securities	97,265,571
Dividends on equity securities	117,759,984
Alternative investment income	54,765,397
Interest on short-term investments	1,395,302
Miscellaneous	556,107
	1,427,844,302

Less investment expenses	99,949,605
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Net investment income from investing activities	1,327,894,697
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From securities lending activities:

Securities lending income	3,046,173
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Securities lending expenses:

Borrower rebates	(851,628)
Management fees	584,344
Total securities lending activities expenses	(267,284)

Net investment income from securities lending activities	3,313,457
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Total net investment income	1,331,208,154
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Total additions	2,098,492,553
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Deductions:

Benefit payments (note A(3))	1,060,561,148
Refunds of member contributions	7,204,411
Administrative expenses	11,941,446
Total deductions	1,079,707,005

Net increase in net position	1,018,785,548
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Net position restricted for pension benefits (note D):

Beginning of year	11,293,042,401
End of year	\$ 12,311,827,949

See accompanying notes to financial statements.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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, 2013 are as follows:

Employers:		
State		1
County		4
Total employers		5
Pensioners and beneficiaries currently receiving benefits:		
Pensioners currently receiving benefits:		
Police and firefighters		3,317
All others employees		35,424
Total pensioners		38,741
Beneficiaries currently receiving benefits:		
Police and firefighters		223
All others employees		2,848
Total beneficiaries		3,071
Total pensioners and beneficiaries		41,812
Terminated vested members entitled to benefits but not yet receiving benefits:		
Police and firefighters		251
All others employees		7,061
Total terminated vested members		7,312

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Current employees:

Vested:

Police and firefighters	4,123
All other employees	43,695

Nonvested:

Police and firefighters	848
All other employees	17,560

Total current employees	66,226
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Total membership	115,350
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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 rate for Police and Fire employees will increase over four years to 22.00% on July 1, 2012, 23.00% on July 1, 2013, 24.00% on July 1, 2014 and 25.00% on July 1, 2015 and the rate for All Other Employees will increase to 15.50% effective July 1, 2012, 16.00% effective July 1 2013, 16.50% effective July 1, 2014 and 17.00% effective July 1, 2015. 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' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Effective July 1, 2012, employers may be required to make additional employer contributions to the ERS in certain situations. This legislation requires employers to pay additional contributions if a retiring employee, who was first employed prior to July 1, 2012 and who was last employed by the employer, has significant nonbase pay increases included in their average final compensation. The additional contribution is equal to the actuarial present value of the additional benefits earned due to the "excessive" nonbase pay increases.

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 Comprehensive Annual Financial Report.

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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

plan, members may retire with full benefits at age 55 and 5 years of 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 of credited 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 of credited 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 service or age 55 years and 20 years of credited service with reduced benefits. The benefit multiplier used to calculate retirement benefits is 1¼%.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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.

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

Actuarial valuation date	June 30, 2013
Actuarial value of assets	\$ 12,748,828,110
Actuarial Accrued Liability (AAL):	
Entry age	<u>21,243,744,377</u>
Unfunded AAL (UAAL)	<u>\$ 8,494,916,267</u>
Percent funded	60.0%
Annual covered payroll	\$ 3,906,670,616
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*.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Additional information as of the June 30, 2013 actuarial valuation is as follows:

Valuation date	June 30, 2013
Actuarial cost method	Entry age normal
Amortization method	Level percent, open
Remaining amortization period as of June 30, 2013	30 years
Asset valuation method	Four year smoothed market
Actuarial assumptions	
Investment rate of return*	7.75%
Projected salary increases*	
Police and fire employees	5.00% to 19.00%
General employees	4.00% to 8.00%
Teachers	5.00% to 8.50%
*Includes inflation at	3.00%
Cost of living adjustments (COLAs)**	2.5%/1.5%

** 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 year ended June 30, 2013 was \$667,142 which represented 17.1% of covered payroll. Actual contributions (in thousands) by all employers for the year ended June 30, 2013 were \$581,447, which represented 87.2% 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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 § 87 A-35 and HRS § 87 A-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, 2013, the ERS held no amounts in the Contribution Fund as all amounts deposited into the Contribution Fund were paid directly to the IRS.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Investments are reported at fair value. Unrealized gains and losses are included as investment income in the statement of changes in net position. The net position 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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 net position does not include detailed holdings of securities lending collateral by investment classification.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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, 2011 and 2% regular interest rate 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 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 was effective for periods beginning after December 15, 2011. The implementation of Statement No. 63 resulted in a change in the presentation of the statement of plan net assets to the statement of net position and the term net assets is changed to net position throughout the financial statements. The implementation of

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Statement No. 63 did 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.

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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Net position restricted for pension benefits as of June 30, 2013 are as follows:

Pension Accumulation Fund	\$ 10,358,417,898
Annuity Savings Fund	1,939,208,516
Expense Fund	<u>14,201,535</u>
Total net position restricted for pension benefits	\$ <u><u>12,311,827,949</u></u>

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 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. From July 1, 2008 to June 30, 2012, employers contributed 19.70% for their police officers and firefighters, and 15.00% for all other employees. Effective July 1, 2012, the employer rate increased to 22.00% for their police officers and firefighters, and 15.50% 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.

Effective July 1, 2012, the last employer is required 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" nonbase 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 nonbase pay in their Average Final Compensation amount.

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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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. Deposits are presented in the basic financial statements at cost, which represents market or fair value.

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, 2013, the carrying amount of deposits totaled approximately \$39,994,831 and the corresponding bank balance was \$43,968,969, all of which was exposed to custodial credit risk. The following shows the aggregate book and bank balances of all cash accounts:

	<u>June 30, 2013</u>
Carrying amounts of deposit – book balance:	
Cash	\$ 39,994,831
Depository accounts:	
Total bank balances	\$ 43,968,969

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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, 2013. Please refer to note C(2) above for a discussion of fair value on investments.

Cash and short-term investments:	
Cash and cash equivalents	\$ 39,994,831
Short-term bills and notes	2,801,669
Pooled and others	312,478,452
Debt securities:	
Asset-backed securities	42,252,053
Collateralized mortgage obligations	66,148,795
Commercial mortgage-backed securities	54,120,947
Corporate	823,863,910
Government bonds	483,507,376
Government agencies	181,161,600
Index-linked government bonds	450,913,091
Residential mortgage-backed securities	431,777,344
Municipal/Provincial bonds	68,093,424
Pooled and others	23,292,788
Derivatives:	
Forwards – Cash and short-term investments	22,797,395
Options – Equities	(11,501,910)
Options – Debt Securities	(710,994)
Rights/warrants – Equities	66
Swaps	6,282,939
Equities	7,813,379,918
Real estate	1,153,657,262
Alternative investments	624,110,754
Total investments	<u>\$ 12,588,421,710</u>

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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).

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

A table of the ERS' fixed income securities as of June 30, 2013 is below. Securities below investment grade of Baa and nonrates issues amounted to \$290,956,777 or 11.1% 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, 2013									
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	\$ —	—	—	2,771,658	425,246,240	—	—	428,017,898	16.3%
Aaa	2,801,669	12,133,396	41,818,400	684,779,766	—	32,785,977	—	774,319,208	29.5
Aa	—	12,525,163	50,195,603	254,844,302	—	8,998,440	—	326,563,508	12.4
A	—	6,070,404	203,685,050	76,032,195	—	18,693,007	—	304,480,656	11.6
Baa	—	6,607,577	358,233,653	113,796,497	1,188,730	23,357,189	411,304	503,594,950	19.2
Ba	—	221,573	85,221,869	48,224,009	—	13,963,910	2,148,921	149,780,282	5.7
B	—	67,292	63,197,304	1,063,798	—	9,070,919	7,734,142	81,133,455	3.1
Caa	—	1,493,976	7,420,380	—	—	7,392,412	—	16,306,768	0.6
Ca	—	3,132,672	—	—	—	1,552,764	—	4,685,436	0.2
NR	—	—	14,091,651	2,163,266	5,342,374	4,455,124	12,998,421	39,050,836	1.5
	<u>\$ 2,801,669</u>	<u>42,252,053</u>	<u>823,863,910</u>	<u>1,183,675,491</u>	<u>431,777,344</u>	<u>120,269,742</u>	<u>23,292,788</u>	<u>2,627,932,997</u>	100.0
						Derivatives		5,571,945	
						Short-term investments		<u>(2,801,669)</u>	
						Total fixed income securities		<u>\$ 2,630,703,273</u>	

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	\$ 54,159,334
Not subject to custodial credit risk	4,512,407,518
Not exposed – registered	<u>8,021,854,858</u>
Total investments	<u>\$ 12,588,421,710</u>

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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

than 3% of the respective benchmark, then the manager shall not hold more than the benchmark weight plus 2 percentage points.)

At June 30, 2013, 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, 2013, 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	\$ 2,801,669	0.3
Debt securities:		
Asset-backed securities	42,252,053	1.6
Collateralized mortgage obligations	66,148,795	1.3
Commercial mortgage-backed securities	54,120,947	4.2
Corporate	823,863,910	4.5
Government bonds	483,507,376	6.5
Government agencies	181,161,600	4.8
Index-linked government bonds	450,913,091	9.7
Residential mortgage-backed securities	431,777,344	4.7
Municipal/Provincial bonds	68,093,424	8.6
Pooled and others	23,292,788	N/A
Total	\$ 2,627,932,997	

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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 F(9).

The following table summarizes the ERS' exposure to foreign currency risk in U.S. dollars as of June 30, 2013: (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	\$ 5,258	—	—	—	—	—	5,258
Australian dollar	(71,523)	71,837,905	5,907,110	66,566,885	—	—	144,240,377
Brazilian real	7,925	696,479	(277,013)	57,928,436	—	—	58,355,827
British pound sterling	786,528	178,773,756	1,846,338	274,057,673	—	—	455,464,295
Bulgarian new lev	—	—	—	197,438	—	—	197,438
Canadian dollar	3,070,107	32,092,387	794,816	53,074,427	—	—	89,031,737
Chilean peso	10,012	—	(338)	5,134,651	—	—	5,144,325
Colombian peso	—	914,983	—	2,941,116	—	—	3,856,099
Czech koruna	11,506	—	—	679,709	—	—	691,215
Danish krone	4	12,764	—	37,284,108	—	—	37,296,876
Egyptian pound	194,791	—	—	838,772	—	—	1,033,563
Euro	1,445,074	271,734,761	43,849	437,876,190	—	—	711,099,874
Hong Kong dollar	3,871,041	—	—	209,818,720	—	—	213,689,761
Hungarian forint	23,461	—	—	1,520,476	—	—	1,543,937
Indian rupee	15,699,406	—	—	—	—	—	15,699,406
Indonesian rupiah	46,173	—	151	19,956,549	—	—	20,002,873
Japanese yen	(411,403)	30,256,039	11,392,874	179,510,648	—	—	220,748,158
Malaysian ringgit	20,638	2,163,266	(3,749)	10,311,115	—	—	12,491,270
Mexican peso	1,117,798	13,844,893	(305,692)	20,448,628	—	—	35,105,627
New Taiwan dollar	45,643	—	—	84,225,132	—	—	84,270,775
New Zealand dollar	28	49,528,605	804,112	—	—	—	50,332,745
Norwegian krone	114	—	(42,567)	—	—	—	(42,453)
Philippine peso	5,700	—	—	3,041,210	—	—	3,046,910
Polish zloty	55,602	54,968,131	2,562,655	16,089,822	—	—	73,676,210
Singapore dollar	(1,434,335)	—	(2,552)	33,453,509	—	—	32,016,622
South African rand	32,414	42,211,432	(491,109)	53,971,181	—	—	95,723,918
South Korean won	65,812	—	—	119,342,839	—	—	119,408,651
Swedish krona	96,140	11,414,612	—	18,443,813	—	—	29,954,565
Swiss franc	210,442	—	455,489	176,317,124	—	—	176,983,055
Thai baht	24,029	—	—	32,080,548	—	—	32,104,577
Turkish lira	10	—	—	20,544,982	—	—	20,544,992
Various countries	—	—	—	1,416,170,281	—	—	1,416,170,281
Total	\$ 24,928,395	760,450,013	22,684,374	3,351,825,982	—	—	4,159,888,764

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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. 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.

At June 30, 2013 there was no credit risk exposure to borrowers since the ERS temporarily suspended the securities lending program in June 2013 due to the transition to a new bank custodian effective July 1, 2013. The securities lending program resumed in July 2013 following the successful transition of assets to the new custodian.

Other than the temporary suspension of securities lending program, 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. The bank custodian 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).

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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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, 2013 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 net position.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

Summary of derivative risk types as of June 30, 2013:

	Fair value
Credit contracts:	
Swaps	\$ (17,956)
Equity contracts:	
Options	(11,501,910)
Rights/Warrants	66
Foreign exchange contracts:	
Forwards	22,797,395
Interest rate contracts:	
Options	513,022
Swaps	6,300,895
Other contracts:	
Options	(1,224,016)
Total derivatives	\$ 16,867,496

The following table summarizes the ERS' investments in derivative securities and contracts held at June 30, 2013:

Asset categories	Notional values	Market value
Forwards		
Currency purchases	\$ —	22,797,395
Total forwards	—	22,797,395
Futures		
Interest rate contracts	420,931,245	—
Futures total	420,931,245	—
Options		
Options	—	(11,501,910)
Options on futures	—	513,022
Swaption	—	(1,224,016)
Options total	—	(12,212,904)
Rights/warrants	—	66
Swaps		
Credit default swaps	—	(17,956)
Interest rate swaps	—	6,300,895
Swaps total	—	6,282,939
Grand total	\$ 420,931,245	16,867,496

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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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 net position – all trust funds. At June 30, 2013, the net notional value of futures contracts was \$420,931,245.

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, 2013, 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 net position – 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

On June 30, 2013, 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 N.A.	\$ —	(128,328)	—	—	—	—	(128,328)
Barclays Cap Secs London	—	54,019	—	—	—	—	54,019
BNP Paribas Fixed Income	—	(1,642)	—	—	—	—	(1,642)
Citibank N.A. New York	—	(14,732)	—	—	—	—	(14,732)
Citigroup Global Markets, Cme	—	—	—	—	—	1,014,186	1,014,186
Cme_Barcus	—	—	—	—	—	(1)	(1)
Cme_Csfbus	—	—	—	—	—	3,185,762	3,185,762
Cme_Mscsus	—	—	—	—	—	878,295	878,295
Cme_Ubswsu	—	—	—	—	—	36,085	36,085
Credit Suisse International, London	(9)	—	—	—	—	—	(9)
Deutsche Bank AG New York	—	(17,956)	—	—	—	—	(17,956)
Deutsche Bank London	—	(50,470)	—	—	—	—	(50,470)
Deutsche Bank Securities, CME	—	—	—	—	—	341,820	341,820
Goldman Sachs and Co, Cme	—	—	—	—	—	938,894	938,894
Goldman Sachs Bank USA	—	(307,812)	—	—	—	—	(307,812)
Hsbc Bank USA, NA-CCC	(86,504)	—	—	—	—	—	(86,504)
JP Morgan Chase Bank/HSBCSI	—	—	(24,361)	—	—	—	(24,361)
Morgan Stanley Capital Services New York	—	—	—	—	(513,017)	—	(513,017)
Royal Bank of Scotland FIN MKTS Fixed	—	—	—	(92,335)	—	—	(92,335)
UBS Securities	—	(170,494)	—	—	—	—	(170,494)
Foreign Currency Forwards	—	—	—	—	—	22,797,395	22,797,395
Exchange Traded – Futures and Options	—	—	—	—	—	(10,971,365)	(10,971,365)
Not Available on Rights and Warrants	—	—	—	—	—	66	66
Total	\$ (86,513)	(637,415)	(24,361)	(92,335)	(513,017)	18,221,137	16,867,496

On June 30, 2013, the segmented time distribution for ERS' investments in derivatives was as follows:

	<u>Fair value</u>	<u>Years to maturity</u>
Forwards:		
Foreign exchange contracts	\$ 22,797,395	Range from 0.0 to 0.5 years
Options:		
Options	(11,501,910)	Range from 0.0 to 0.2 years
Options on futures	513,022	Range from 0.1 to 0.2 years
Swaption	(1,224,016)	Range from 0.0 to 0.7 years
Rights/warrants:		
Equity contracts	66	Range from 0.0 to 1.9 years
Swaps:		
Swaps	6,282,939	Range from 2.7 to 28.0 years
Grand total	\$ 16,867,496	

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Financial Statements

June 30, 2013

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, 2013. 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 \$546,000,000 as of June 30, 2013, consisting of \$148,000,000 in real estate investments, and \$398,000,000 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, 2013

Schedule of Funding Progress

(Amounts in thousands)

<u>Actuarial valuation date</u>	<u>Actuarial value of assets (1)</u>	<u>Actuarial accrued liability (AAL) (2)</u>	<u>Unfunded actuarial accrued liability (UAAL) (3) = (2)-(1)</u>	<u>Funded ratio (4) = (1)/(2)</u>	<u>Annual covered payroll (5)</u>	<u>UAAL as a percentage of annual covered payroll (6) = (3)/(5)</u>
June 30:						
2013	\$ 12,748,828	21,243,744	8,494,916	60.0%	\$ 3,906,670	217.4%
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

Schedule of Employer Contributions

(Amounts in thousands)

<u>Year ended June 30:</u>	<u>Annual required contribution</u>	<u>Actual contribution</u>	<u>Percentage contributed</u>
2013	\$ 667,142	581,447	87.2%
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

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Notes to Required Supplementary Information – Unaudited

June 30, 2013

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, 2013
Actuarial cost method	Entry age normal
Amortization method	Level percent, open
Remaining amortization period as of June 30, 2013*	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% to 19.0%
General employees	4.0% to 8.0%
Teachers	5.0% to 8.5%
Cost-of-living adjustments (COLAs)***	2.5%/1.5%

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

** Includes inflation at 3%

*** 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.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

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

Year ended June 30, 2013

	<u>Pension Accumulation Fund</u>	<u>Annuity Savings Fund</u>	<u>Expense Fund</u>	<u>Total</u>
Additions:				
Appropriations and contributions:				
Employers	\$ 581,447,213	—	—	581,447,213
Members	—	185,837,186	—	185,837,186
Net investment gain	<u>1,331,208,154</u>	<u>—</u>	<u>—</u>	<u>1,331,208,154</u>
Total additions	<u>1,912,655,367</u>	<u>185,837,186</u>	<u>—</u>	<u>2,098,492,553</u>
Deductions:				
Benefit payments	1,060,561,148	—	—	1,060,561,148
Refunds of member contributions	—	7,204,411	—	7,204,411
Administrative expenses	<u>—</u>	<u>—</u>	<u>11,941,446</u>	<u>11,941,446</u>
Total deductions	<u>1,060,561,148</u>	<u>7,204,411</u>	<u>11,941,446</u>	<u>1,079,707,005</u>
Other changes in net position restricted for pension benefits:				
Transfer due to retirement of members	119,729,429	(119,729,429)	—	—
Transfer of interest allocation	(87,209,348)	87,209,348	—	—
Transfer to pay administrative expenses	(16,598,987)	—	16,598,987	—
Return of unrequited funds due to savings in administrative expenses	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u>15,921,094</u>	<u>(32,520,081)</u>	<u>16,598,987</u>	<u>—</u>
Net increase	868,015,313	146,112,694	4,657,541	1,018,785,548
Net position restricted for pension benefits:				
Beginning of year	<u>9,490,402,585</u>	<u>1,793,095,822</u>	<u>9,543,994</u>	<u>11,293,042,401</u>
End of year	<u>\$ 10,358,417,898</u>	<u>1,939,208,516</u>	<u>14,201,535</u>	<u>12,311,827,949</u>

See accompanying independent auditors' report.

**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, 2013

		Beginning balance	Additions	Deductions	Ending balance
Assets					
Cash	\$	—	—	—	—
Total assets	\$	—	—	—	—
Liabilities					
Due to employers	\$	—	196,507,139	196,507,139	—
Total liabilities	\$	—	196,507,139	196,507,139	—

See accompanying independent auditors' report.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Supplementary Information – Schedule of Administrative Expenses

Year ended June 30, 2013

Personnel services:	
Salaries and wages	\$ 4,610,238
Fringe benefits	1,743,839
Net change in unused vacation credits	2,031
Total personnel services	<u>6,356,108</u>
Professional services:	
Actuarial	115,406
Auditing and tax consulting	423,085
Disability hearing expenses	96,466
Legal services	369,111
Medical	385,694
Other services	322,088
Total professional services	<u>1,711,850</u>
Communication:	
Postage	165,053
Printing and binding	124,391
Telephone	70,338
Travel	47,662
Total communication	<u>407,444</u>
Rentals:	
Rental of equipment	65,305
Rental of premises	17,052
Total rentals	<u>82,357</u>
Other:	
Armored car service	5,521
Computer and office automation systems	992
Repairs and maintenance	1,188,436
Stationery and office supplies	29,608
Miscellaneous	41,659
Total other	<u>1,266,216</u>
Depreciation	<u>2,117,471</u>
	<u>\$ 11,941,446</u>

See accompanying independent auditors' report.

**EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII**

Supplementary Information – Schedule of Investment Expenses

Year ended June 30, 2013

Real estate and alternative investment expenses:	
Operating expenses	\$ 50,636,478
Mortgage interest	11,389,441
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Total real estate and alternative investment expenses	62,025,919
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Investment expenses:	
Investment manager/advisor fees	36,902,783
Bank custodian fees	100,000
Other investment expenses	920,903
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Total investment expenses	37,923,686
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Securities lending expenses:	
Borrower rebates	(851,628)
Management fees	584,344
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Total securities lending expenses	(267,284)
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	\$ 99,682,321
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See accompanying independent auditors' report.