Employees' Retirement System of the State of Hawaii

January 14, 2013
Board Meeting

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AGENDA

- Key Changes and Issues for 2012 Valuation
- Investment Performance
- Actuarial Valuation Results
- Open Group Projections
- Projection of Funded Status
- Projection of Alternative Returns
- GASB Update

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ACTUAL VALUATION – KEY CHANGES AND ISSUES

- 2012 investment performance below expectations
  - -0.6% return on market value of assets
  - Expected 7.75%
- 2011 Legislature created new benefit tier for employees hired after June 30, 2012
  - Not yet reflected in liabilities, but is reflected in funding period calculation
- 2011 Legislature created schedule of increasing Employer Contributions over next few years
- 2012 Legislature removed non-base pay from definition of compensation for employees hired after June 30, 2012
  - Impacts funding period because loss of contributions is felt before loss of benefits

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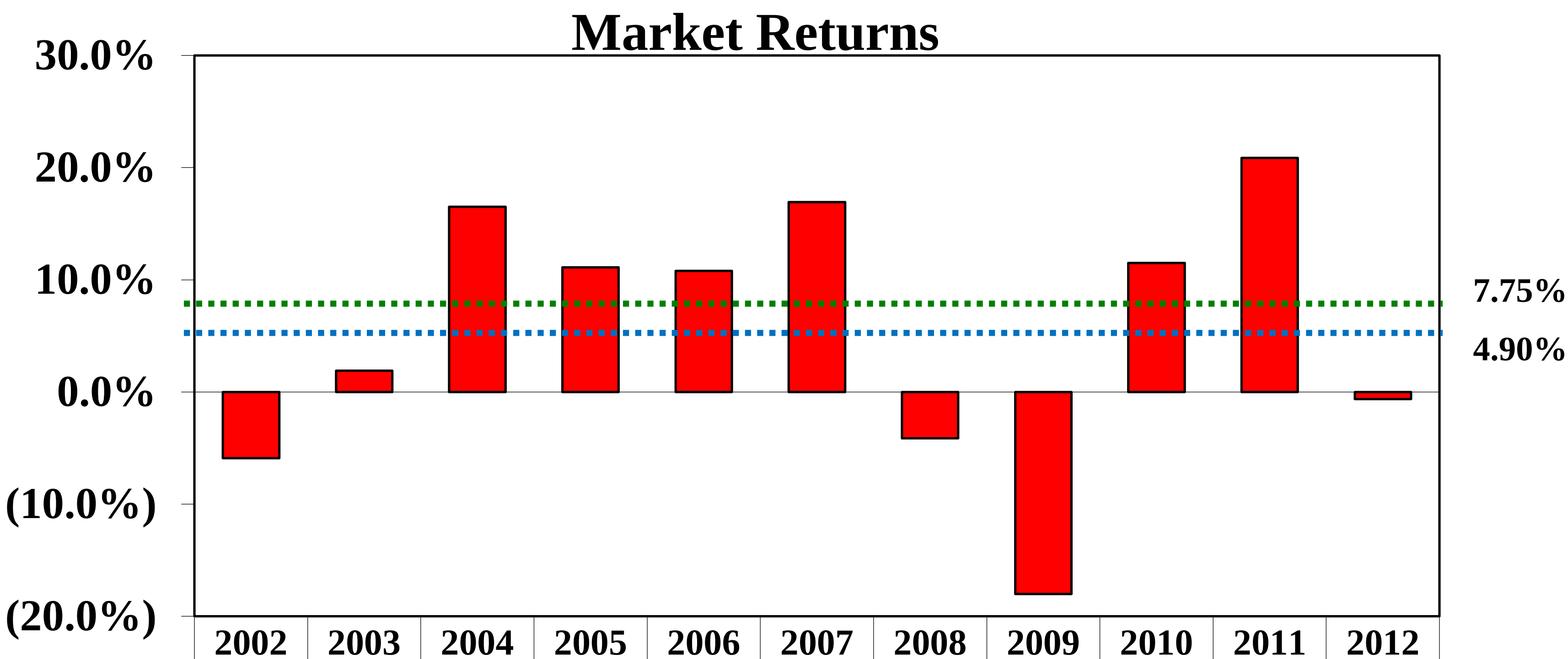
Sources of Impact

- Negative Experience on two of three potential sources
  - ***Investments*** underperformed 7.75% assumption (Negative)
  - ***Liabilities*** grew slower than expected, mostly due to lower than anticipated salary increases (Positive)
  - ***Contributions*** in dollars are expected to be smaller in the future than projected from last year (Negative)
    - Elimination of contributions (and benefits) on non-base pay for employees hired after June 30, 2012
    - Lower than anticipated salary increases mean smaller pays (and contributions) in the future if the rates remain the same

Estimated Yields on Market Value of Assets



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Market Return	-5.9%	1.9%	16.5%	11.1%	10.8%	16.9%	-4.1%	-18.0%	11.5%	20.9%	-0.6%

4.9% average return for 10 year period ending June 30, 2012

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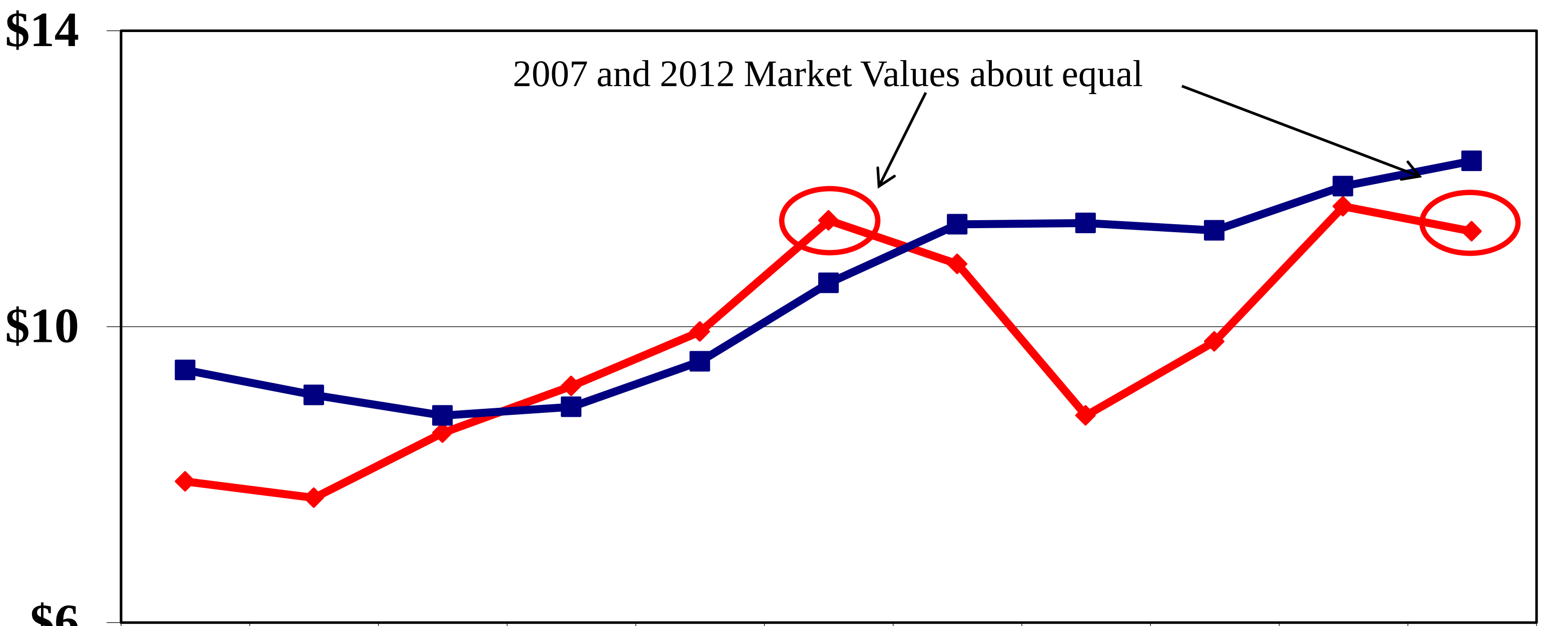
Market and Actuarial Values of Assets

$ Billions



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Market Value	**$7.9**	**$7.7**	**$8.6**	**$9.2**	**$9.9**	**$11.4**	**$10.8**	**$8.8**	**$9.8**	**$11.6**	**$11.3**
Actuarial Value	**$9.4**	**$9.1**	**$8.8**	**$8.9**	**$9.5**	**$10.6**	**$11.4**	**$11.4**	**$11.3**	**$11.9**	**$12.2**

AVA is 108.5% of MVA at 2012, compared to102.6% % at 2011

AVA is deferring $957 million is investment losses compared with $300 million last year

Actuarial Valuation Results

	2010 Valuation	2011 Valuation	2012 Valuation
Based on Smoothed Asset Value			
UAAL ($ Billions)	$7.14	$8.15	$8.44
Actuarial Funded Ratio	61.4%	59.4%	59.2%
Funding Period in years*	41	25	30
30 Year GASB ARC	16.90%	18.56%	18.64%
Based on Market Value			
Actuarial Funded Ratio	53.1%	57.9%	54.6%
30 Year Employer ARC	19.25%	18.67%	20.08%

*2011 and 2012 based on open group projection, recognizing new benefits for members hired after June 30, 2012

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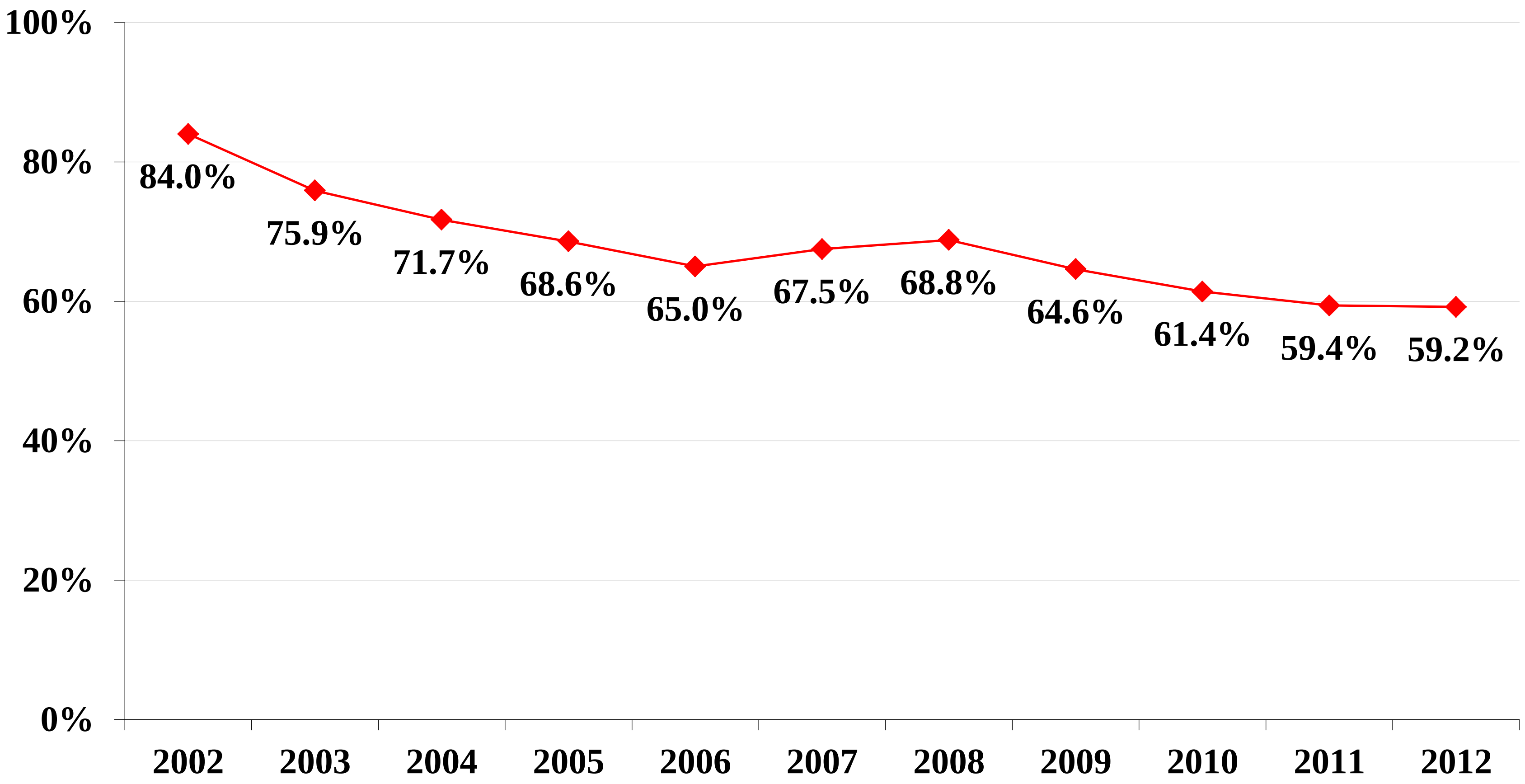
GASB #25 Funded Ratio



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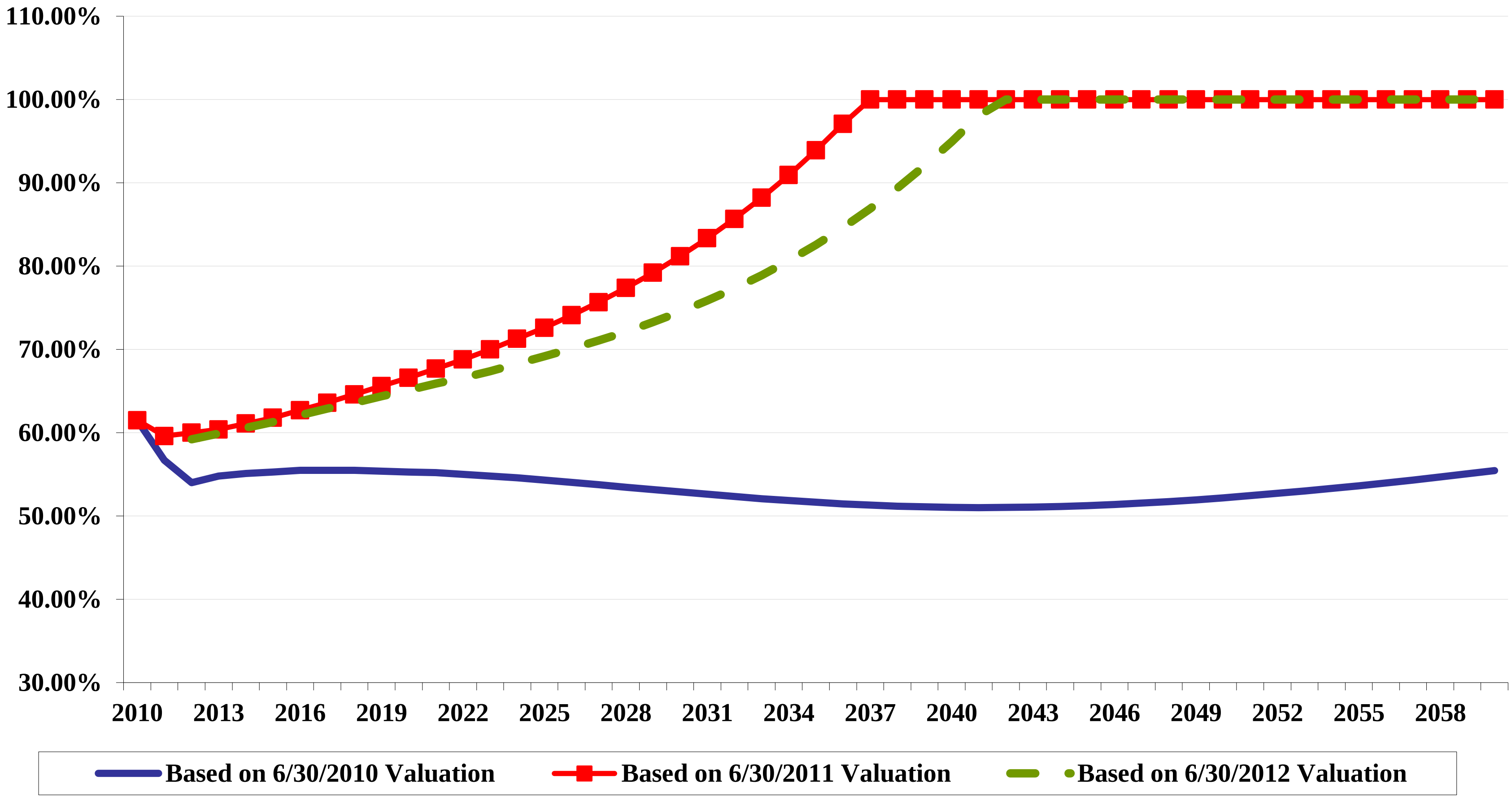
Projection of Funded Ratio from 6/30/2012 Valuation



Assumes all assumptions are met, including 7.75% return on actuarial value of assets

2012 Projection recognizes new salary definition for new hires after 6/30/2012

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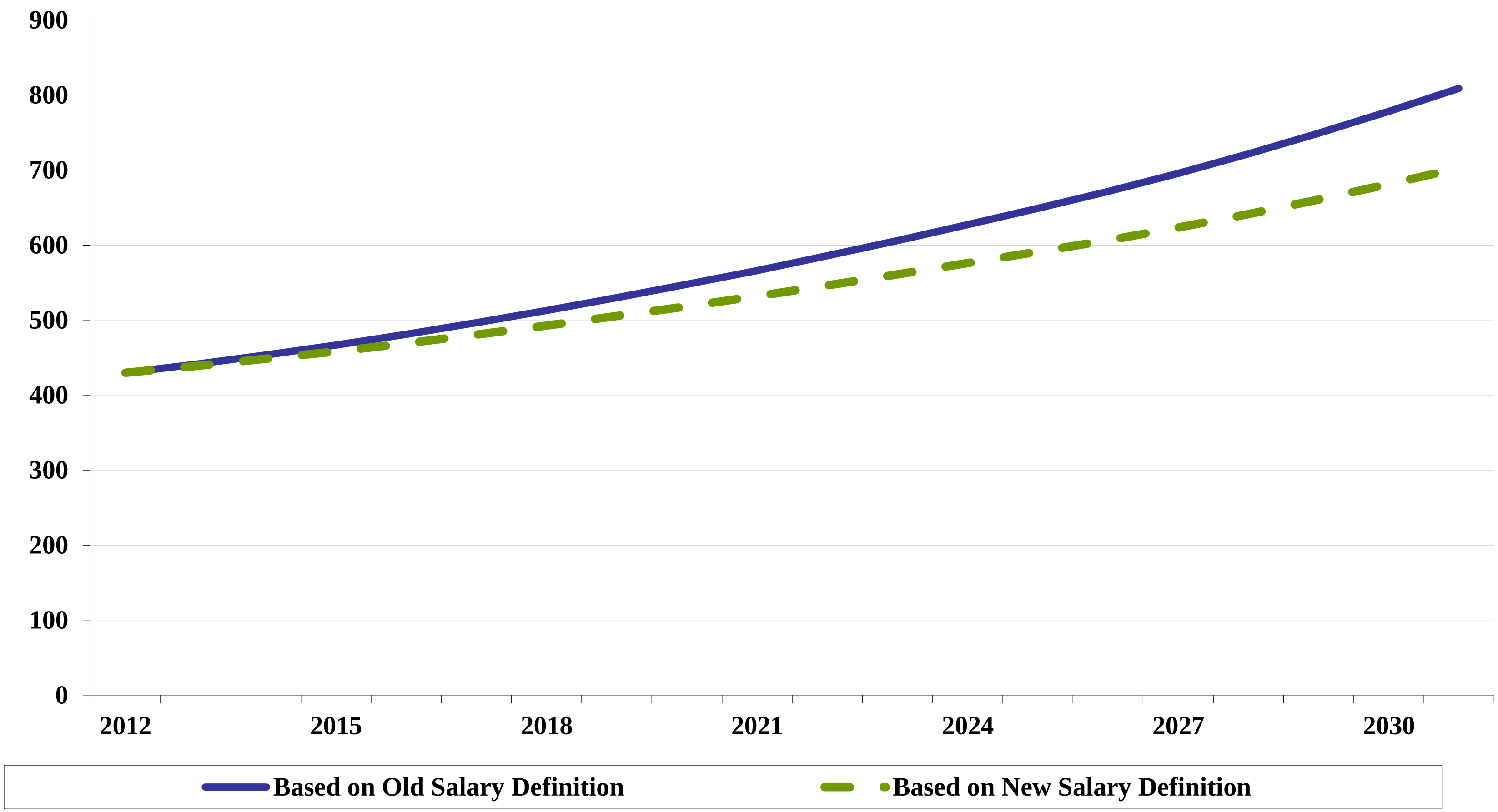
Projected P&F Payroll



Assumes all assumptions are met, including 7.75% return on market value of assets

New salary definition for new hires after 6/30/2012 does not include overtime

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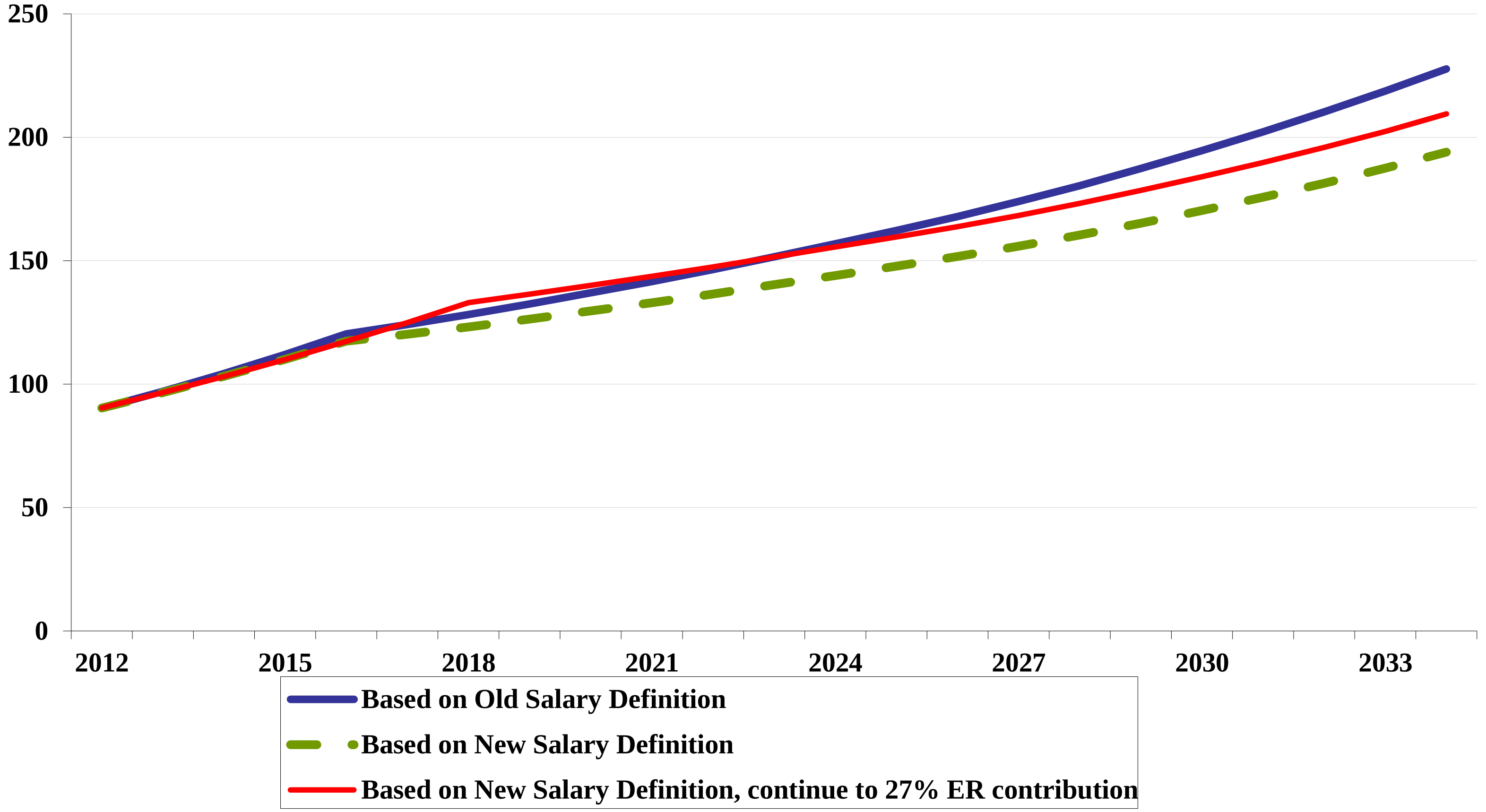
Contributions

- With the lower overall salary available for contributions, the contribution rates on those lower salaries will likely need to be increased to get back to similar dollar amounts as before
- For example, to get a 30-year funding period the employer contribution rate for police and fire employees would need to increase beyond the current schedule, perhaps to 27%. However, this 27% will be applied to a smaller overall payroll base, so the net dollars will still be lower than if the definition of salary had never been made

Projected P&F ER Contributions



Assumes all assumptions are met, including 7.75% return on market value of assets
New salary definition for new hires after 6/30/2012 does not include overtime

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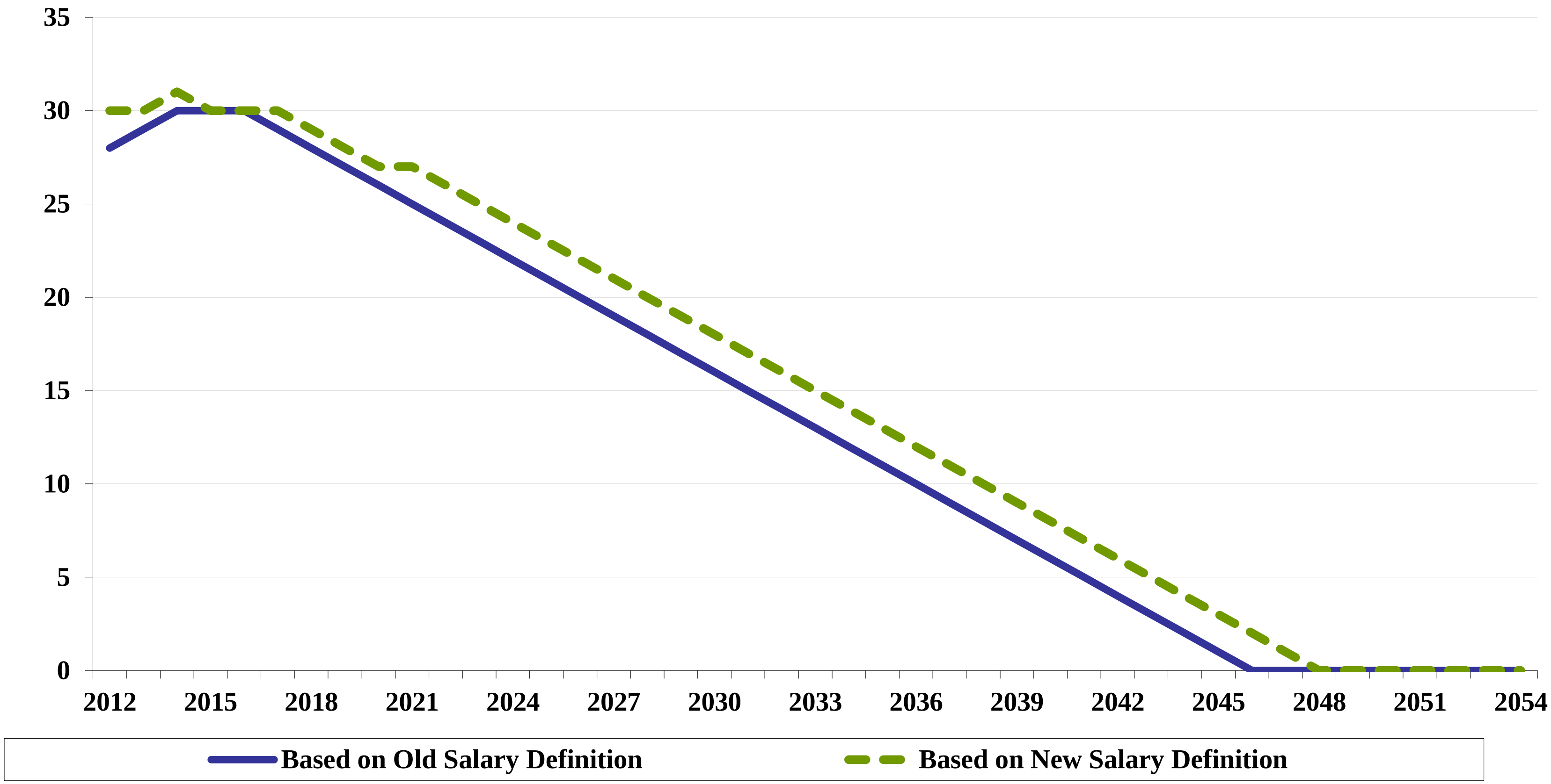
Projected Funding Period



Assumes all assumptions are met, including 7.75% return on market value of assets
New salary definition for new hires after 6/30/2012 does not include overtime

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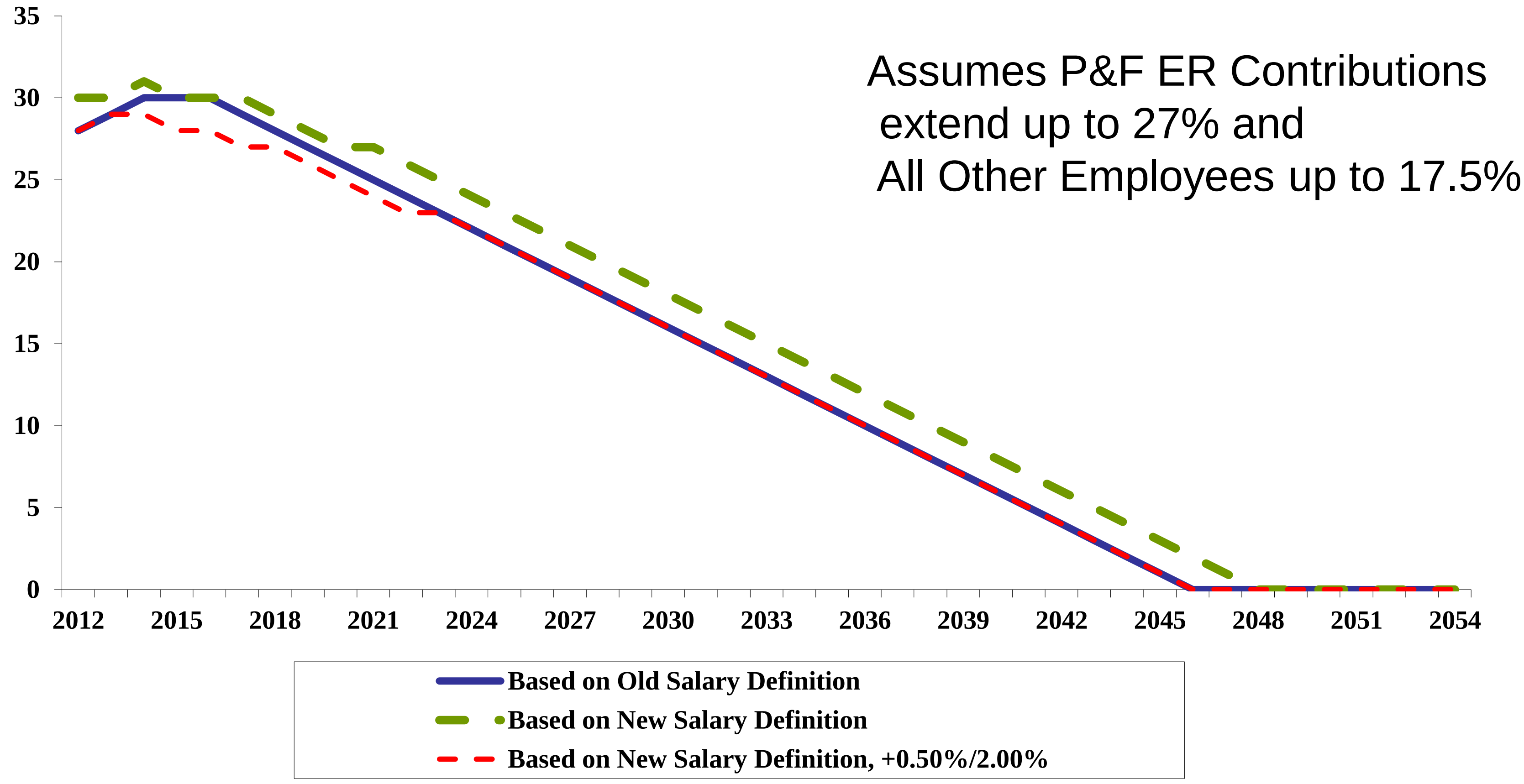
Projected Funding Period, with an extended contribution policy



Assumes all assumptions are met, including 7.75% return on market value of assets
New salary definition for new hires after 6/30/2012 does not include overtime

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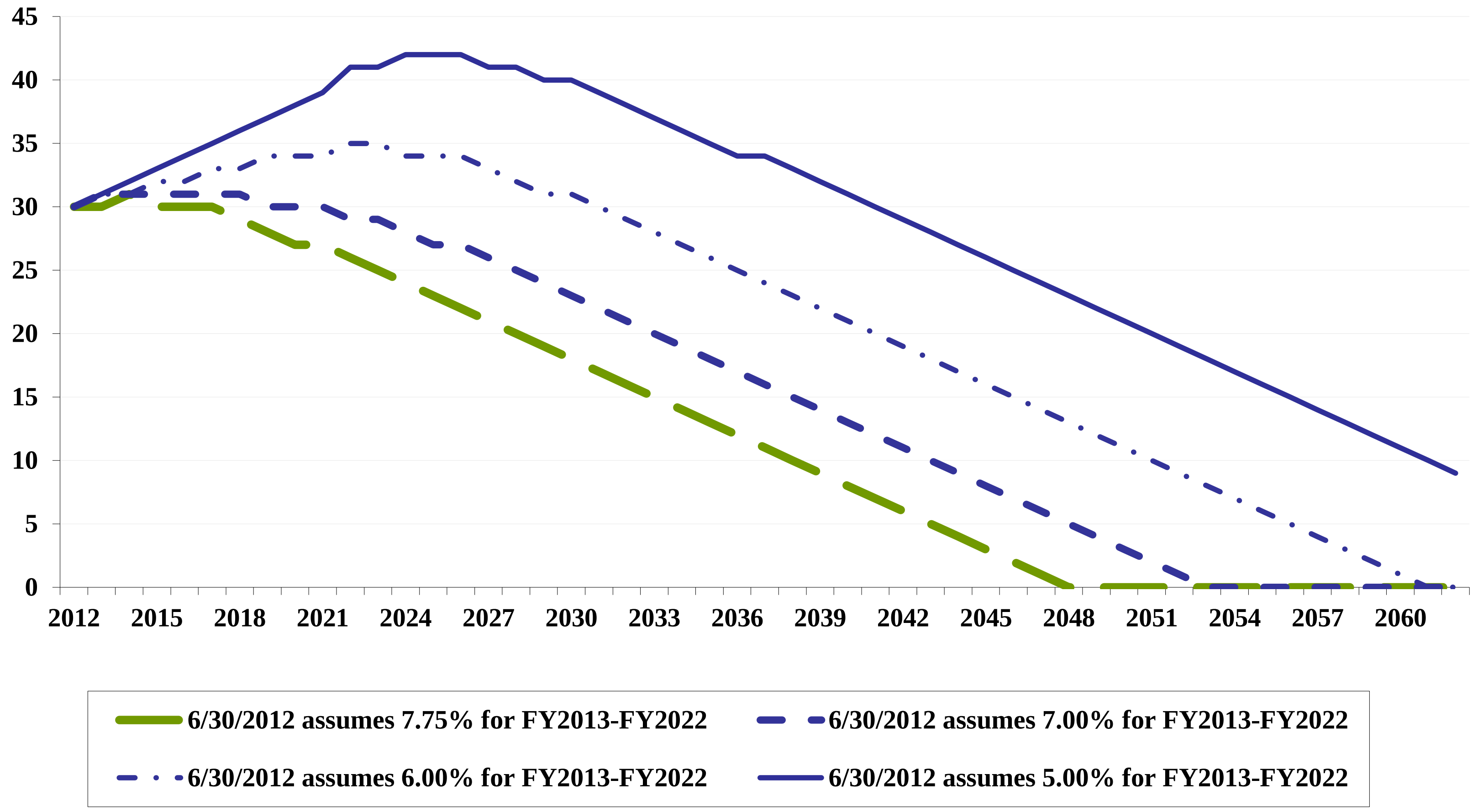
Stress Testing

- With the higher contribution policies and the new benefit structure for future employees, the System has been put in a position where a significant amount of adverse experience can be absorbed over the longer term

Sensitivity to Future Investment Returns: Funding Period, based on current contribution policy



Assumes all other assumptions met
Assumes 7.75% return after FY2022 in all scenarios

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Basic Retirement Funding Equation

$$C + I = B$$

Where

- C is Contribution Income
- I is Investment Return
- B is Benefits Paid

"Money In = Money Out"

Questions

GASB UPDATE

What has GASB done?

- The Statements change current pension accounting and financial reporting standards for state and local governments
  - Disconnect pension accounting from pension funding
  - Require employers to recognize the Net Pension Liability (NPL) on their balance sheets ***(where NPL is code for the Unfunded Accrued Liability based on Market Value of Assets)***
  - Require employers to recognize a new measure of the Pension Expense (PE) on their income statements, which would be different from their actuarially determined contributions (ARC)
  - Replace most of the current note disclosures and required supplementary information with information based on the new measures

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Timing

- GASB 67 Plan Reporting
  - Effective for fiscal years beginning after June 15, 2013
  - For Hawaii ERS, June 30, 2014 financial statements
- GASB 68 Employer Reporting
  - Effective for fiscal years beginning after June 15, 2014
  - For the State, June 30, 2015 financial statements
    - Local employers could be various

Big Picture

- There will be a liability on the governments' books that is larger than ever seen
  - It will encompass all systems
  - This will be a "bumpy" liability; changing each year with a new blended discount rate and change in market value of assets
- There will be an expense on the governments' books-a larger expense than ever seen
  - The shorter amortization will accelerate recognition of pension cost
- The changes only impact the accounting rules, but …..

Before and After

	GASB 25/27	GASB 67/68
Liability	Up to six allowable actuarial cost methods	Only Individual Entry Age allowed
Asset Offset	Various asset smoothing methods allowed	Fair market value
Expense	Various amortization periods and methods allowed	Rigid rules for Pension Expense components
LTeROR	Flexible on plan's return assumption	Still flexible on plan's return assumption

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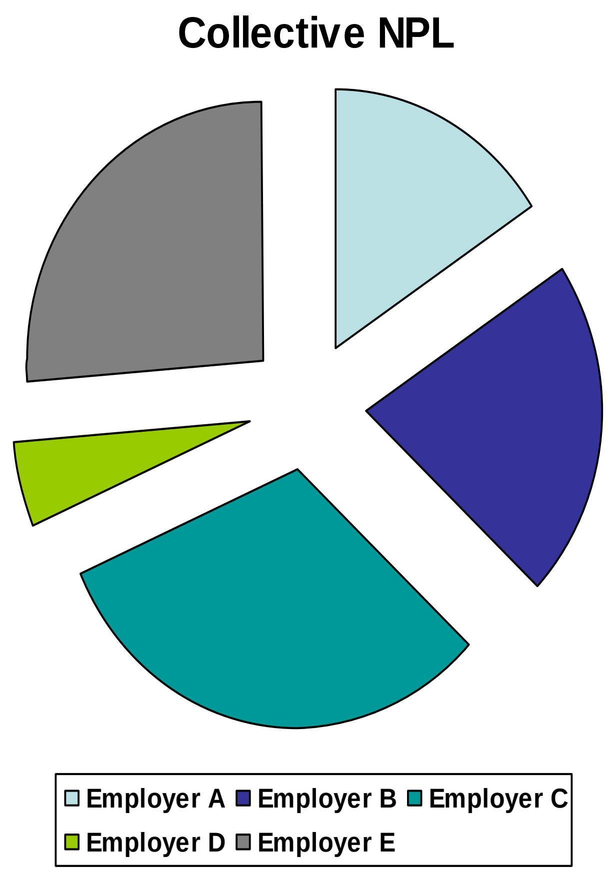
Cost-Sharing Plans Proportionate Shares



- Cost-Sharing Plan – "A multiple-employer defined benefit pension plan in which the pension obligations to the employees of more than one employer are pooled and pension plan assets can be used to pay the benefits of the employees of any employer that provides pensions through the pension plan."
- Under GASB 27, employers in a cost-sharing plan report the contractually required contribution in their financial statements
- Under GASB 68, employers in cost-sharing plans will have to report their proportionate share of the collective Net Pension Liability

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Nonemployer Contributing Entities

- Legally required to contribute *directly to* the pension plan of another entity
- Classification
  - "Special funding situations" (SFSs)
  - Other circumstances
- SFS reporting requirements
  - NECE—similar to cost-sharing
  - Employers—liability reduced by measure of NECE involvement
  - Could eliminate it completely

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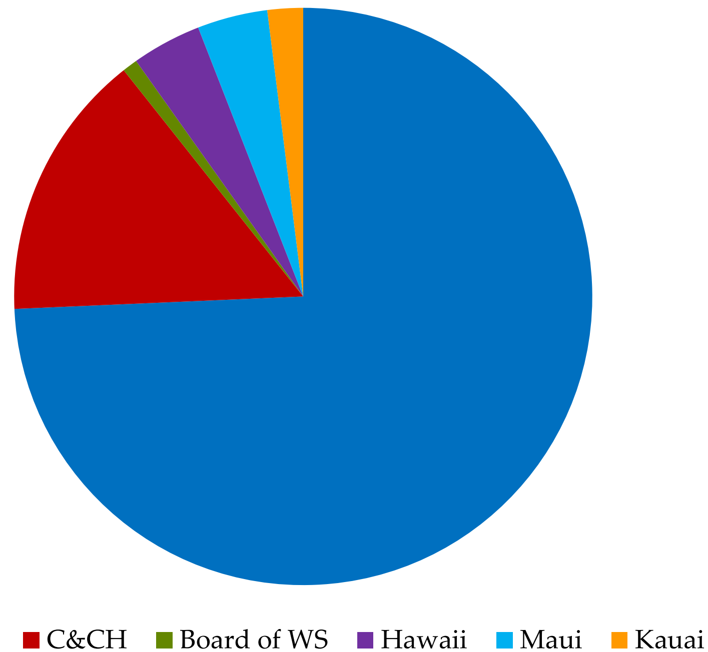
Example for ERS

- Each employer will be allocated a proportionate share of the NPL, based on proportion of contributions



- Notables:
  - State will have 74% ($6,984 M)
  - Next largest is 15% ($1,412 M)

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Determining the Discount Rate

- Discount rate used in determining the Total Pension Liability (TPL) is a blend of two rates:
  - Long-term expected rate of return on pension plan investments
    - This rate is generally consistent with the funding valuation
    - 7.75% for ERS
  - Yield or index rate for a 20-year, tax-exempt general obligation municipal bond
    - Will vary
    - ~4.0%
- Weight given to the long-term rate is based on a closed group projection

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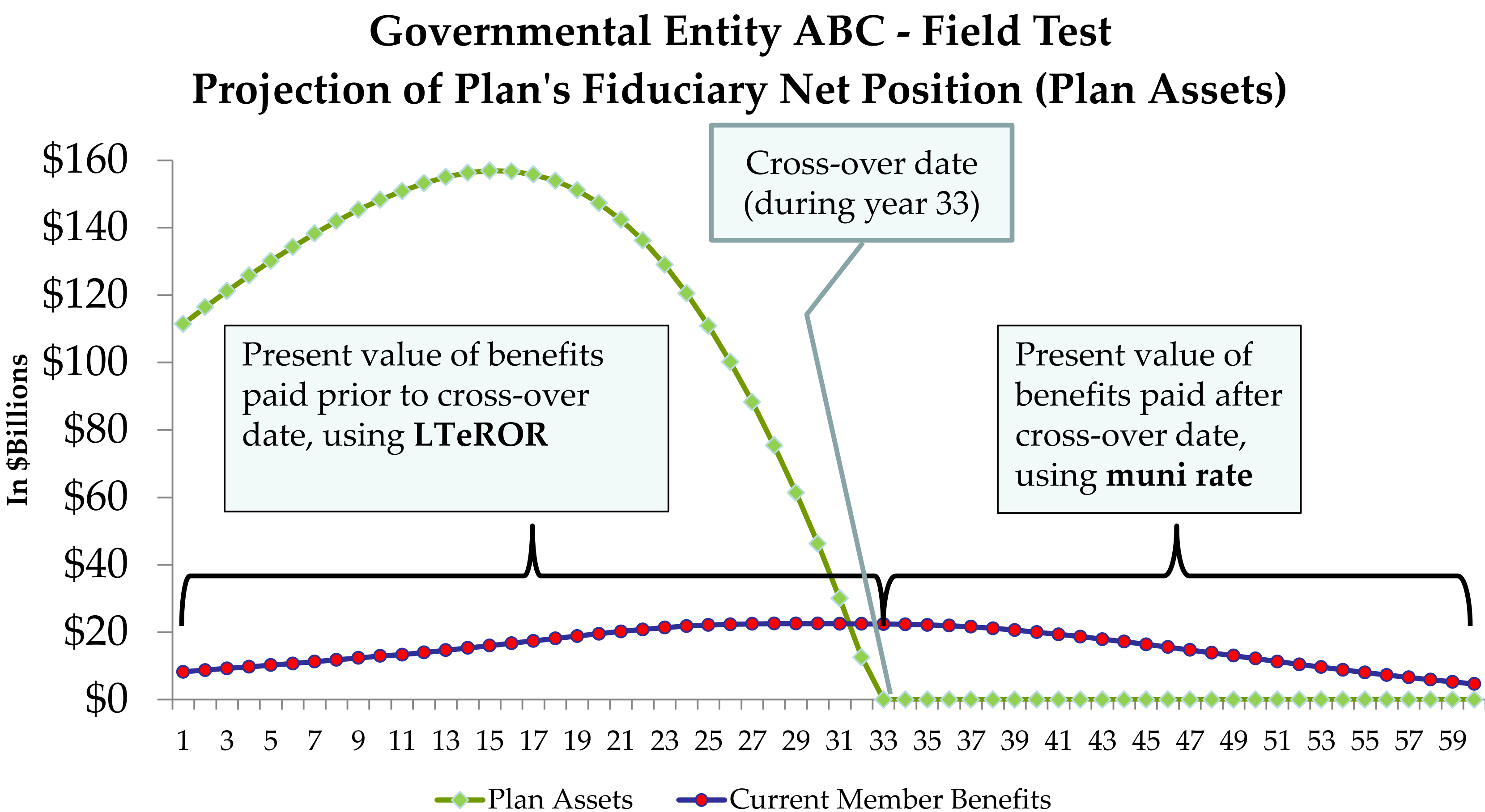
Determining the Discount Rate

- The premise…
  - The pension plan is primarily responsible for paying pension benefits to the extent the plan has sufficient assets
    - Assets invested with long-term investment horizon
  - The employer is primarily responsible for paying benefits to the extent the plan does not have sufficient assets
    - From the general fund or bond revenues

Illustration – Other Client



Using a 4% muni rate – The blended discount rate in this example would be approximately 6.00%

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Funding Policy will dictate the discount rate

- By having a stronger funding policy, the cross-over date is pushed back, which will increase the blended discount rate and lower the NPL on the balance sheet

General Outcomes

- ***Many plans contribute:***
  - Normal cost PLUS *closed* amortization payments
- These probably have discount rates = LTeROR

- ***Many plans contribute:***
  - Normal cost PLUS *open* amortization payments
- These almost always have discount rates less than LTeROR

- ***Other plans:***
  - A flat statutory percent of pay, or
  - Target cost methods, or
  - Pursuant to a more complex model
- These might have discount rates lower than LTeROR

Attention to Funding Policy

- Plans and employers should get together to draft funding policies because:
  - No more ARC, a current de facto funding standard
  - Required Supplementary Information (RSI) section of the CAFR will include the disclosure of an Actuarially Determined Employer Contribution (ADC), if one is calculated, and compare it to the actual employer contribution made. This will become the source for researchers to find out whether a plan's funding policy requires contributions that are reasonable/systematic/actuarially based
  - The funding policy is the primary driver of whether and when there is a cross-over date for lowering the discount rate
  - Just because it is the right thing to do.

Lots More Work

- By preparers of plan CAFRs
- By preparers of employer CAFRs
- By actuaries (likely two reports)
- By auditors

Communication Challenges

- Explaining:
  - The new very large liability on balance sheet
  - The annual changes in liability and pension expense, e.g., explaining why pension expense number is actually pension income in some years
  - Why accounting numbers do not equal funding numbers; which ones are right?
  - Why it costs so much to prepare

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