



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

Financial Statements

June 30, 2020

(With Independent Auditors' Report Thereon)

Submitted by

**THE AUDITOR
STATE OF HAWAII**

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

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Independent Auditors' Report

The Auditor
The State of Hawaii:

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, 2020 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.

Auditors' 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 fiduciary net position of the Employees' Retirement System of the State of Hawaii as of June 30, 2020, and the changes in fiduciary 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 9 and the required supplementary information, including the schedules of changes in the employers' net pension liability and related ratios, employers' net pension liability, employer contributions, and investment returns, on pages 47 through 54 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 Supplementary 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 including the combining schedule of changes in fiduciary net position, social security contribution fund – statement of changes in assets and liabilities, and schedules of administrative expenses and investment expenses in schedules 1 through 4 for the year ended June 30, 2020 is presented for purposes of additional analysis, and is not a required part of the basic financial statements. The combining schedule of changes in fiduciary net position, social security contribution fund – statement of changes in assets and liabilities, and schedules of administrative expenses and investment expenses are 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 combining schedule of changes in fiduciary net position, social security contribution fund – statement of changes in assets and liabilities, and schedules of administrative expenses and investment expenses are 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 November 9, 2021, 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
November 9, 2021

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis (Unaudited)

June 30, 2020

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, 2020. The MD&A is presented as a narrative overview and analysis. 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 two main basic financial statements include the combining statement of fiduciary net position as of June 30, 2020, and the related statement of changes in fiduciary net position during the fiscal year from July 1, 2019 to June 30, 2020 (FY 2020). These provide a snapshot of the resources available at the end of the fiscal year and a summary of changes in resources available to pay pension benefits to members, retirees, and beneficiaries.

The related notes to financial statements are an integral part of the basic 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 Schedules of Changes in the Employers' Net Pension Liability and Related Ratios, Employers' Net Pension Liability, Employer Contributions and Investment Returns, and the related Notes to Required Supplementary Information, are required to be presented to supplement the basic financial statements for placing the financial statements in an appropriate operational, economic, or historical context.

The remaining supplementary information is derived from and relate directly to the underlying accounting and other records used to prepare the financial statements, and provides additional detailed information concerning the changes in operating reserves established by legislation, and the operating and investment related expenses of the ERS.

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June 30, 2020

Financial Highlights

While the fiduciary net position restricted for pension benefits (or net assets) increased slightly during FY 2020 to \$17.4 billion, the funded status of ERS decreased to 53.2% as of June 30, 2020. This represents an increase of \$0.2 billion, 0.9%, from the fiduciary net position restricted for pension benefits of \$17.2 billion as of June 30, 2019.

The ERS investment return (net and gross of fees) was 1.3% for the 2020 fiscal year compared to a 6.0% return during the 2019 fiscal year, using the time-weighted rate of return methodologies that are generally accepted by the Global Investment Performance Standards. The investment program underperformed its actuarial and investment goal of 7.0% that was effective June 30, 2020. Under GASB Statement No. 67, *Financial Reporting for Pension Plans – an amendment of GASB Statement No. 25*, the annual money-weighted return on ERS' pension plan investments, net of pension plan investment expense, was 2.1% and 5.7% for FY 2020 and FY 2019, respectively.

Effective October 1, 2014, the Board of Trustees of the System approved the adoption of a change in its asset allocation policy from the asset-class policy to a new risk-based asset allocation framework within the categories of Broad Growth, Principal Protection, Real Estate, and Real Return, that is expected to be implemented through 2020. This is the fourth year that the results of operations for these FY 2020 financial statements are prepared on the risk-based investment strategy since the portfolio was transitioned to the new policy during the 2017 fiscal year. Please refer to note 6(a) for more detailed information on the asset allocation policy.

During 2020 and 2019, there was no significant legislation passed that significantly affects the operations or provisions of the pension trust. This was the third of four years that will have significant increases in employer contribution rates from 2017 legislation that is discussed below.

Total pension liability as of June 30, 2020 increased to \$32.7 billion from \$31.4 billion as of June 30, 2019, while the corresponding net pension liability was \$15.3 billion and \$14.2 billion, for June 30, 2020 and June 30, 2019, respectively. Covered payroll for the ERS increased in FY 2020 to \$4.5 billion compared to FY 2019 to \$4.4 billion, for a 3.0% increase.

The fiduciary net position as a percentage of total pension liability decreased to 53.2% from 54.9% as of June 30, 2020 and June 30, 2019, respectively, while the funded ratio on an actuarial basis increased to 55.3% from 55.2%, respectively. The main difference between the two methods is under GASB Statement No. 67 for financial reporting purposes the fiduciary net position is based only on the market value of assets while under actuarial value for the net assets for funding purposes allows for a four-year market smoothing of assets of net appreciation.

Contributions from members and employers increased by a total of \$190.1 million during FY 2020, or 15.9% from FY 2019. The increase is due primarily to an increase in the statutory employer contribution rate; and to a lesser extent member pay increases, more active members being required to contribute, and new employees contributing at higher contribution rates.

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June 30, 2020

Total retirement benefit payments increased by \$76.0 million, or 5.2%, to \$1,545.6 million in FY 2020 from \$1,469.6 million in FY 2019. Pension benefits continues to increase due to 2.5% more retirees and beneficiaries (51,153 in 2020 compared to 49,885 in 2019), an increase in the average pension benefit for new retirees, and the annual 2.5% postretirement increase.

Administrative expenses increased by \$4.0 million to \$17.8 million in FY 2020 from \$13.8 million in FY 2019. The increase in administrative expenses is primarily the result of timing of Information technology related charges and, to a lesser extent, increases in payroll related items for salaries and the fringe benefit rate during FY 2020, and an increase in professional services for internal audit fees and the actuarial experience study conducted every three years. Administrative expenses for all years were within the ERS' budgeted amounts.

Analysis of Fiduciary Net Position Restricted for Pension Trust

Summary of Fiduciary Net Position

June 30, 2020 and 2019

(Dollars in millions)

	2020	2019	FY 2020 percentage change
Assets:			
Cash and cash equivalents and short-term investments	\$ 3,477.4	2,319.2	49.9 %
Receivables	249.6	222.3	12.3
Investments	14,120.4	15,120.6	(6.6)
Invested securities lending collateral	992.6	1,021.7	(2.8)
Equipment	7.6	6.6	15.2
Total assets	18,847.6	18,690.4	0.8
Liabilities:			
Securities lending liability	992.6	1,021.7	(2.8)
Investment accounts and other payables	469.6	441.7	6.3
Total liabilities	1,462.2	1,463.4	(0.1)
Fiduciary net position restricted for pensions	\$ 17,385.4	17,227.0	0.9

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June 30, 2020

Summary of Changes in Fiduciary Net Position

June 30, 2020 and 2019

(Dollars in millions)

	2020	2019	FY 2020 percentage change
Additions:			
Contributions	\$ 1,386.0	1,195.9	15.9 %
Net investment income	358.3	932.7	(61.6)
Total additions	1,744.3	2,128.6	(18.1)
Deductions:			
Retirement benefit payments	1,545.6	1,469.6	5.2
Refund of contributions	22.4	16.6	34.9
Administrative expenses	17.8	13.8	29.0
Total deductions	1,585.8	1,500.0	5.7
Increase in fiduciary net position	\$ 158.5	628.6	(74.8)

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.

Investments for the risk-based allocation policy approved in FY 2015 based on the type of security for financial reporting are listed below. This framework shifts the portfolio asset allocation from a return-based process to a risk-based process that makes use of strategic/functional classes that in-turn utilize underlying asset classes and strategies. Each of these classes is designed to achieve a certain goal (e.g., Real Return class) and/or be exposed to a specific set of macroeconomic risks that are common among the different strategy types and/or assets within the class (e.g., Broad Growth class). As a result of this structure, each strategic class is expected to be exposed to a set of major and minor macroeconomic risks. Since 2016 the ERS has been transitioning towards these new targets. Following the 2019 Asset Liability Study the long-term portfolio allocations were slightly amended to reduce the real return and private growth targets while the allocation to diversifying strategies target increased from 27% to 35% to allow for more uncorrelated and complimentary (to growth) strategies to be added to the portfolio. During the 2020 fiscal year, the ERS continued its focus on implementing these risk-based strategies.

The asset distribution of the ERS' investment securities for the pension trust, excluding pending trade settlements and securities lending collateral, at June 30, 2020 and 2019 is presented below at fair value. Fluctuations will occur based on the trading activity and timing of the settlements. Investment balances

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Management's Discussion and Analysis (Unaudited)

June 30, 2020

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.

Investment Asset Class

June 30, 2020 and 2019

(Dollars in millions)

	<u>2020</u>	<u>Percentage</u>	<u>2019</u>	<u>Percentage</u>
Short-term investments and cash	\$ 3,477.4	19.8 %	\$ 2,319.2	13.3 %
Equity securities	6,257.2	35.6	7,252.4	41.6
Fixed income	4,131.9	23.5	4,740.4	27.2
Real estate	1,531.8	8.7	1,285.3	7.4
Alternative investments	<u>2,199.5</u>	<u>12.4</u>	<u>1,842.5</u>	<u>10.5</u>
Total investment assets	✔ 17,597.8	<u>100.0 %</u>	✔ 17,439.8	<u>100.0 %</u>
Less loans on real estate and alternative investments	<u>190.7</u>		<u>142.8</u>	
Total	\$ <u>17,407.1</u>		\$ <u>17,297.0</u>	

The rate of return (gross of fees time-weighted rate of returns) on the ERS investment portfolio during FY 2020 was 1.3% lead by returns in the crisis risk offset program, real return and principal protection , while there was underperformance or losses in the traditional equity markets and certain fixed income assets, down from 6.0% in FY 2019. Total net investment income was \$358.3 million in FY 2020 versus \$932.7 million in FY 2019.

The ERS earned positive returns during a volatile year with the crisis risk offset (+6.5%), real return (+6.6%) and principal protection (+4.5%) asset classes, compared to small losses in broad growth (-0.4%) assets. All asset classes underperformed the ERS's 7.0% benchmark during the year. The crisis risk offset program earned 6.5% on the strong performance within the long duration fixed income segment (+25.1%), followed by real return (+6.6%) and principal protection (+4.5%). Within the broad growth class, there was a mixture of gains and losses within sub-components, resulting in a slight overall loss for the class of (-0.4%).

The ERS participates in a securities lending program through its global custodian as a way to earn incremental income to enhance the investment portfolio yield.

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.

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June 30, 2020

Total investment management fees earned by external investment advisors remained relatively consistent in FY 2020 compared to FY 2019 due primarily from elimination of accrued performance fees on certain assets in FY 2020. Investment advisor fees may fluctuate each year due to certain equity and real estate investment managers may receive an incentive fee for superior investment returns by the manager above their corresponding benchmark, while maintaining an acceptable level of investment risk. Incentive fees for real estate managers are recognized on the accrual basis of accounting for the change in real estate values during the year, and are only paid upon the sale of the asset if the asset has "excess earnings" when the real estate asset is actually sold. 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.

Contributions

Contributions from employers and employees totaled \$1,386.0 million and \$1,195.9 million in FY 2020 and FY 2019, respectively. During FY 2020, total contributions increased by \$190.1 million, or 15.9%, mainly due to an increase in the statutory employer contribution rate, member pay increases, more active members being required to contribute, and new employees contributing at higher contribution rates. Employer contribution rates will continue to increase over the next year as a result of 2017 legislation discussed below.

Pension Plan Benefits and Expenses

Pension benefit payments continue to be the primary expense of the ERS with payments increasing to \$1,545.6 million in FY 2020 from \$1,469.6 million in FY 2019. The pension benefits increase is attributed to the continued net increase in the number of retirees being paid, higher pension benefits for recent retirees, and the annual postretirement increase for ERS' retirees.

Refunds to terminating Hybrid and Contributory Class members increased to \$22.4 million in FY 2020 from \$16.6 million in FY 2019.

Administrative expenses increased to \$17.8 million from \$13.8 million in FY 2019 due primarily from an increase for computer related costs for equipment and maintenance during the year. This was followed by an increase in payroll related costs for pay raises and an increase in the fringe benefit rate assessment, and to a lesser extent for professional services related to an actuarial experience study completed and increased internal audit activities.

Pension Plan Changes

There was no significant legislation passed in 2020 and 2019 that affects pension plan provisions. Pension plan changes, including legislative and Board of Trustees' actions, are summarized in the notes to the financial statements.

Actuarial Valuations and Measurement of Net Pension Liability

The funding status decreased during FY 2020 on the fiduciary net position (market asset basis) to 53.2% as of June 30, 2020 from 54.9% as of June 30, 2019, as a result of investment returns being lower than benchmark, an increase in liabilities with actual salary increases being larger than current expectations, and to a lesser extent the four-year phase-in of increased employer contribution rates.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis (Unaudited)

June 30, 2020

During a volatile FY 2020 resulting from the global pandemic, the ERS's investment portfolio earned 1.3% based on the market value of assets and was less than the target rate of 7.0%. This compares to rate of return for the actuarial value was 5.6% in FY 2020, which is different than the market return due to the smoothing methodology used in the determination of the actuarial value of assets, combined with the third year of scheduled contribution rate increases (of a four-year phase in period).

The total pension liability for fiscal year ended June 30, 2020 is based on the actuarial valuation performed as of June 30, 2020 and a measurement date of June 30, 2020.

Per the valuation as of June 30, 2020, the ERS's total pension liability was \$32.7 billion, covered payroll totaled \$4.5 billion, and the ERS's fiduciary net position of \$17.4 billion resulting in a net pension liability of \$15.3 billion. The June 30, 2019, valuation results include the ERS' total pension liability of \$31.4 billion, covered payroll totaled \$4.4 billion, and the ERS's fiduciary net position was \$17.2 billion resulting in a net pension liability of \$14.2 billion. The ERS's fiduciary net position as a percentage of total pension liability was 53.2% and 54.9% on June 30, 2020 and 2019, resulting in the net pension liability as a percentage of covered payrolls of 341.6% and 323.8%, respectively. The increase in pension liabilities is overall payroll growth and individual salary increases.

Based on the results of the actuarial valuation as of June 30, 2020, including existing statutory employer contribution rates, the ERS actuary determined the funding period for paying off the unfunded actuarial accrued liability (UAAL) of the ERS Pension Trust is 26 years. Because this period is less than the 30 years, the objectives set in Hawaii Revised Statutes (HRS) are currently being realized. (HRS§88-122(e)(1) state that the employer contribution rates are subject to adjustment when the funding period is in excess of 30 years.)

Increase in Statutory Employer Contribution Rates – Future State and counties employer contributions are expected to increase pursuant to a phased-in contribution rate increase over four years beginning July 1, 2017. Per Act 17 (SLH 2017), the rate for Police and Firefighters employees increases to 28.00% on July 1, 2017; 31.00% on July 1, 2018; 36.00% on July 1, 2019; and 41.00% on July 1, 2020; and the rate for All Other Employees increases to 18.00% on July 1, 2017; 19.00% on July 1, 2018; 22.00% on July 1, 2019; and 24.00% on July 1, 2020. These employer contribution rates are applied to the total covered payroll in each respective category to determine the required employer contributions.

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 Fiduciary Net Position

June 30, 2020

Assets:

Cash and cash equivalents and short-term investments:

Cash and cash equivalents	\$ 953,191,671
Short-term investments	2,524,206,530
	<u>3,477,398,201</u>

Receivables:

Accounts receivable and others	5,728,204
Investment sales proceeds	150,789,478
Accrued investment income	38,399,145
Employer and member contributions	54,670,412
	<u>249,587,239</u>

Investments, at fair value:

Equity securities	6,257,170,203
Fixed-income securities	4,131,855,027
Real estate investments	1,531,902,816
Alternative investments	2,199,495,724
	<u>14,120,423,770</u>

Other:

Invested securities lending collateral	992,602,987
Equipment, at cost, net of depreciation	7,654,129
	<u>1,000,257,116</u>

Total assets

18,847,666,326

Liabilities:

Accounts and other payables	128,401,072
Payable for securities purchased	150,439,791
Securities lending collateral	992,602,987
Notes payable	190,742,000
	<u>1,462,185,850</u>

Commitments and contingencies

Fiduciary net position restricted for pensions

\$ 17,385,480,476

See accompanying notes to financial statements.

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Statement of Changes in Fiduciary Net Position

Year ended June 30, 2020

Additions:

Contributions:

Employers contributions	\$ 1,098,589,013
Members contributions	287,398,031
Total contributions	<u>1,385,987,044</u>

Investment income:

From investing activities:

Net appreciation in fair value of investments	(39,409,286)
Interest on fixed-income securities	157,681,571
Dividends on equity securities	117,277,446
Income on real estate investments	81,755,691
Interest on short-term investments	3,665,938
Alternative investment income	117,736,703
Miscellaneous	771,552
	<u>439,479,615</u>

Less investment expenses	<u>86,461,633</u>
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Net investment income from investing activities	<u>353,017,982</u>
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From securities lending activities:

Securities lending income	19,006,966
Less securities lending expenses, net	<u>13,742,284</u>

Net investment income from securities lending activities	<u>5,264,682</u>
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Total net investment income	<u>358,282,664</u>
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Total additions, net	<u>1,744,269,708</u>
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Deductions:

Benefit payments	1,545,589,761
Refunds of member contributions	22,443,593
Administrative expenses	<u>17,782,865</u>

Total deductions	<u>1,585,816,219</u>
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Net increase in fiduciary net position	158,453,489
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Fiduciary net position restricted for pensions:

Beginning of year	<u>17,227,026,987</u>
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End of year	<u>\$ 17,385,480,476</u>
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See accompanying notes to financial statements.

**EMPLOYEES' RETIREMENT SYSTEM
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Notes to Financial Statements

June 30, 2020

(1) Description of the ERS

(a) 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 provisions of the ERS are contained in Chapter 88 of the Hawaii Revised Statutes (HRS) and applicable provisions of the federal Internal Revenue Code (IRC). The ERS is a cost-sharing, multiple-employer public employee retirement system established as a defined-benefit pension plan to administer a pension benefits program for all state and county employees, including teachers, professors, police officers, firefighters, correction officers, judges, and elected officials.

The ERS is a qualified defined-benefit pension plan under Section 401(a) of the IRC. Since January 1, 1988, member contributions have been tax deferred under Section 414(h)(2) of the Internal Revenue Code, and Chapter 88 mandates that employers pick up the employee contributions. These contributions are classified as member contributions in the financial statements. As a public entity, the ERS is not required to file a federal income tax return with the IRS. As a defined-benefit pension plan, the ERS is required to withhold federal income tax from member and benefit recipient payments in accordance with the IRC.

The ERS Pension Trust is comprised of three pension classes for membership purposes and is considered to be a single plan for accounting purposes because all assets of the ERS may legally be used to pay the benefits of any of the ERS members or beneficiaries, as defined by the terms of the ERS. The ERS provides retirement, survivor, and disability benefits for three membership classes known as the contributory, hybrid, and noncontributory members.

Generally, all full-time employees of the state and counties of Hawaii are required to be members of the ERS. Some positions of the state and counties of Hawaii are not eligible for ERS membership and may be covered by another separate retirement program. Membership of the plan and the benefits provided are based on the individual's employment group and ERS membership date. A member may belong to only one class based on their latest employment. A member may change classes in certain situations due to a change in their employment date or job classification. If a member earns service in different classes or benefit structures, the member's retirement benefit is bifurcated based on the applicable membership service earned (such as service credits and benefit multiplier percentage of such service).

The two major employment groups applicable to employer and member contribution rates, vesting requirements, and benefit provisions are (a) Police and Firefighters and (b) All Other Employees. There are four major benefit structures for contributory class members based on employment group and membership date while there are two benefit structures for hybrid class members based on their membership date, as discussed below. The noncontributory class has one benefit structure.

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Notes to Financial Statements

June 30, 2020

Employer, pensioner, and employee membership data as of March 31, 2020 is as follows:

Employers:	
State	1
County	4
Total employers	<u>5</u>
Pensioners and beneficiaries currently receiving benefits:	
Pensioners currently receiving benefits:	
Police and firefighters	3,971
All others employees	42,515
Total pensioners	<u>46,486</u>
Beneficiaries currently receiving benefits:	
Police and firefighters	346
All others employees	4,321
Total beneficiaries	<u>4,667</u>
Total pensioners and beneficiaries	<u>51,153</u>
Terminated vested members entitled to benefits but not yet receiving benefits:	
Police and firefighters	386
All others employees	8,818
Total terminated vested members	<u>9,204</u>
Inactive members:	
Police and firefighters	788
All other employees	20,197
Total inactive members	<u>20,985</u>
Total terminated vested and inactive members	<u>30,189</u>
Active members:	
Vested:	
Police and firefighters	4,012
All other employees	43,758
Total vested members	<u>47,770</u>
Nonvested:	
Police and firefighters	928
All other employees	18,052
Total nonvested members	<u>18,980</u>
Total active members	<u>66,750</u>
Total membership	<u>148,092</u>

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(b) *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 HRS and is governed by a Board of Trustees (the Board) as discussed below.

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 and retirees 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 Executive Director and Chief Investment Officer and engages actuarial and other services required to transact the business of the ERS.

(c) *Class Descriptions and Funding Policy*

Members of the ERS are contributory, hybrid, or noncontributory members. 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 as a percentage of payroll.

The statutory employer contribution rate includes the normal cost and accrued liability contribution and is determined separately for two groups of employees: (a) police officers and firefighters, and (b) all other employees. Employer contribution rates are subject to adjustment in certain situations based on the plan's funded status or actuarial investigations. The ERS performs an actuarial investigation of the experience at least once every five years, plus an annual actuarial valuation of the assets and liabilities of the funds of the pension trust. The Board adopts mortality, service, and other assumptions, factors, and tables as deemed appropriate and necessary, based on the actuarial investigation and actuary recommendation. Generally, actuarial assumptions and methods were adopted by the Board on August 12, 2019 as recommended by Gabriel, Roeder, Smith and Company (GRS) (from the experience study as of June 30, 2018, with most of the assumptions based on the period from July 1, 2013, through June 30, 2018) while the investment return assumption was adopted beginning with the 2016 valuation.

Effective July 1, 2008, the statutory employer contribution rate for employees in the Police officers and firefighters 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 officers and firefighters employees increased 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 increased 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.

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Per Act 17 (SLH 2017), employer contribution rates from State and counties are expected to increase pursuant to a phased-in contribution rate increase over four years beginning July 1, 2017. The rate for Police and Firefighters increased to 28.00% on July 1, 2017; 31.00% on July 1, 2018; and 36.00% on July 1, 2019; and increases to 41.00% on July 1, 2020 and the rate for All Other Employees increased to 18.00% on July 1, 2017; 19.00% on July 1, 2018; and 22.00% on July 1, 2019; and increases to 24.00% on July 1, 2020.

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 non-base 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" non-base pay increases.

Until June 30, 1984, all employees were required to be contributory members. Employees covered by Social Security on June 30, 1984 were given the option of changing to a noncontributory member or remain a contributory member. All new employees hired after June 30, 1984 and before July 1, 2006, who are covered by Social Security, were generally required to be noncontributory members. Qualified employees that were contributory or noncontributory members were given the option to change to Hybrid Class benefits structure effective July 1, 2006, or remain in their existing class. Starting July 1, 2006, all new employees covered by Social Security are required to be Hybrid members, unless they are required to be Contributory members. Most employees not covered by Social Security (primarily Police and Firefighters employees) are required to be Contributory members.

The three membership classes provide a monthly retirement allowance (maximum allowance) equal to the benefit multiplier % (generally 1.25% or 2%) 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 members hired after June 30, 2012. If a member earns service in a different benefit structure, the member's retirement benefit is bifurcated based on the applicable membership service earned (such as service credits and benefit multiplier percentage of such service). In lieu of the maximum allowance, the member may elect to receive an actuarially equivalent alternate retirement option with a reduced lifetime allowance (such as survivor benefit).

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, and before July 1, 2012, 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 2.5% on each July 1 following the calendar year of retirement, if the retiree became an ERS member prior to July 1, 2012. This cumulative benefit is not compounded and increases each year by 2.5% of the original retirement allowance without a ceiling (2.5% of the original retirement allowance the first year, 5.0% the second year, 7.5% the third year, etc.). For new members hired after June 30, 2012, the

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postretirement annuity increase was decreased to 1.5% per year of the original retirement allowance without a ceiling (1.5% of the original retirement allowance the first year, 3.0% the second year, 4.5% the third year, etc.).

The following summarizes the provisions relevant to the largest employee groups of the respective membership class. Retirement benefits for certain groups, such as sewer workers, judges, and elected officials, vary from general employees.

All contributions, benefits, and eligibility requirements are governed by Chapter 88 of the HRS. All of the statutory member contributions discussed in this section are classified as "member contributions" with the adoption of GASB Statement No. 82, *Pension Issues – an amendment of GASB Statements No. 67, No. 68, and No. 73*.

(i) *Contributory*

Police officers, firefighters, and certain other members that are not covered by Social Security first hired prior to July 1, 2012 contribute 12.2% of their salary and receive a retirement benefit using the benefit multiplier of 2.5% for qualified service, up to a maximum of 80% of AFC. These members may retire at age 55 with five years of credited service or at any age with 25 years of credited service, provided the last five years of credited service is any of the qualified occupations.

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, provided the last 5 years of credited service is any of the qualified occupations.

All other employees hired prior to July 1, 2012 are required to contribute 7.8% of their salary and are fully vested for benefits upon receiving five years of credited service. Contributory members may retire with full benefits at age 55 and five years of credited service. They may take early retirement at any age with at least 25 years of credited service and receive benefits reduced 5% per year under age 55 plus 4% per year under age 50. The benefit multiplier is 2% for employees covered by Social Security.

All other employees in the contributory class 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. Members may take early retirement at age 55 with 25 years of credited service and receive benefits reduced by 5% per year under age 60. The benefit multiplier is 1.75% for employees covered by Social Security.

(ii) *Hybrid*

All other employees hired before July 1, 2012 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. Early retirement benefits are available at age 55 and 20 years of credited service with benefits

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reduced by 5% per year under age 62. The benefit multiplier used to calculate retirement benefits is 2%. Hybrid members are covered by Social Security.

All other employees 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. Early retirement is available at age 55 and 20 years of credited service with benefits reduced 5% per year under age 65. The benefit multiplier used to calculate retirement benefits is 1.75%. Hybrid members are covered by Social Security.

(iii) Noncontributory

All other employees are fully vested upon receiving 10 years of credited service. The employer is required to make all contributions for these members. Employees may retire with full benefits at age 62 years and 10 years of credited service or age 55 and 30 years of credited services. Early retirement is available at age 55 years and 20 years of credited service with benefits reduced by 6% per year under age 62. The benefit multiplier used to calculate retirement benefits is 1.25%.

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. There is no age requirement to qualify for disability benefits.

Ordinary death benefits for contributory and noncontributory members require at least 1 year and 10 years of service, respectively. Ordinary death benefits for hybrid members require 5 years of service if hired prior to July 1, 2012, or 10 years of service if hired after June 30, 2012. There is no service requirement to qualify for service-connected death benefits.

(d) 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 as contributory, hybrid, or noncontributory membership. 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.

(e) Other Post Employment Benefits

In addition to the retirement benefits provided by the ERS Pension Trust, the participating employers, pursuant to HRS Chapter 87A, provide certain healthcare and life insurance benefits for State and county qualified 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 10 or more years of credited service.

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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 10 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 10 and 15 years of credited service; (b) 75% of the base monthly contribution if the employee retired with between 15 and 25 years of credited service; and (c) 100% of the base monthly contribution if the employee retired with 25 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 10 and 15 years of credited service; (b) 75% of the base monthly contribution for a self-only plan if the employee retired with between 15 and 25 years of credited service; and (c) 100% of the base monthly contribution for a self-only plan if the employee retired with 25 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.

(2) 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 IRS; and
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, 2020, the ERS held no amounts in the Contribution Fund as all amounts deposited into the Contribution Fund were paid directly to the IRS.

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(3) Summary of Accounting Policies

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

(a) 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 the Social Security Fund as 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 in conformity with U.S. generally accepted accounting principles (GAAP) using the accrual basis of accounting. Administrative expenses are financed exclusively with investment income.

(b) Method Used to Value Cash and Investments

The ERS' investment policy for cash and investments, including the legal authority, are discussed below in note 6. Notes 3 and 6 include a comprehensive discussion on fair value, including the disclosure requirements of fair value required by GASB Statement No. 72, Fair Value Measurement and Application.

Cash, investments, and notes payable in the Pension Trust are reported at fair value. The definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Unrealized gains and losses are included as investment income in the statement of changes in fiduciary net position. The investments of the Pension Trust Fund and Contribution Fund (the Retirement Funds) are valued on a monthly basis.

(c) 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.

Employers and members contributions are recognized in the period in which the contributions are legally due.

(d) Payment of Benefits

Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

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(e) Securities Lending

The ERS records collateral received under securities lending agreements where the ERS has the ability to spend, pledge, or sell the collateral without borrower default. Liabilities resulting from these transactions are also recorded. 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 fiduciary net position does not include detailed holdings of securities lending collateral by investment classification.

(f) 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 Reserve – Fixed at 4½% regular interest rate for employees hired before July 1, 2011 and 2% regular interest rate for employees hired after June 30, 2011
- b. Expense Reserve – To be credited with all money to pay the administrative expenses of the ERS
- c. Pension Accumulation Reserve – To be credited with any remaining investment earnings.

(g) Risk Management

The ERS reports liabilities, as discussed in note 8, 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.

(h) Use of Estimates

In preparing financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect certain reported amounts and disclosures. Actual results could differ from those estimates.

Investments in limited partnerships and other alternative investments are 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.

The total pension liability is based on calculations that incorporate various actuarial and other assumptions, including discount rate, mortality, investment rate of return, inflation, and payroll growth. The actuarial assumptions were based on the results of an experience study as of June 30, 2018, with most of the assumptions based on the period from July 1, 2013, through June 30, 2018.

(i) Recently Issued Accounting Standards

In January 2017, GASB issued Statement No. 84, *Fiduciary Activities* (Statement No. 84). Statement No. 84 establishes criteria for identifying fiduciary activities and guidance on reporting those activities.

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This Statement provides guidance on four fiduciary funds that should be reported, if applicable: pension (and other employee benefit) trust funds, investment trust funds, private-purpose trust funds, and custodial funds. The requirements of Statement No. 84 are effective for reporting periods beginning after December 15, 2018, postponed by GASB Statement No. 95, Postponement of the Effective Dates of Certain Authoritative Guidance for one year. ERS has not yet determined the impact of this standard on its financial statements and disclosures.

(4) Description of Reserves

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

(a) Pension Accumulation Reserve

To accumulate contributions made by the State and counties, (except member contributions "picked up" as employer contributions under pursuant to IRC Section 414(h)(2)) transfers of retired members' contributions plus related interest income from the Annuity Savings Reserve, and income from investments. All pension benefits, including the pensioners' bonus, are paid through this reserve.

(b) Annuity Savings Reserve

To accumulate members' contributions (including member contributions "picked up" as employer contributions under pursuant to IRC Section 414(h)(2)) and related interest income. Upon a member's retirement, the accumulated contributions and related interest income are transferred to the Pension Accumulation Reserve or refunded to the member upon termination.

(c) Expense Reserve

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 reserve 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.

Fiduciary net position restricted for pensions as of June 30, 2020 are as follows:

Pension accumulation reserve	\$ 14,197,534,708
Annuity savings reserve	3,164,652,385
Expense reserve	<u>23,293,383</u>
Total fiduciary net position restricted for pensions	<u>\$ 17,385,480,476</u>

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(5) Contributions

The ERS' funding policy provides for periodic employer contributions expressed as a percentage of annual covered payrolls. 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. See note 1(c), Class Descriptions and Funding Policy, for the effective statutory employer contribution rates.

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" non-base pay during the last 10 years of employment. The additional contributions are based on the increased costs of the actuarial equivalent increase in pension benefits the member will be paid in retirement compared to the pension benefits that would be paid if the member did not have excess non-base pay in their AFC amount.

Member contributions rates are statutorily established in accordance with Chapter 88 of the HRS, and are discussed in note 1(c), Class Descriptions and Funding Policy, above. Since 1989, participating employers "pick up" ERS member contributions made by payroll deduction as "employer contributions" for tax purposes under IRC Section 414(h)(2). These contributions are classified as member contributions being paid by the member for ERS purposes.

(6) Deposits and Investments Disclosures

(a) Investment Policy

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. Investments in the Securities Lending Collateral Pool and the Contribution Fund are limited to investment grade, short-term marketable securities.

The investment decision is further dictated by internal investment policies and asset allocation established by the Board. 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

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accordance with the Board's asset allocation strategy, assigned investment mandate, and in compliance with Chapter 88, HRS, as amended.

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. Plan assets are managed on a total return with the long-term objective of achieving and maintaining a fully funded status basis (when combined with receiving the required employer and member contribution requirements) for the benefits provided through the Pension Trust. As part of the investment policy, the Board reviews the asset allocation annually and should perform a formal asset allocation study at least every three years to verify or amend the targets.

At the end of the fiscal year, June 30, 2020, the ERS was strategically invested in the following classes:

	Strategic Allocation (functional/risk-based classes)
Broad Growth	68%
Principal Protection	8%
Real Return	8%
Crisis Risk Offset	16%
Total	100%

During FY 2020, the Broad Growth strategic asset class includes sub-asset classes or components of Active Public Equity, Passive Public Equity, Core Real Estate, Extended Global Credit, Low Volatility Equity, Options-based Equity, Non-Core Real Estate, and Private Equity. The Principal Protection asset class includes the Global Intermediate Fixed Income. The Real Return asset class includes components of Inflation-linked Fixed Income, Infrastructure, and Timber. The Crisis Risk Offset sub-asset classes are Alternative Return Capture Strategies, Trend Following Strategies, and Long Duration Fixed Income. The ERS may also hold opportunities and other investments.

As a result of the formal asset-liability study that began in fiscal year 2019 and was completed in fiscal year 2020, the Board adopted a new long-term strategic allocation policy. As part of this new long-term strategic policy, the portfolio will transition to two major strategic classes (rather than four). Current classes and sub-classes will be remapped to the two major strategic classes where applicable. It is expected that final implementation and allocations across the new long-term strategic allocation policy will be largely completed by the end of the 2022 fiscal year.

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The ERS will strategically invest in the following strategic asset classes:

Strategic allocation (risk-based classes)	Strategic class weights	Expected long-term geometric average strategic range	Expected long-term real return*	Expected annual standard deviation
Broad growth	63 %	7.9 %	5.7 %	14.7 %
Diversifying Strategies	37 %	3.7 %	1.5 %	6.7 %
Total portfolio	100 %			

* Uses an expected inflation of 2.2%

The ERS utilizes two high-level strategic classes (Broad Growth and Diversifying Strategies) for allocating assets and managing risk within the total portfolio. Both of these strategic classes contain sub-components that in-turn utilize asset classes and/or specific strategies for implementation. The Broad Growth class utilizes three sub-components (Public Growth, Private Growth, and Real Assets) which are ultimately invested in public equity, options-based equity, credit fixed income, private real assets, and private equity. The Diversifying Strategies class is designed to be uncorrelated to the Broad Growth class and it utilizes three sub-components (Liquid Defensive, Liquid Diversifying, and Illiquid Diversifying). The Diversifying Strategies class utilizes a multitude of asset classes and strategies, including US treasury and agency bonds, inflation-linked treasury bonds, systematic trend following, alternative risk premia, global macro, insurance-linked securities, relative value strategies, and niche private assets, among others. The ERS may also hold opportunities and other investments if they are determined to be additive to the portfolio's risk/return posture.

It is expected that the ERS's implementation of the new long-term strategic allocation effective as of July 1, 2020, will be completed by the end of FY 2022, as follows.

	Implementation Plan for Long-term Strategic Policy			
	Current (June 30, 2020)	7/1/2020	Long Term 7/1/2021	Long-term 7/1/2022
Broad growth	68%	72%	67.5%	63%
Principal protection	8%	0%	0%	0%
Real return	8%	0%	0%	0%
Crisis risk offset	16%	0%	0%	0%
Diversifying Strategies	0%	28%	32.5%	37%
	100%	100%	100%	100%

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Rate of Return

For the year ended June 30, 2020, the annual money-weighted return on pension plan investments, net of pension plan investment expense, was 2.1%. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for changing amounts actually invested.

(b) Deposits

Cash includes amounts in demand deposits for operations and invested funds held by ERS investment managers. 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 coverage, are guaranteed by securities pledged as collateral by the bank with the State Director of Finance. Uninsured and uncollateralized amounts are primarily cash held by the investment custodian for settlement of investment transactions. Deposits are presented in the basic financial statements at cost, which represent 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, 2020, the carrying amount of deposits totaled approximately \$953,191,671 and the corresponding bank balance was \$958,208,278, all of which was exposed to custodial credit risk.

(c) Investments

The following table shows the investments of the ERS by investment type as of June 30, 2020.

Cash and short-term investments:	
Cash and cash equivalents	\$ 953,191,671
Short-term bills and notes	990,377,396
Pooled and others	1,536,720,819
Fixed-income securities:	
U.S. Treasury bonds and notes	2,506,352,362
U.S. government agencies bonds	6,224,640
U.S. government agency mortgage backed	305,453,520
U.S. government-sponsored agency mortgage backed	11,153,343
Asset backed securities	27,718,204
U.S. corporate bonds	800,431,457
Non-U.S. government/agency bonds	179,720,165
Non-U.S. corporate bonds	164,282,359
Pooled and others	58,757,697

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Derivatives:	
Forwards – cash and short-term investments	\$ (2,891,685)
Forwards – debt securities	22,464,312
Futures – debt securities	42,756,323
Options – equities	(51,799,315)
Options – debt securities	(14,890)
Swaps – debt securities	6,555,535
Equities	6,308,969,518
Real estate	1,531,902,816
Alternative investments	<u>2,199,495,724</u>
Total investments	<u>\$ 17,597,821,971</u>
Short-term instruments for securities lending collateral pool	\$ 992,602,987

Investments are measured at fair value. The ERS categorizes its fair value measurements within the fair value hierarchy established by GAAP. Fair value is a market-based measurement of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that a transaction to sell an asset or transfer a liability takes place in either the principal market or most advantageous market (after taking into account transaction costs and transportation costs).

The fair value hierarchy categorizes the inputs to valuation techniques used to measure fair value into three levels. The hierarchy is based on the valuation inputs used to measure the fair value of the asset and gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

- Level 1 – Unadjusted quoted prices for identical instruments in active markets
- Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs are observable
- Level 3 – Valuations derived from valuation techniques in which significant inputs are unobservable.

If the fair value of an asset or a liability is measured using inputs from more than one level of the fair value hierarchy, the measurement is considered to be based on the lowest-priority-level input that is significant to the entire measurement. The categorization of investments within the hierarchy is based upon the pricing transparency of the instrument and should not be perceived as the particular investment's risk.

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Fair Value Hierarchy Levels

Equity securities classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities 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. Short-term investments and fixed-income securities classified as Level 1 include U.S. Treasury securities. Fixed income pooled funds classified in Level 1 of the hierarchical framework are mutual funds with instruments which trade on a national exchange and the fund's net asset value (NAV) is the basis for the fund's transactions. Derivative securities classified in Level 1 include certain options and futures are valued using prices quoted in active markets for those securities.

Short-term, preferred shares, fixed-income securities, and invested securities lending collateral classified in Level 2 have non-proprietary information that was readily available to market participants from multiple independent sources, which are known to be actively involved in the market. Pricing inputs may include market quotations, yields, maturities, call features and ratings. Derivative securities classified in Level 2 are securities whose values are derived daily from associated traded securities. Preferred shares and fixed income securities classified in Level 3 are private investments, thinly traded securities, mortgaged backed term loans and bonds where input data is sourced from instruments whose values are estimated, out of necessity, using unobservable inputs due to lack of comparable securities in the market place or are valued using discounted cash flows.

Real estate (direct investment) and alternative investments (direct investment) limited partnerships and limited liability companies classified as Level 3 are considered to be directly held. 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 and are audited annually. 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 appraiser(s). 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 readily accessible market values 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.

Notes payable are shown at estimated fair values. Notes payable, classified as Level 3, consists of mortgage notes within the limited liability companies and limited partnerships of real estate (direct investment) that are secured by real estate of the respective company.

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Investments measured at the NAV

Short-term investment funds, pooled equity (not publicly traded) and fixed income (not publicly traded) are reported on their respective NAV. Fair value is 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. Annual audits of the pooled funds include a review of compliance with the investment company's valuation policies.

Real estate and alternative investments (pooled or commingled funds) are measured at 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 using valuation assumptions based on both market and property specific inputs, which are not observable and involve a certain degree of expert judgment. 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 readily accessible market values for these assets existed.

Investments measured at NAV are not required to be categorized in the fair value hierarchy levels.

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The following table shows the fair value hierarchy by investment type as of June 30, 2020.

Investments, Derivative Instruments, and Invested Securities Lending Collateral Measured at Fair Value

	<u>Total</u>	<u>Fair value measurement using</u>		
		<u>Active markets for identical assets (Level 1)</u>	<u>Significant other observable inputs (Level 2)</u>	<u>Significant unobservable inputs (Level 3)</u>
Investments by fair value level:				
Short-term investments:				
Short-term bills and notes	\$ 990,377,396	986,378,239	3,999,157	—
Total short-term investments	<u>990,377,396</u>	<u>986,378,239</u>	<u>3,999,157</u>	<u>—</u>
Equity securities:				
Common stocks	4,643,593,908	4,643,593,098	—	810
Preferred shares and other	349,381,895	317,695,214	7,065,100	24,621,581
Total equity securities	<u>4,992,975,803</u>	<u>4,961,288,312</u>	<u>7,065,100</u>	<u>24,622,391</u>
Fixed-income securities:				
U.S. Treasury bonds and notes	2,506,352,362	2,365,451,965	140,900,397	—
U.S. government agencies bonds	6,224,640	—	6,224,640	—
U.S. government agency mortgage backed	305,453,520	—	305,453,520	—
U.S. government-sponsored agency mortgage backed	11,153,343	—	11,153,343	—
Asset backed securities	27,718,204	—	27,718,204	—
U.S. corporate bonds	800,431,457	—	749,137,955	51,293,502
Non-U.S. government/agency bonds	179,720,165	—	179,419,013	301,152
Non-U.S. corporate bonds	164,282,359	—	138,600,381	25,681,978
Pooled and others	3,406,252	—	3,392,155	14,097
Total fixed-income securities	<u>4,004,742,302</u>	<u>2,365,451,965</u>	<u>1,561,999,608</u>	<u>77,290,729</u>
Real estate (direct investment)	581,211,501	—	—	581,211,501
Alternative investments (direct investment)	183,372,424	—	—	183,372,424
Total assets at fair value level	<u>10,752,679,426</u>	<u>8,313,118,516</u>	<u>1,573,063,865</u>	<u>866,497,045</u>
Liabilities:				
Notes payable (on real estate-direct)	190,742,000	—	—	190,742,000
Total investments (excluding derivatives), net of notes payable measured by fair value level	<u>\$ 10,561,937,426</u>	<u>8,313,118,516</u>	<u>1,573,063,865</u>	<u>675,755,045</u>

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Investments, Derivative Instruments, and Invested Securities Lending Collateral Measured at Fair Value

	<u>Total</u>	<u>Fair value measurement using</u>		
		<u>Active markets for identical assets (Level 1)</u>	<u>Significant other observable inputs (Level 2)</u>	<u>Significant unobservable inputs (Level 3)</u>
Investment derivative instruments:				
Currency purchases	\$ (2,891,685)	—	(2,891,685)	—
To Be Announced (TBAs) forwards	22,464,312	—	22,464,312	—
Bond futures	7,310,238	7,310,238	—	—
Commodity futures	6,762,878	6,762,878	—	—
Currency futures	4,713,434	4,713,434	—	—
Index fixed income futures	1,850,089	1,850,089	—	—
Interest rate futures	22,119,684	22,119,684	—	—
Options	(51,799,315)	(16,418,114)	(35,381,201)	—
Options on debt securities	(14,890)	—	(14,890)	—
Credit default swaps	(584,726)	—	(584,726)	—
Total return swaps	9,211,245	—	9,211,245	—
Interest rate swaps	(2,070,984)	—	(2,070,984)	—
Total investment derivative instruments	\$ <u>17,070,280</u>	<u>26,338,209</u>	<u>(9,267,929)</u>	<u>—</u>
Invested securities lending collateral:				
Short-term instruments:				
Certificate of deposits	\$ 133,068,479	—	133,068,479	—
Repurchase agreements	154,709,802	—	154,709,802	—
Global commercial paper	215,402,162	—	215,402,162	—
Global asset backed notes	60,887,290	—	60,887,290	—
Global corporate notes	428,535,254	—	428,535,254	—
Total invested securities lending collateral	\$ <u>992,602,987</u>	<u>—</u>	<u>992,602,987</u>	<u>—</u>

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Investments measured at NAV:

Short-term investments	\$ 1,536,720,819
Equity securities	1,315,993,715
Fixed income	55,351,445
Real estate	950,691,315
Alternative investments	<u>2,016,123,300</u>
Total investments measured at NAV	<u>\$ 5,874,880,594</u>

	June 30, 2020	Unfunded commitments	Redemption frequency (if currently eligible)	Redemption notice period (days)
Short-term investments (a)	\$ 1,536,720,819	—	Daily	1 Day
Equity securities (b)	1,315,993,715	—	Daily	2 Days
Fixed income (c)	55,351,445	194,580,000	Various	Various
Real estate (d)	950,691,315	732,051,000	Not eligible	N/A
Alternative investments (e)	<u>2,016,123,300</u>	<u>2,001,262,000</u>	Not eligible	N/A
Total investments measured at NAV	<u>\$ 5,874,880,594</u>	<u>2,927,893,000</u>		

- (a) Short-term investments primarily consist of three pooled funds to invest excess cash at the ERS' custodian, The Bank of New York Mellon and about 20 other accounts. NAV is 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.
- (b) Equity securities consist of one fund that invests based on the all country world index. NAV is 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.
- (c) Fixed income investments consist of three private market limited partnerships or limited liability companies to capitalize in multiple strategies that target investments on a global basis including, but not limited to, obligations of leveraged, financially troubled, or liquidating businesses or entities, bank loans, high yield bonds, securitized credit (including debt issued by asset-backed security offerings), derivatives (such as swap agreements), etc. NAV is 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.

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- (d) Real estate consists of 51 limited partnerships or limited liability companies that primarily invest in U.S. real estate. 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 and are generally audited annually.
- (e) Alternative investments consist of 221 limited partnerships or limited liability companies that invest in venture capital, growth equity, corporate finance/buyout, special situations, mezzanine debt, distressed debt, or co/direct investments. 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 and are generally audited annually.

Reconciliation of Investment Level Disclosure to the Statement of Fiduciary Net Position

	<u>Investments by Fair Value Level</u>	<u>Investments Measured by the NAV</u>	<u>Derivative Investments by Fair Value Level</u>	<u>Invested Securities Lending Collateral by Fair Value Level</u>	<u>Statement of Fiduciary Net Position</u>
Assets					
Short-term investments	\$ 990,377,396	\$ 1,536,720,819	\$ (2,891,685)	\$ -	\$ 2,524,206,530
Equity securities	4,992,975,803	1,315,993,715	(51,799,315)	-	6,257,170,203
Fixed income securities	4,004,742,302	55,351,445	71,761,280	-	4,131,855,027
Real estate investments	581,211,501	950,691,315	-	-	1,531,902,816
Alternative investments	183,372,424	2,016,123,300	-	-	2,199,495,724
lending collateral	-	-	-	992,602,987	992,602,987
	<u>\$ 10,752,679,426</u>	<u>\$ 5,874,880,594</u>	<u>\$ 17,070,280</u>	<u>\$ 992,602,987</u>	<u>\$ 17,637,233,287</u>
Liabilities					
Notes payable	\$ 190,742,000	\$ -	\$ -	\$ -	\$ 190,742,000
	<u>\$ 190,742,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 190,742,000</u>

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(d) Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Information regarding ERS' credit risk on derivative investments is discussed below in derivative disclosures note 6(j) while policies related to credit risk for securities lending program are discussed in note 6(i) below.

Risk-Based Asset Class

The fixed income mandate was transitioned to the new risk-based asset allocation methodology. Authorized security types are the same as the Asset-type based allocation guidelines. Investment managers were assigned to:

- Extended Global Credit component of the Broad Growth risk-based asset class, or
 - Benchmark: 50% BC Global Credit (Hedged) + 33.34% BC Global High Yield (Hedged) + 16.66% S&P LSTA Leveraged Loan
- Principal Protection risk-based asset class.
 - Benchmark: BC U.S. Intermediate Aggregate ex-Credit

Summary of concentration limits for debt securities are:

- Principal protection managers may invest in specific issue or issuer of 5% (without limit in supranationals, U.S. Treasuries, U.S. agencies, CMOs and asset-backed securities with minimum of AAA rating, sovereign debt, and equivalently rated agencies of Organization for Economic Cooperation and Development (OECD) governments). These managers are limited to (i) 10% in emerging markets (local currency and debt); (ii) 10% in private placements; (iii) 10% in preferred stocks and converted common stocks (common stock holdings not to exceed 180 days); (iv) 10% in non-U.S. Agency CMOs; and (v) 10% of Non-U.S. dollar denominated securities (excludes money market securities and money market futures).
- Extended Global Credit managers may invest in specific issue or issuer of 5% (without limit in supranationals, U.S. Treasuries, U.S. agencies, CMOs and asset-backed securities with minimum of AAA rating, sovereign debt, and equivalently rated agencies of OECD governments). They are limited to: (i) 10% in preferred stocks and converted common stocks (common stock holdings not to exceed 180 days); (iii) 75% in noninvestment grade / unrated; and (iv) in nonbenchmark markets up to 40% of nonbenchmark nongovernment supported and up to 40% of nonbenchmark government supported. Foreign currency is limited to (i) a 40% net foreign currency exposure (as measured by net amount of currency's outstanding long and short positions versus the U.S. dollar); and (ii) a 80% gross foreign currency exposure (as measured by absolute value of all country-level currency long and short currency positions versus the U.S. dollar).

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A table of the ERS' fixed-income securities as of June 30, 2020 is below. Securities below investment grade of BAA and nonrated issues (average rating by S&P, Moody's, and/or Fitch) amounted to \$792,987,736 or 19.2% of total fixed-income investments. All short-term investments, not held in a pooled investment, are rated A1/P1 or better.

Credit Ratings - Average rating by S&P, Moodys and Fitch as of June 30, 2020

Ratings	US Govt Agency	US Govt sponsored-agency mortgage backed	US corporate bonds	Asset backed	Non-US corporate bonds	Non US-govt/agencies bonds	Pooled & others	Total
AAA	\$ 6,224,640	\$ 305,272,306	\$ -	\$ 3,501,830	\$ 2,905,793	\$ 15,840,580	\$ -	\$ 333,745,149
AA1	-	-	1,098,430	-	-	6,934,963	-	8,033,393
AA2	-	-	1,452,185	-	896,605	18,659,412	-	21,008,202
AA3	-	-	2,674,147	-	338,257	68,360,633	-	71,373,037
A1	-	-	10,523,729	-	2,893,260	9,481,763	-	22,898,752
A2	-	-	19,717,656	1,250,785	4,733,610	4,790,229	-	30,492,280
A3	-	-	20,435,574	-	6,767,342	644,033	-	27,846,949
BAA1	-	-	30,881,518	241,169	9,921,495	11,062,987	-	52,107,169
BAA2	-	-	41,379,088	722,808	12,445,143	8,202,840	-	62,749,879
BAA3	-	-	72,031,332	2,485,353	28,841,282	15,987,529	-	119,345,496
BA1	-	-	18,295,586	1,056,664	12,786,420	2,044,895	755,398	34,938,963
BA2	-	-	33,970,755	-	15,782,649	945,440	610,098	51,308,942
BA3	-	-	26,161,754	1,546,137	11,001,126	1,271,051	-	39,980,068
B1	-	-	66,558,328	-	13,042,003	-	-	79,600,331
B2	-	-	152,581,757	-	8,931,716	1,438,345	-	162,951,818
B3	-	-	87,383,304	3,749,245	6,883,027	-	1,175,834	99,191,410
CAA1	-	-	43,319,873	-	3,236,184	-	-	46,556,057
CAA2	-	-	32,245,397	1,047,089	2,323,174	-	-	35,615,660
CAA3	-	-	9,748,819	-	676,200	485,550	-	10,910,569
CA	-	-	5,379,939	-	-	1,478,356	-	6,858,295
DEF	-	-	1,788,069	-	1,391,717	192,705	-	3,372,491
Not rated	-	181,214	122,804,217	12,117,124	18,485,356	11,898,854	56,216,367	221,703,132
	<u>\$ 6,224,640</u>	<u>\$ 305,453,520</u>	<u>\$ 800,431,457</u>	<u>\$ 27,718,204</u>	<u>\$ 164,282,359</u>	<u>\$ 179,720,165</u>	<u>\$ 58,757,697</u>	<u>1,542,588,042</u>
								US Treasury Bonds and Notes
								2,506,352,362
								US Government agency - Government National
								Mortgage Association (GNMAs) mortgage backed
								11,153,343
								subtotal
								\$ 4,060,093,747
								Derivatives (debt securities)
								71,761,280
								Total fixed income securities in Investments
								<u>\$ 4,131,855,027</u>

(e) 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, The Bank of New York Mellon. Pooled funds not held by the custodial bank, such as certain equity investments, are registered in the name of the ERS. The ERS had \$953,191,671 in cash and securities exposed to custodial credit risk as of June 30, 2020.

(f) 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.

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

At June 30, 2020, 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 to report.

(g) 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, 2020, 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 (excluding derivatives)

	<u>Fair value</u>	<u>Weighted Duration (years)</u>
Fixed income securities:		
U.S. Treasury bonds and notes	\$ 2,506,352,362	6.4
U.S. government agencies bonds	6,224,640	4.8
U.S. government agency mortgage backed	305,453,520	21.9
U.S. government-sponsored agency mortgage backed	11,153,343	19.8
Asset backed securities	27,718,204	10.2
U.S. corporate bonds	800,431,457	4.4
Non-U.S. government/agency bonds	179,720,165	13.7
Non-U.S. corporate bonds	164,282,359	5.0
Pooled and others	<u>58,757,697</u>	6.9
Total	<u>\$ 4,060,093,747</u>	7.8

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(h) 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 6(j).

The following table summarizes the ERS' exposure to foreign currency risk in U.S. dollars as of June 30, 2020: (Securities denominated in U.S. dollars are not presented.)

	Cash and Short					Real	
	Term Instruments	Debt Securities	Derivatives	Equities	Alternative	Estate	Grand Total
Argentine peso	\$ 62,289	\$ 360,240	\$ -	\$ -	\$ -	\$ -	\$ 422,529
Australian dollar	330,892	6,591,418	81,763,914	69,116,000	-	-	157,802,224
Brazilian real	294,713	569,676	(5,030,663)	24,450,595	-	-	20,284,321
Canadian dollar	(5,380,879)	25,798,125	(75,008,986)	132,903,652	-	-	78,311,912
Chilean peso	5,368	-	(16,741,862)	44,817	-	-	(16,691,677)
Chinese Yuan Renmin	1,622	-	(27,340,088)	13,831,146	-	-	(13,507,320)
Colombian peso	35,988	-	6,479,413	21,432	-	-	6,536,833
Czech koruna	12,444	-	(6,187,220)	1,488,454	-	-	(4,686,322)
Danish krone	184,152	431,040	(588,559)	38,882,783	-	-	38,909,416
Euro currency unit	2,631,239	94,494,357	(135,494,980)	366,768,836	-	-	328,399,452
Hong Kong dollar	808,705	-	(1,099,131)	162,243,324	-	-	161,952,898
Hungarian forint	8,204	-	(30,288,933)	933,013	-	-	(29,347,716)
Indian Rupee	-	-	6,282,639	-	-	-	6,282,639
Indonesian rupiah	7,105	1,104,649	26,359,512	2,260,977	-	-	29,732,243
Israeli shekel	58,602	-	(23,437,137)	6,284,214	-	-	(17,094,321)
Japanese yen	5,181,917	11,095,536	(27,553,489)	358,719,042	-	-	347,443,006
Malaysian ringgit	671,984	-	(71,015)	8,503,062	-	-	9,104,031
Mexican peso	242,398	-	28,126,000	6,842,334	-	-	35,210,732
New Taiwan dollar	685,499	-	15,161,081	119,970,859	-	-	135,817,439
New Zealand dollar	84,545	925,442	17,499,981	10,227,475	-	-	28,737,443
Norwegian krone	165,142	-	(53,193,784)	7,111,611	-	-	(45,917,031)
Philippine peso	-	-	6,337,063	1,823,214	-	-	8,160,277
Polish zloty	(5,032)	-	(25,242,207)	1,787,655	-	-	(23,459,584)
Pound sterling	1,275,442	175,671,835	(168,691,376)	196,252,735	-	-	204,508,636
Russian ruble (new)	-	2,189,845	(2,273,092)	2,190,843	-	-	2,107,596
Singapore dollar	204,225	-	(40,440,462)	26,136,449	-	-	(14,099,788)
South African rand	637,001	-	493,126	30,975,124	-	-	32,105,251
South Korean won	222,940	-	(43,544,227)	30,989,193	-	-	(12,332,094)
Swedish krona	24,274	1,178,636	48,726,761	28,546,659	-	-	78,476,330
Swiss franc	(58,356)	-	100,566,480	116,382,734	-	-	216,890,858
Thai baht	1,516,013	-	(2,326,643)	15,417,111	-	-	14,606,481
Turkish lira	422,302	-	(6,939,595)	2,586,624	-	-	(3,930,669)
Urugayan peso	335,195	-	-	-	-	-	335,195
Various Countries	-	-	-	1,315,992,660	-	-	1,315,992,660
Total	\$ 10,665,933	\$ 320,410,799	\$ (353,697,479)	\$ 3,099,684,627	\$ -	\$ -	\$ 3,077,063,880

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(i) Securities Lending

The ERS participates in a securities lending program administered by its bank custodian, The Bank of New York Mellon. Under this program, which is permissible under Chapter 88 of the HRS, certain equity and fixed-income securities of the ERS are lent to participating broker-dealers and banks (borrowers). In return, the ERS receives cash, securities issued or guaranteed by the U.S. government, securities issued or guaranteed by OECD member states or their local authorities, Canadian Provincial debt, equity securities that are part of the U.S. and non-U.S. indices, and/or letters of credit as collateral. The ERS does not have the ability to pledge or sell collateral securities absent of borrower default thus only cash received as collateral is reported on the financial statements in accordance with accounting standards. Risk is mitigated by the investment policies and operational procedures regarding issuer, credit, exposure, and rating limits utilized in the securities lending program. Borrowers are 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 falls below the minimum collateral requirements, additional collateral is provided. In addition, the bank custodian indemnifies the ERS by agreeing to purchase replacement securities or return cash collateral in the event the borrower fails to return the loaned security or fails to pay the ERS for income distributions by the securities' issuers while the securities are on loan.

The ERS does not impose any restrictions on the amount of loans the bank custodian makes on behalf of the ERS. Also, the ERS and the borrowers maintains the right to terminate securities lending transactions on demand. The Bank of New York Mellon 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 notes 3(b) and 6(a). As such, the maturities of the investments made with cash collateral generally do not match the maturities of the securities loans. The extent of such mismatch as of June 30, 2020 was 90 days.

At June 30, 2020, there was no credit risk exposure to borrowers since the ERS was collateralized, as discussed above. The total securities on loan and collateral received are shown below.

<u>Securities lent for collateral</u>	<u>Fair value of underlying securities</u>	<u>Collateral received</u>	
		<u>Cash</u>	<u>Noncash</u>
U.S. fixed income	\$ 718,360,969	462,161,002	290,371,384
U.S. equities	512,428,457	485,770,053	39,700,146
International equities	243,682,341	43,353,592	227,195,702
International fixed income	5,919,056	1,318,340	4,852,370
	<u>\$ 1,480,390,823</u>	<u>992,602,987</u>	<u>562,119,602</u>

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(j) 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 the counterparty to meet the terms of the contract, changes in the market value of the underlying collateral, changes in the interest rate environment, and fluctuation in foreign currency rates. The ERS enters into various derivative investment contracts to hedge for the minimization of transaction costs and as a means of implementing value added strategies to enhance returns as authorized by Board policy.

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

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

The tables below summarize the ERS' investments in derivative securities and contracts held at June 30, 2020 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 collaterals, 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 fiduciary net position.

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The following table summarizes the ERS' investments in derivative securities and contracts held at June 30, 2020 with the related maturity information:

<u>Asset categories</u>	<u>Notional values</u>	<u>Market value</u>	<u>Maturity (range from)</u>
Forwards:			
Currency purchases	\$	(2,891,685)	0.0 yrs
To Be Announced (TBAs)		22,464,312	30.1 yrs to 30.2 yrs
Total forwards	—	19,572,627	
Futures:			
Bond contracts	1,948,552,490	7,310,238	0.3 yrs
Commodity contracts	23,360,877	6,762,878	0.2 yrs to 1.5 yrs
Currency contracts	(217,981,449)	4,713,434	0.1 yrs to 0.3 yrs
Index contracts	126,801,775	1,850,089	0.1 yrs to 0.5 yrs
Interest rate contracts	5,047,182,757	22,119,684	0.1 yrs to 4.3 yrs
Futures total	6,927,916,450	42,756,323	
Options:			
Options		(51,799,315)	0.0 yrs to 0.2 yrs
Options on debt securities		(14,890)	0.0 yrs to 0.7 yrs
Options total	—	(51,814,205)	
Swaps:			
Credit default swaps		(584,726)	0.5 yrs to 41.2 yrs
Total return swaps		9,211,245	0.0 yrs
Interest rate swaps		(2,070,984)	0.3 yrs to 30.5 yrs
Swaps total	—	6,555,535	
Grand total	\$ 6,927,916,450	17,070,280	

Forward Currency Exchange Contracts and TBA Securities

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

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The TBA market that ERS invests in as part of its toolkit to manage interest rates and liquidity includes the forward trading of mortgage-backed securities (MBS) issued by federal agencies and federally sponsored agencies (commonly known as pass-through securities issued by Freddie Mac, Fannie Mae, and Ginnie Mae). The TBA market is one of the most liquid, and consequently the most important secondary market for mortgage loans as one MBS pool can be considered to be interchangeable with another pool.

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 fiduciary net position. Refer to the table above for the net notional value of futures contracts at June 30, 2020.

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, 2020, the ERS had credit default, total return, inflation, and interest rate 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. 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 fiduciary net position.

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.

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On June 30, 2020, credit ratings of the counterparty for ERS' investments in derivatives were as follows:

<u>Counterparty</u>	<u>S&P's rating</u>	<u>Moody's rating</u>	<u>Fair value</u>
Bank of America Corp	A-	A2	\$ 15,701
Bank of America Merrill Lynch	A-	A2	(1,730,173)
Barclays PLC	BBB	Baa2	(12,650)
BNP Paribas SA	A+	Aa3	(905)
Citibank NA	A+	Aa3	83,416
Citigroup Inc	BBB+	A3	(126,498)
CME Group Inc	AA-	Aa3	(2,083,127)
Credit Suisse Group AG	BBB+		(5,606)
Credit Suisse Securities (USA) LLC	BBB+	Baa2	6,939,485
Deutsche Bank Securities Inc	BBB+	A3	2,231,739
Goldman Sachs & Co LLC	BBB+	A3	7,039,228
HSBC Holdings PLC	A-		(46,525)
Intercontinental Exchange Inc	A	A2	(375,743)
JP Morgan	A-	A2	423,109
JPMorgan Chase & Co	A-	A2	(35,915)
London Stock Exchange Group PLC	A	A3	12,145
Morgan Stanley	BBB+	A3	654,438
Morgan Stanley & Co LLC	BBB+	A3	3,103,698
SG Americas Securities LLC	A	A1	14,099,671
UBS Securities	A-	A3	(407,384)
UBS Securities LLC	A-	A3	185,150
Exchange traded derivatives			<u>(12,892,973)</u>
Total			<u>\$ 17,070,281</u>

(7) Pension Liability

(a) Net Pension Liability

The components of the net pension liability of the ERS at June 30, 2020 were as follows:

Total pension liability	\$ 32,691,755,844
Plan fiduciary net position	<u>17,385,480,476</u>
Net pension liability	<u>\$ 15,306,275,368</u>
Plan fiduciary net position as a percentage of total pension liability	53.2%
Net pension liability as a percentage of covered payroll	341.6%

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.

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(b) Summary of Actuarial Assumptions

The total pension liability was determined using the provisions of GAS Statement No. 67, *Financial Reporting for Pension Plans – an amendment of GASB Statement No. 25*, and GASB Statement No. 82, *Pension Issues – an amendment of GASB Statements No. 67, No. 68, and No. 82* actuarial valuation as of June 30, 2020. These GASB rules only define pension liability for financial reporting purposes. The actuarial assumptions were based on the results of an experience study as of June 30, 2018, with most of the assumptions based on the period from July 1, 2013, through June 30, 2018. When measuring the total pension liability, GASB uses the same actuarial-cost method, all actuarial assumptions, and the same discount rate as the ERS uses for funding, which can be found in the Notes to Required Supplementary Information.

Summary of Actuarial Valuation as of June 30, 2020 is as follows:

Actuarial-cost method	Entry age normal
Amortization method	Level percent, open
Actuarial assumptions:	
Inflation assumption	2.50%
Investment rate of return, including inflation at 2.50%	7.00
Payroll growth	3.50
Projected salary increases, including inflation at 2.50%:	
Police officers and firefighters employees	5.00% to 7.00%
General employees	3.50% to 6.50%
Teachers	3.75% to 5.75%

Mortality rate assumptions include the effects of the retirement status of members.

Pre-retirement mortality rates are:

Multiples of the Pub-2010 mortality table for active employees based on the occupation of the member as follows:

	<u>General employees</u>	<u>Teachers</u>	<u>Police officers and firefighters</u>
	<u>Male and Female</u>	<u>Male and Female</u>	<u>Male and Female</u>
Ordinary	94 %	92 %	83 %
% of ordinary choosing annuity	41	52	24
Duty related	6	8	17

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Post-retirement mortality rates are:

Healthy Retirees: The 2019 Public Retirees of Hawaii mortality table, generational projection using the BB projection table from the year 2019 and with multipliers based on plan and group experience. The following are sample rates of the base table as of 2019 with the corresponding multipliers:

Healthy Annuitant Mortality Rates Before Projection (Multiplier Applied)

Age	General employees		Teachers		Police and Fire	
	Males	Females	Males	Females	Males	Females
50	0.2901%	0.2376%	0.2640%	0.1980%	0.3394%	0.2376%
55	0.4195%	0.3042%	0.3817%	0.2535%	0.4908%	0.3042%
60	0.5773%	0.3175%	0.5253%	0.2646%	0.6754%	0.3175%
65	0.8603%	0.3175%	0.7829%	0.2646%	1.0066%	0.3175%
70	1.2866%	0.7022%	1.1708%	0.5852%	1.5053%	0.7022%
75	2.0370%	1.3340%	1.8537%	1.1117%	2.3833%	1.3340%
80	3.4486%	2.2177%	3.1382%	1.8481%	4.0349%	2.2177%
85	6.2716%	3.9579%	5.7072%	3.2982%	7.3378%	3.9579%
90	11.8489%	7.7873%	10.7825%	6.4895%	13.8632%	7.7873%
Multiplier	100 %	108 %	91 %	90 %	117 %	108 %
Setback	—	—	—	—	—	—

The following table provides the life expectancy for individuals retiring in future years based on the assumption with full generational projection:

		Life Expectancy for an Age 65 Retiree in Years				
		Year of retirement				
Gender		2025	2030	2035	2040	2045
General retirees	Male	23.8	24.2	24.7	25.2	25.6
	Female	26.8	27.2	27.5	27.9	28.2
Teachers	Male	24.5	25.0	25.4	25.9	26.3
	Female	28.2	28.5	28.8	29.1	29.5
Police and Fire	Male	22.5	23.0	23.5	24.0	24.5
	Female	26.8	27.2	27.5	27.9	28.2

Disabled retirees: Base table for healthy retiree's occupation, set forward five years, generational projection using the BB projection table from the year 2019. Minimum mortality rate of 3.5% for males and 2.5% for females.

The long-term expected rate of return on pension plan investments was determined using a "top down approach" of the Client-Constrained Simulation-based Optimization Model (a statistical technique known as "re-sampling with replacement" that directly keys in on specific plan-level risk factors as stipulated by the ERS Board) in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major

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asset class. These ranges are then combined to produce the long-term expected rate of return by weighting the expected future nominal rates of return (real returns + inflation) by the target asset allocation percentage. The rate of returns based on ERS's investment consultant as of June 30, 2020, are summarized in the following table:

<u>Classes</u>	<u>Strategic class weights</u>	<u>Long-term expected geometric rate of return</u>
Broad growth:		
Private Equity	13.5%	8.45%
Global Equity	20.0%	7.35%
Low Volatility Equity	4.0%	6.60%
Global Options	4.0%	6.25%
Credit	6.0%	6.65%
Core Real Estate	6.0%	5.70%
Non-Core Real Estate	4.5%	8.45%
Timber/Agriculture/Infrastructure	5.0%	5.40%
Diversifying Strategies:		
TIPs	2.0%	3.40%
Global Macro	4.0%	5.90%
Reinsurance	4.0%	6.00%
Alternative Risk Premia	8.0%	4.90%
Long Treasuries	5.0%	3.20%
Intermediate Government	4.0%	3.00%
Systematic Trend Following	10.0%	5.30%

The ERS utilizes two high-level strategic classes (Broad Growth and Diversifying Strategies) for allocating assets and managing risk within the total portfolio. Both of these strategic classes contain sub-components that in-turn utilize asset classes and/or specific strategies for implementation. The Broad Growth class utilizes three sub-components (Public Growth, Private Growth, and Real Assets) which are ultimately invested in public equity, options-based equity, credit fixed income, private real assets, and private equity. The Diversifying Strategies class is designed to be uncorrelated to the Broad Growth class and it utilizes three sub-components (Liquid Defensive, Liquid Diversifying, and Illiquid Diversifying). The Diversifying Strategies class utilizes a multitude of asset classes and strategies, including US treasury and agency bonds, inflation-linked treasury bonds, systematic trend following, alternative risk premia, global macro, insurance-linked securities, relative value strategies, and niche private assets, among others. The ERS may also hold opportunities and other investments if they are determined to be additive to the portfolio's risk/return posture.

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Single Discount Rate

A single discount rate of 7.00% was used to measure the total pension liability. This single discount rate was based on the expected rate of return on pension plan investments of 7.00%. The projection of cash flows used to determine this single discount rate assumed that plan member contributions will be made at the current contribution rate and that employer contributions will be made at rates equal to the difference between actuarially determined contribution rates and the member rate. Based on these assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

(c) Sensitivity of the Net Pension Liability to Changes in the Single Discount Rate

The following presents the ERS' net pension liability calculated using a single discount rate of 7.00%, as well as what the ERS', net pension liability would be if it were calculated using a single discount rate that is one-percentage-point lower (6.00%) or one-percentage-point higher (8.00%) than the current rate.

	1% Decrease (6.00%)	Current discount rate (7.00%)	1% Increase (8.00%)
\$	19,732,216,656	15,306,275,368	11,657,505,156

(8) 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, 2020. Losses not covered by insurance are generally paid from legislative appropriations.

(a) 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.

(b) 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.

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(c) *Workers' Compensation Policy*

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

(9) 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 \$3,354,844,000 as of June 30, 2020, consisting of \$621,531,000 in fixed income, \$732,051,000 in real estate investments, and \$2,001,262,000 in alternative investments.

(10) 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.

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Required Supplementary Information – Unaudited
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**Schedule of Changes in the Employers' Net Pension Liability and
Related Ratios**

	Fiscal year Ended June 30						
	2014	2015	2016	2017	2018	2019	2020
A. Total pension liability							
1. Service Cost	\$ 421,956,129	437,901,029	484,278,499	576,724,568	584,470,193	619,504,278	626,699,489
2. Interest on the total pension liability	1,618,917,776	1,693,252,684	1,748,619,873	1,894,622,190	1,976,275,120	2,063,885,936	2,164,804,653
3. Changes of benefit terms	—	—	—	—	—	—	—
4. Difference between expected and actual experience of the total pension liability	66,400,876	(192,816,757)	297,534,219	61,179,390	124,753,379	221,473,495	71,837,371
5. Changes of assumptions	—	261,213,541	2,915,922,677	—	—	60,320,037	—
6. Benefit payments, including refunds of employee contributions	(1,130,921,611)	(1,181,252,658)	(1,245,517,025)	(1,323,129,244)	(1,416,727,842)	(1,486,137,444)	(1,568,033,354)
7. Net change in total pension liability	976,353,170	1,018,297,839	4,200,838,243	1,209,396,904	1,268,770,850	1,479,046,302	1,295,308,159
8. Total pension liability – beginning	21,243,744,377	22,220,097,547	23,238,395,386	27,439,233,629	28,648,630,533	29,917,401,383	31,396,447,685
9. Total pension liability – ending	22,220,097,547	23,238,395,386	27,439,233,629	28,648,630,533	29,917,401,383	31,396,447,685	32,691,755,844
B. Plan fiduciary net position							
1. Contributions – employer	653,127,697	717,792,981	756,558,222	781,244,218	847,595,466	922,635,334	1,098,589,013
2. Contributions – employer (picked-up employee contributions)	204,821,010	221,909,859	235,079,968	249,211,751	257,294,033	270,764,670	284,142,994
2. Contributions – employee	1,306,327	1,595,560	1,721,893	1,492,316	2,133,901	2,458,908	3,255,037
3. Net investment income	2,175,479,961	556,436,475	(169,368,110)	1,934,512,507	1,225,572,599	932,696,412	358,282,664
4. Benefit payments, including refunds of employee contributions	(1,130,921,611)	(1,181,252,658)	(1,245,517,025)	(1,323,129,244)	(1,416,727,842)	(1,486,137,444)	(1,568,033,354)
5. Pension plan administrative expense	(12,626,030)	(14,032,964)	(13,960,587)	(14,986,159)	(15,784,490)	(13,798,866)	(17,782,865)
6. Other	—	—	—	—	—	—	—
7. Net change in plan fiduciary net position	1,891,187,354	302,449,253	(435,485,639)	1,628,345,389	900,083,667	628,619,014	158,453,489
8. Fiduciary net position – beginning	12,311,827,949	14,203,015,303	14,505,464,556	14,069,978,917	15,698,324,306	16,598,407,973	17,227,026,987
9. Fiduciary net position – ending	14,203,015,303	14,505,464,556	14,069,978,917	15,698,324,306	16,598,407,973	17,227,026,987	17,385,480,476
C. Net pension liability	\$ 8,017,082,244	8,732,930,830	13,369,254,712	12,950,306,227	13,318,993,410	14,169,420,698	15,306,275,368
D. Fiduciary net position as a percentage of the total pension liability	63.92 %	62.42 %	51.28 %	54.80 %	55.48 %	54.87 %	53.18 %
E. Covered-employee payroll	\$ 3,829,002,983	3,995,447,345	4,112,227,306	4,243,521,876	4,256,052,840	4,376,216,753	4,481,443,808
F. Net pension liability as a percentage of covered employee payroll	209.38 %	209.38 %	218.57 %	325.11 %	305.18 %	312.94 %	341.55 %

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

Required Supplementary Information – Unaudited

June 30, 2020

* Schedule is intended to show information for 10 years. Additional years will be displayed as they become available.

Schedule of the employers' net pension liability

Fiscal year ended June 30	Total pension liability	Fiduciary net position	Net pension liability	Fiduciary net position as a% of total pension liability	Covered payroll	Net pension liability as a percentage of covered payroll
2014	\$ 22,220,097,547	14,203,015,303	8,017,082,244	63.92 %	\$ 3,829,002,983	209.38 %
2015	23,238,395,386	14,505,464,556	8,732,930,830	62.42	3,995,447,345	218.57
2016	27,439,233,629	14,069,978,917	13,369,254,712	51.28	4,112,227,306	325.11
2017	28,648,630,533	15,698,324,306	12,950,306,227	54.80	4,243,521,876	305.18
2018	29,917,401,383	16,598,407,973	13,318,993,410	55.48	4,256,052,840	312.94
2019	31,396,447,685	17,227,026,987	14,169,420,698	54.87	4,376,216,753	323.78
2020	32,691,755,844	17,385,480,476	15,306,275,368	53.18	4,481,443,808	341.55

* Schedule is intended to show information for 10 years. Additional years will be included prospectively as data becomes available.

Schedule of Employer Contributions

(Amounts in thousands)

Fiscal year ended June 30	Statutory contributions	Covered employee payroll	Contributions as a percentage of covered payroll
2011	\$ 538,692	3,731,383	14.44
2012	548,353	3,706,137	14.80
2013	581,447	3,720,810	15.63
2014	653,128	3,829,003	17.06
2015	717,793	3,995,447	17.97
2016	756,558	4,112,227	18.40
2017	781,244	4,243,522	18.41
2018	847,595	4,256,053	19.92
2019	922,635	4,376,217	21.08
2020	1,098,589	4,481,443	24.51

Note: All contributions shown reflect statutory employer-paid contributions only. Employer contributions (picked-up employee/member contributions) and member contributions are excluded.

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

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June 30, 2020

Schedule of Investment Returns

For fiscal year ended June 30	Annual money- weighted rate of return
2014	17.9 %
2015	4.0
2016	(1.2)
2017	13.7
2018	7.8
2019	5.7
2020	2.1

* Schedule is intended to show information for 10 years. Additional years will be included prospectively as data becomes available.

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

Notes to Required Supplementary Information – Unaudited

June 30, 2020

(1) Description

There have been no changes in benefit terms or actuarial assumptions since the last valuation.

Future employer contribution rates will increase due to legislation passed in 2017.

Per Act 17 (SLH 2017), future employer contributions from State and counties are expected to increase pursuant to a phased-in contribution rate increase over four years beginning July 1, 2017. The rate for employees in the Police and Firefighters category increases to 28.00% on July 1, 2017; 31.00% on July 1, 2018; 36.00% on July 1, 2019; and 41.00% on July 1, 2020 and the rate for All Other Employees increases to 18.00% on July 1, 2017; 19.00% on July 1, 2018; 22.00% on July 1, 2019; and 24.00% on July 1, 2020.

Methods and assumptions used in calculations of actuarially determined contributions

The actuarially determined contribution rates in the schedule of contributions are calculated as of June 30, 2020. The following significant actuarial methods and assumptions were used to determine contribution rates reported in that schedule.

Valuation date	June 30, 2020
Actuarial-cost method	Entry age normal
Amortization method	Level percent, open
Asset-valuation method	Four-year smoothed market
Assumed inflation rate	2.5 %
Investment rate of return	7.00% (including 2.5% for inflation and a 4.50% net real rate of return)
 Cost-of-living adjustments (COLAs):	
COLAs are not compounded; they are based on original pension amount.	
– Membership date prior to July 1, 2012	2.50% (not compounded)
– Membership date after June 30, 2012	1.50% (not compounded)
Payroll growth rate assumption	3.50 %

Projected salary increases comprise of the following components:

	General employees	Teachers	Police officers and firefighters
Service component by year of credited service (a)	0.0% to 3.0%	0.0% to 2.0%	0.0% to 2.0%
General increase (b)	1.0%	1.25%	2.5%
Inflation (c)	2.5%	2.5%	2.5%
Total increase (a + b + c)	3.5% to 6.5%	3.75% to 5.75%	5.0% to 7.0%

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

Notes to Required Supplementary Information – Unaudited

June 30, 2020

Detailed salary increase rates by years of service are shown below:

Years of service	General employees		Teachers		Police and fire	
	Service-related component (a)	Total annual rate of increase (a + b + c)	Service-related component (a)	Total annual rate of increase (a + b + c)	Service-related component (a)	Total annual rate of increase (a + b + c)
1	3.00 %	6.50 %	2.00 %	5.75 %	2.00 %	7.00 %
2	3.00	6.50	1.75	5.50	2.00	7.00
3	2.00	5.50	1.75	5.50	1.00	6.00
4	1.50	5.00	1.50	5.25	1.00	6.00
5	1.50	5.00	1.00	4.75	1.00	6.00
6	1.25	4.75	1.00	4.75	0.75	5.75
7	1.25	4.75	0.75	4.50	0.75	5.75
8	1.00	4.50	0.75	4.50	0.75	5.75
9	1.00	4.50	0.50	4.25	0.50	5.50
10	1.00	4.50	0.50	4.25	0.50	5.50
11	0.75	4.25	0.50	4.25	0.50	5.50
12	0.75	4.25	0.50	4.25	0.50	5.50
13	0.50	4.00	0.25	4.00	0.25	5.25
14	0.50	4.00	0.25	4.00	0.25	5.25
15	0.50	4.00	0.25	4.00	0.25	5.25
16	0.50	4.00	0.25	4.00	0.25	5.25
17	0.50	4.00	0.25	4.00	0.25	5.25
18	0.50	4.00	0.25	4.00	0.25	5.25
19	0.50	4.00	0.25	4.00	0.25	5.25
20	0.25	3.75	0.25	4.00	0.25	5.25
21	0.25	3.75	0.25	4.00	0.25	5.25
22	0.25	3.75	0.25	4.00	0.25	5.25
23	0.25	3.75	0.25	4.00	0.25	5.25
24	0.25	3.75	0.25	4.00	0.25	5.25
25 or more	—	3.50	—	3.75	—	5.00

Mortality rates used in the valuation are:

Pre-retirement mortality rates:

Multiples of the RP 2014 mortality table based on the occupation of the member.

The following factors are used in conjunction with the described above to derive the death rates:

	General employees	Teachers	Police and Fire
	Male and Female	Male and Female	Male and Female
Ordinary	94 %	92 %	83 %
% of ordinary choosing annuity	41	52	24
Duty related	6	8	17

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

Notes to Required Supplementary Information – Unaudited

June 30, 2020

Post-retirement mortality rates:

Healthy retirees:

The 2019 Public Retirees of Hawaii mortality table, generational projection using the BB projection table from the year 2020 and with multipliers based on plan and group experience.

The following are sample rates of the base table as of 2019 with the corresponding multipliers:

Healthy Annuitant Mortality Rates Before Projection (Multiplier Applied)

Age	General employees		Teachers		Police and Fire	
	Males	Females	Males	Females	Males	Females
50	0.2901%	0.2376%	0.2640%	0.1980%	0.3394%	0.2376%
55	0.4195%	0.3042%	0.3817%	0.2535%	0.4908%	0.3042%
60	0.5773%	0.3175%	0.5253%	0.2646%	0.6754%	0.3175%
65	0.8603%	0.3175%	0.7829%	0.2646%	1.0066%	0.3175%
70	1.2866%	0.7022%	1.1708%	0.5852%	1.5053%	0.7022%
75	2.0370%	1.3340%	1.8537%	1.1117%	2.3833%	1.3340%
80	3.4486%	2.2177%	3.1382%	1.8481%	4.0349%	2.2177%
85	6.2716%	3.9579%	5.7072%	3.2982%	7.3378%	3.9579%
90	11.8489%	7.7873%	10.7825%	6.4895%	13.8632%	7.7873%
Multiplier	100 %	108 %	91 %	90 %	117 %	108 %
Setback	—	—	—	—	—	—

The following are life expectancy for individuals retiring in future years based on the assumption with full generational projection:

		Life Expectancy for an Age 65 Retiree in Years				
		Year of retirement				
Gender		2025	2030	2035	2040	2045
General retirees	Male	23.8	24.2	24.7	25.2	25.6
	Female	26.8	27.2	27.5	27.9	28.2
Teachers	Male	24.5	25.0	25.4	25.9	26.3
	Female	28.2	28.5	28.8	29.1	29.5
Police and Fire	Male	22.5	23.0	23.5	24.0	24.5
	Female	26.8	27.2	27.5	27.9	28.2

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

Notes to Required Supplementary Information – Unaudited

June 30, 2020

Disabled Retirees:

Base table for healthy retiree's occupation, set forward five years, generational projection using the BB projection table from the year 2020. Minimum mortality rate of 3.5% for males and 2.5% for females.

Change of Assumptions

There were no changes to the 2020 assumptions.

Prior year trends including changes in assumptions are discussed below in Note 2.

(2) Significant Factors Affecting Trends in Actuarial Information

(a) 2019 Changes in Actuarial Assumptions

The following changes were made to the actuarial assumption as of June 30, 2018 to June 30, 2019:

- The assumed salary increase schedules include an ultimate component for general wage inflation that may add on additional increases for individual merit (which would include promotions) and then an additional component for step rates based on service. There were no changes for General Employees and Teachers. The overall impact increased for salary rate increase rates received for most Police and Firefighters over their career due to extending the 2-year step schedule to 25-years.
- Mortality rates generally decreased due to the continued improvements in using a fully generational approach and Scale BB (published by the Society of Actuaries), although mortality rates increased in certain age groups across all employment groups.
- The rates of disability of active employees increased for all General Employees and Teachers, and for Police and Firefighters from duty-related reasons.
- There were minor increases in the retirement rates for members in certain groups based on age, employment group and/or membership class.

(b) 2016 Changes in Actuarial Assumptions

The following changes were made to the actuarial assumptions as of June 30, 2015 to June 30, 2016:

- The investment rate of return assumption was decreased from 7.65% to 7.00%.
- Change the investment return assumption from net of all expenses to net of only investment expenses, add explicit charge for administrative expenses (0.35% of pay)
- The inflation assumption was decreased from 3.00% to 2.50%.
- Decrease the wage inflation (or employer budget growth) assumption from 4.00% to 3.50%
- The inflation component of salary increase rates decreased for all groups. The salary increase rates were changed to reflect a smaller productivity component for Teachers, Police and Firefighters. The service-based component generally increased for most general employees, decreased for most Teachers, and remain unchanged for most Police and Firefighters. The overall impact decreased assumed salary rate increase rates for all general employees and Teachers, while remaining unchanged for almost all Police and Firefighters.

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

Notes to Required Supplementary Information – Unaudited

June 30, 2020

- The rates of mortality for active employees were decreased.
- The rates of mortality for healthy retirees and beneficiaries for most employee groups were decreased, adding an explicit assumption for continued future mortality improvement (generational approach).
- The rates of mortality for disabled retirees for most employee groups were decreased.
- The rates of disability of active employees increased for all General Employees, for Police and Firefighters from duty-related reasons and for Teachers from non-duty-related reasons.
- The rates of termination assumption for all employee groups was changed from separate male and female by employee group to a combined male & female by employee group. The rate of terminations for Police & Firefighters was increased. The rate of terminations for General Employees in the first six years of service decreased, and remains unchanged for other General Employees. After six years of service, the rates of termination generally increased Teachers, and remain unchanged for other Teachers.

(c) 2015 Changes in Actuarial Assumptions

The investment rate of return assumption was decreased from 7.75% as of June 30, 2014 to 7.65% as of June 30, 2015.

(d) 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 and Firefighters. 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 for most employee groups were increased.
- The rates of mortality for active employees for most employee groups were increased.
- The rates of disability for active employees for most general employees and teachers were decreased.
- The rates of retirement for most employees were increased.
- The rates of termination in the first six years of service for males generally increased, and remained mostly unchanged for females. After six years of service, the rates of termination generally increased for younger employees and decreased for employees from the age of 50.

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

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

Year ended June 30, 2020

	<u>Pension accumulation reserves</u>	<u>Annuity reserves</u>	<u>Expense reserves</u>	<u>Total</u>
Additions:				
Appropriations and contributions:				
Employers	\$ 1,098,589,013	\$ —	\$ —	\$ 1,098,589,013
Members	—	287,398,031	—	287,398,031
Net investment income	<u>358,282,664</u>	<u>—</u>	<u>—</u>	<u>358,282,664</u>
Total additions	<u>1,456,871,677</u>	<u>287,398,031</u>	<u>—</u>	<u>1,744,269,708</u>
Deductions:				
Benefit payments	1,545,589,761	—	—	1,545,589,761
Refunds of member contributions	—	22,443,593	—	22,443,593
Administrative expenses	<u>—</u>	<u>—</u>	<u>17,782,865</u>	<u>17,782,865</u>
Total deductions	<u>1,545,589,761</u>	<u>22,443,593</u>	<u>17,782,865</u>	<u>1,585,816,219</u>
Other changes in net position restricted for pension benefits:				
Transfer due to retirement of members	189,800,493	(189,800,493)	—	—
Transfer of interest allocation	(120,411,283)	120,411,283	—	—
Transfer to pay administrative expenses	(20,427,078)	—	20,427,078	—
Return of unrequited funds due to savings in administrative expenses	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u>48,962,132</u>	<u>(69,389,210)</u>	<u>20,427,078</u>	<u>—</u>
Net increase	(39,755,952)	195,565,228	2,644,213	158,453,489
Fiduciary net position restricted for pensions:				
Beginning of year	<u>14,237,290,660</u>	\$ <u>2,969,087,157</u>	\$ <u>20,649,170</u>	<u>17,227,026,987</u>
End of year	\$ <u><u>14,197,534,708</u></u>	<u><u>3,164,652,385</u></u>	<u><u>23,293,383</u></u>	<u><u>17,385,480,476</u></u>

See accompanying independent auditors' report.

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

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

Year ended June 30, 2020

Assets	Beginning balance	Additions	Deductions	Ending balance
Receivable from employers	\$ —	245,961,789	\$ 245,961,789	—
Total assets	<u>\$ —</u>	<u>245,961,789</u>	<u>245,961,789</u>	<u>—</u>
Liabilities				
Due to employers	\$ —	245,961,789	\$ 245,961,789	—
Total liabilities	<u>\$ —</u>	<u>245,961,789</u>	<u>245,961,789</u>	<u>—</u>

See accompanying independent auditors' report.

Schedule 3

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

Other Supplementary Information – Schedule of Administrative Expenses

Year ended June 30, 2020

Personnel services:		
Salaries and wages	\$	6,853,075
Fringe benefits		4,227,943
Net change in unused vacation credits		110,159
		<hr/>
Total personnel services		11,191,177
		<hr/>
Professional services:		
Actuarial		220,322
Auditing and tax consulting		448,448
Disability hearing expenses		81,092
Legal services		575,543
Medical		372,904
Other services		135,872
		<hr/>
Total professional services		1,834,181
		<hr/>
Communication:		
Postage		160,160
Printing and binding		84,821
Telephone		69,034
Travel		105,678
		<hr/>
Total communication		419,693
		<hr/>
Rentals:		
Rental of equipment		73,716
Rental of premises		36,711
		<hr/>
Total rentals		110,427
		<hr/>
Other:		
Armored car service		1,405
Computer and office automation systems		337,490
Repairs and maintenance		2,380,785
Stationery and office supplies		28,327
Miscellaneous		109,643
		<hr/>
Total other		2,857,650
		<hr/>
Depreciation		1,369,737
		<hr/>
	\$	<u><u>17,782,865</u></u>

See accompanying independent auditors' report.

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

Other Supplementary Information – Schedule of Investment Expenses

Year ended June 30, 2020

Real estate and alternative investment expenses:	
Operating expenses	\$ 31,940,863
Mortgage interest	6,083,257
Total real estate and alternative investment expenses	38,024,120
Investment expenses:	
Investment manager/advisor fees	40,294,367
Bank custodian fees	300,971
Other investment expenses	7,842,175
Total investment expenses	48,437,513
Securities lending expenses:	
Borrower rebates	12,933,322
Management fees	808,962
Total securities lending expenses	13,742,284
	\$ 100,203,917

See accompanying independent auditors' report.