



January 27, 2023

VIA EMAIL

The Honorable Ronald D. Kouchi
Senate President
415 South Beretania Street
Hawai'i State Capitol, Room 409
Honolulu, Hawai'i 96813

VIA EMAIL

The Honorable Scott K. Saiki
Speaker, House of Representatives
415 South Beretania Street
Hawai'i State Capitol, Room 431
Honolulu, Hawai'i 96813

RE: Financial Audit of the Employees' Retirement System of the State of Hawai'i

Dear President Kouchi and Speaker Saiki:

The audit report on the financial statements of the Employees' Retirement System of the State of Hawai'i for the fiscal year ended June 30, 2021, was issued on November 23, 2022. The Office of the Auditor retained KPMG LLP to perform the financial audit. For your information, we are attaching a copy of the two-page Auditor's Summary of the financial audit report.

You may view the financial audit report and Auditor's Summary on our website at:

https://files.hawaii.gov/auditor/Reports/2021_Audit/ERS2021.pdf; and

https://files.hawaii.gov/auditor/Reports/2021_Audit/ERS_Summary_2021.pdf.

If you have any questions about the report, please contact me.

Very truly yours,

Leslie H. Kondo
State Auditor

LHK:LYK:emo

Attachment

ec/attach (Auditor's Summary only): Members of the Senate

Members of the House of Representatives

Carol Taniguchi, Senate Chief Clerk

Brian Takeshita, House Chief Clerk

Auditor's Summary

Financial Audit of the Employees' Retirement System of the State of Hawai'i

Financial Statements, Fiscal Year Ended June 30, 2021



THE PRIMARY PURPOSE of the audit was to form an opinion on the fairness of the presentation of the financial statements for the Employees' Retirement System of the State of Hawai'i, as of and for the fiscal year ended June 30, 2021. The audit was conducted by KPMG LLP.

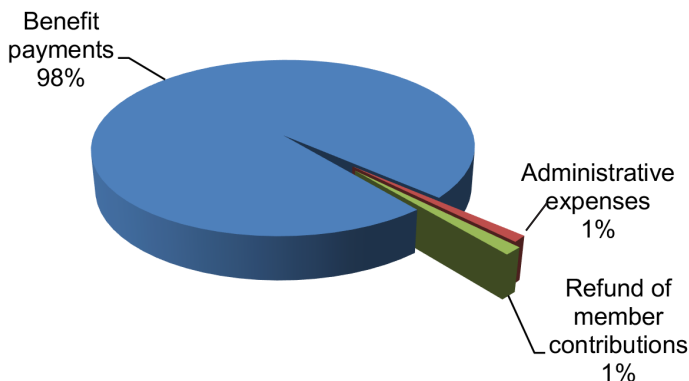
About the System

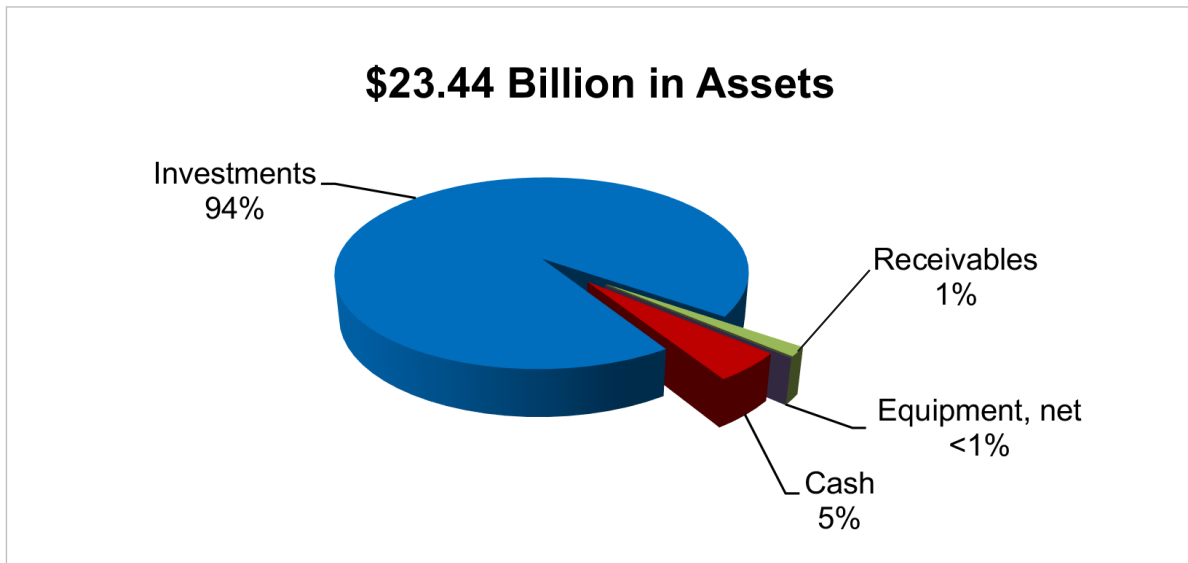
The Employees' Retirement System of the State of Hawai'i (ERS) is a cost-sharing, multiple-employer retirement system for government workers. Through its pension benefits program, ERS provides a defined-benefit pension plan for all state and county employees, including teachers, professors, police officers, firefighters, correction officers, judges, and elected officials. ERS is governed by a Board of Trustees, which consists of eight members.

Financial Highlights

FOR THE FISCAL YEAR ended June 30, 2021, ERS reported total net additions of approximately \$6.24 billion. Additions consisted of \$1.58 billion from contributions and \$4.66 billion in net investment income.

\$1.69 Billion in Deductions





Total deductions of approximately \$1.69 billion consisted of (1) \$1.65 billion for benefit payments; (2) \$19 million for administrative expenses; and (3) \$24 million for refund of member contributions.

As of June 30, 2021, assets totaled \$23.44 billion and liabilities totaled \$1.51 billion, leaving a net position balance of \$21.94 billion. Total assets included (1) investments of \$21.96 billion; (2) receivables of \$354 million; (3) cash of \$1.12 billion; and (4) net equipment of \$6 million.

Auditor's Opinion

ERS RECEIVED AN UNMODIFIED OPINION that the financial statements were presented fairly, in all material respects, in accordance with generally accepted accounting principles.

Findings

THERE WERE NO REPORTED DEFICIENCIES IN INTERNAL CONTROL over financial reporting that were considered to be material weaknesses and no instances of noncompliance or other matters required to be reported under *Government Auditing Standards*.

For the complete report and financial statements visit our website at:
https://files.hawaii.gov/auditor/Reports/2021_Audit/ERS2021.pdf



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

Financial Statements

June 30, 2021

(With Independent Auditors' Report Thereon)

Submitted by

**THE AUDITOR
STATE OF HAWAII**

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

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KPMG LLP
Suite 2210
1003 Bishop Street
Honolulu, HI 96813-6400

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, 2021 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, 2021, 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 and investment returns, on pages 47 through 49 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, 2021 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 23, 2022, 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 solely 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 ERS' internal control over financial reporting and compliance.

KPMG LLP

Honolulu, Hawaii
November 23, 2022

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis (Unaudited)

June 30, 2021

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, 2021. 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 information.

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, 2021, and the related statement of changes in fiduciary net position during the fiscal year from July 1, 2020 to June 30, 2021 (FY 2021). 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 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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis (Unaudited)

June 30, 2021

Financial Highlights

The fiduciary net position increased by \$4.5 billion, or 25.9%, during FY 2021 to \$21.9 billion, with the corresponding increase in funded status to 64.3% as of June 30, 2021. The ERS' fiduciary net position for pension benefits was \$17.4 billion, for a 53.2% funded status as of June 30, 2020.

The ERS investment return (net and gross of fees) was 26.6% for the 2021 fiscal year compared to a 1.3% return during the 2020 fiscal year, using the time-weighted rate of return methodologies that are generally accepted by the Global Investment Performance Standards. The investment program outperformed its actuarial and investment goal of 7.0% that was effective June 30, 2021. 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 26.9% and 2.1% for FY 2021 and FY 2020, 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. Following the completion of the 2019 Asset Liability Study the Board adopted a new long-term strategic allocation policy that established two major asset classes of broad growth and diversifying strategies (rather than four Broad Growth, Principal Protection, Real Return and Crisis Risk Offset) that is expected to be largely completed by the end of the 2022 fiscal year. Please refer to note 6(a) for more detailed information on the asset allocation policy.

During 2021 and 2020, there was no significant legislation passed that significantly affects the operations or provisions of the pension trust. This was the last of four years that will have significant increases in employer contribution rates from 2017 legislation in Note 1.

Total pension liability as of June 30, 2021 increased to \$34.1 billion from \$32.7 billion as of June 30, 2020, while the corresponding net pension liability decreased to \$12.2 billion as of June 30, 2021 from \$15.3 billion on June 30, 2020. Covered payroll for the ERS increased in FY 2021 to \$4.7 billion compared to FY 2020 of \$4.5 billion, for a 4.4% increase.

The fiduciary net position as a percentage of total pension liability increased to 64.3% from 53.2% as of June 30, 2021 and June 30, 2020, respectively, while the funded ratio on an actuarial basis increased to 58.3% from 55.3%, 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 \$196.2 million during FY 2021, or 14.2% from FY 2020. 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.

Total retirement benefit payments increased by \$105.8 million, or 6.8% in FY 2021 from \$1,545.6 million in FY 2020. Pension benefits continues to increase due to 2.5% more retirees and beneficiaries (52,618 in 2021 compared to 51,153 in 2020), an increase in the average pension benefit for new retirees, and the annual 2.5% postretirement increase.

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

Management's Discussion and Analysis (Unaudited)

June 30, 2021

Administrative expenses increased by \$1.3 million to \$19.1 million in FY 2021 from \$17.8 million in FY 2020. The increase in administrative expenses is primarily the result of an increase in depreciation of computer systems placed in service during the fiscal year, and to a lesser extent timing of Information technology related charges, and an increase in professional services for internal audit fees in FY 2021. These were offset by a reduction in the employee fringe benefit assessment, actuarial experience study conducted every three years. Administrative expenses for all years were within the ERS' budgeted amounts.

Analysis of Fiduciary Net Position

Summary of Fiduciary Net Position

June 30, 2021 and 2020

(Dollars in millions)

	<u>2021</u>	<u>2020</u>	<u>FY 2021 percentage change</u>
Assets:			
Cash and cash equivalents and short-term investments	\$ 2,726.7	3,477.4	(21.6)%
Receivables	353.5	249.6	41.6 %
Investments	19,352.1	14,120.4	37.1 %
Invested securities lending collateral	1,003.7	992.6	1.1 %
Equipment	<u>6.0</u>	<u>7.6</u>	(21.1)%
Total assets	<u>23,442.0</u>	<u>18,847.6</u>	24.4 %
Liabilities:			
Securities lending liability	1,003.7	992.6	1.1 %
Investment accounts and other payables	<u>502.5</u>	<u>469.6</u>	7.0 %
Total liabilities	<u>1,506.2</u>	<u>1,462.2</u>	3.0 %
Fiduciary net position	<u>\$ 21,935.8</u>	<u>17,385.4</u>	26.2 %

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

Management's Discussion and Analysis (Unaudited)

June 30, 2021

Summary of Changes in Fiduciary Net Position

June 30, 2021 and 2020

(Dollars in millions)

	<u>2021</u>	<u>2020</u>	<u>FY 2021 percentage change</u>
Assets:			
Contributions	\$ 1,582.2	1,386.0	14.2 %
Net investment income	<u>4,662.2</u>	<u>358.3</u>	1,201.2 %
Total additions	<u>6,244.4</u>	<u>1,744.3</u>	258.0 %
Deductions:			
Retirement benefit payments	1,651.4	1,545.6	6.8 %
Refund of contributions	23.6	22.4	5.4 %
Administrative expenses	<u>19.1</u>	<u>17.8</u>	7.3 %
Total deductions	<u>1,694.1</u>	<u>1,585.8</u>	6.8 %
Increase in fiduciary net position	<u>\$ 4,550.3</u>	<u>158.5</u>	2,770.9 %

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 that was completed in FY 2020, the Board adopted a new long-term strategic allocation policy. As part of the long-term strategic policy, the portfolio transitioned to two major asset classes (rather than four). Prevailing classes and sub-classes were remapped to the two major strategic classes where applicable. It 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.

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

Management's Discussion and Analysis (Unaudited)

June 30, 2021

The asset distribution of the ERS' investment securities for the pension trust, excluding pending trade settlements and securities lending collateral, at June 30, 2021 and 2020 are presented below at fair value. Fluctuations will occur based on the trading activity and timing of the settlements. Investment balances between the asset classes will change over time based on market sectors' performance and our rebalancing efforts to maintain asset allocation targets. Changes will also occur for financial reporting since certain real estate and alternative investments are reported on the consolidated method of accounting using the value of the underlying investments since ERS is the majority owner of the business organization.

Investment Asset Class

June 30, 2021 and 2020

(Dollars in millions)

	<u>2021</u>	<u>Percentage</u>	<u>2020</u>	<u>Percentage</u>
Short-term investments and cash	\$ 2,726.7	12.3 %	\$ 3,477.4	19.8 %
Equity securities	7,487.6	33.9	6,257.2	35.6
Fixed income	6,392.6	29.0	4,131.9	23.5
Real estate	1,871.1	8.5	1,531.8	8.7
Alternative investments	3,600.8	16.3	2,199.5	12.4
 Total investment assets	 22,078.8	 <u>100.0 %</u>	 17,597.8	 <u>100.0 %</u>
 Less loans on real estate and alternative investments	 254.1		 190.7	
 Total	 \$ <u>21,824.7</u>		 \$ <u>17,407.1</u>	

The rate of return (gross of fees time-weighted rate of returns) on the ERS investment portfolio during FY 2021 was 26.6% with outperformance in the Broad Growth asset class, while the Diversifying Strategies asset class underperformed its benchmark (and the overall ERS investment target). This compares to an overall return on the portfolio of 1.3% in FY 2020. Total net investment income was \$4,662.2 million in FY 2021 compared to \$358.3 million in FY 2020.

The ERS earned exceptional returns of 34.8% in the broad growth class, lead by private growth (+55.5%), public growth (+33.8%), and followed by real assets (+13.3%). In comparison, the diversifying strategies return of 1.8% underperformed the ERS benchmark of 7.0%, comprised of illiquid diversifying (+4.9%), liquid diversifying (+4.1%), and liquid defensive (+ 1.1%).

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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Management's Discussion and Analysis (Unaudited)

June 30, 2021

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.

Total investment management fees earned by external investment advisors in 2021 increased in-line with the superior returns earned during the year compared to the sub-par returns for 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 \$1,582.2 and \$1,386.0 million in FY 2021 and FY 2020, respectively. During FY 2021, total contributions increased by \$196.2 million, or 14.2%, primarily from 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.

Pension Plan Benefits and Expenses

Pension benefit payments continue to be the primary deduction of the ERS with payments increasing to \$1,651.4 in FY 2021 from \$1,545.6 million in FY 2020. 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 \$23.6 million in FY 2021 from \$22.4 million in FY 2020.

Administrative expenses increased to \$19.1 million in FY 2021 from \$17.8 million in FY 2020 due primarily from an increase for computer related costs for equipment (depreciation) and maintenance during the year. This was followed by an increase in professional services for legal fees and increased internal audit activities. The increase in payroll related costs for pay raises was offset by a decrease in the fringe benefit rate assessment.

Pension Plan Changes

There was no significant legislation passed in 2021 and 2020 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 increased during FY 2021 on the fiduciary net position (market asset basis) to 64.3% as of June 30, 2021 from to 53.2% as June 30, 2020, as a result of superior investment returns 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, 2021

During an extraordinary FY 2021 with superior investment earnings, the ERS's investment portfolio earned 26.9% based on the market value of assets. This compares to rate of return for the actuarial value of 10.8% in FY 2021, 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 fourth year of scheduled contribution rate increases (of a four-year phase in period).

The total pension liability for fiscal year ended June 30, 2021 is based on the actuarial valuation performed as of June 30, 2021 and a measurement date of June 30, 2021.

Per the valuation as of June 30, 2021, the ERS's total pension liability was \$34.1 billion, covered payroll totaled \$4.7 billion, and the ERS's fiduciary net position of \$21.9 billion resulting in a net pension liability of \$12.2 billion. The June 30, 2020 valuation results include the ERS' total pension liability of \$32.7 billion, covered payroll totaled \$4.5 billion, and the ERS's fiduciary net position was \$17.4 billion resulting in a net pension liability of \$15.3 billion. The ERS's fiduciary net position as a percentage of total pension liability was 64.3% and 53.2% on June 30, 2021 and 2020, resulting in the net pension liability as a percentage of covered payrolls of 261.5% and 341.6%, 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, 2021, 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 24 years, compared to 26 years as of June 30, 2020. 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.)

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, 2021

Assets:

Cash and cash equivalents and short-term investments:

Cash and cash equivalents	\$ 1,122,056,083
Short-term investments	<u>1,604,664,717</u>
	<u>2,726,720,800</u>

Receivables:

Accounts receivable and others	153,840,248
Investment sales proceeds	65,055,633
Accrued investment income	43,764,073
Employer and member contributions	<u>90,874,146</u>
	<u>353,534,100</u>

Investments, at fair value:

Equity securities	7,487,550,452
Fixed-income securities	6,392,593,824
Real estate investments	1,871,180,686
Alternative investments	<u>3,600,762,896</u>
	<u>19,352,087,858</u>

Other:

Invested securities lending collateral	1,003,664,522
Equipment, at cost, net of depreciation	<u>6,005,533</u>
	<u>1,009,670,055</u>

Total assets

23,442,012,813

Liabilities:

Accounts and other payables	154,392,821
Payable for securities purchased	94,105,759
Securities lending collateral	1,003,664,522
Notes payable	<u>254,058,000</u>

Total liabilities

1,506,221,102

Commitments and contingencies

Fiduciary net position

\$ 21,935,791,711

See accompanying notes to financial statements.

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

Statement of Changes in Fiduciary Net Position

Year ended June 30, 2021

Additions:

Contributions:

Employers contributions	\$ 1,281,558,696
Members contributions	<u>300,626,446</u>
Total contributions	<u>1,582,185,142</u>

Investment income:

From investing activities:

Net appreciation in fair value of investments	4,147,130,645
Interest on fixed-income securities	161,100,654
Dividends on equity securities	92,471,242
Income on real estate investments	65,936,316
Interest on short-term investments	361,212
Alternative investment income	308,353,317
Miscellaneous	<u>2,636,927</u>

4,777,990,313

Less investment expenses	<u>119,947,169</u>
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Net investment income from investing activities	<u>4,658,043,144</u>
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From securities lending activities:

Securities lending income	4,658,495
Less securities lending expenses, net	<u>475,878</u>

Net investment income from securities lending activities	<u>4,182,617</u>
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Total net investment income	<u>4,662,225,761</u>
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Total additions, net	<u>6,244,410,903</u>
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Deductions:

Benefit payments	1,651,431,372
Refunds of member contributions	23,618,435
Administrative expenses	<u>19,049,861</u>

Total deductions	<u>1,694,099,668</u>
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Net increase in fiduciary net position	4,550,311,235
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Fiduciary net position:

Beginning of year	<u>17,385,480,476</u>
End of year	<u>\$ 21,935,791,711</u>

See accompanying notes to financial statements.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Notes to Financial Statements

June 30, 2021

(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.

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

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June 30, 2021

Employer, pensioner, and employee membership data as of March 31, 2021 is as follows:

Employers:	
State	1
County	4
	<hr/>
Total employers	5
	<hr/>
Pensioners and beneficiaries currently receiving benefits:	
Pensioners currently receiving benefits:	
Police and firefighters	4,105
All others employees	43,619
	<hr/>
Total pensioners	47,724
	<hr/>
Beneficiaries currently receiving benefits:	
Police and firefighters	376
All others employees	4,518
	<hr/>
Total beneficiaries	4,894
	<hr/>
Total pensioners and beneficiaries	52,618
	<hr/>
Terminated vested members entitled to benefits but not yet receiving benefits:	
Police and firefighters	239
All others employees	8,772
	<hr/>
Total terminated vested members	9,011
	<hr/>
Inactive members:	
Police and firefighters	869
All other employees	21,357
	<hr/>
Total inactive members	22,226
	<hr/>
Total terminated vested and inactive members	31,237
	<hr/>
Active members:	
Vested:	
Police and firefighters	3,226
All other employees	34,111
	<hr/>
Total vested members	37,337
	<hr/>
Nonvested:	
Police and firefighters	1,671
All other employees	26,553
	<hr/>
Total nonvested members	28,224
	<hr/>
Total active members	65,561
	<hr/>
Total membership	149,416
	<hr/>

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Notes to Financial Statements

June 30, 2021

(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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

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June 30, 2021

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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

Notes to Financial Statements

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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

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

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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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

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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, 2021, the ERS held no amounts in the Contribution Fund as all amounts deposited into the Contribution Fund were paid directly to the IRS.

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

Notes to Financial Statements

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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 Cash Equivalents and Investments

The ERS' investment policy for cash and cash equivalents 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 and cash equivalents, 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.

**EMPLOYEES' RETIREMENT SYSTEM
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June 30, 2021

(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 Adopted 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.

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII

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June 30, 2021

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. Adoption of the standard was effective for the ERS' reporting period ending June 30, 2021 and did not materially impact the ERS' financial statements or disclosures.

In May 2020, GASB issued Statement No. 96, Subscription-based Information Technology Arrangements (SBITAs) (Statement No. 96). Statement No. 96 defines a SBITA; establishes criteria for identifying when a SBITA results in a right-to-use subscription asset—an intangible asset—and a corresponding subscription liability; provides the capitalization criteria for outlays other than subscription payments; including implementation costs; and requires note disclosures regarding a SBITA. To the extent relevant, the standards for SBITAs are based on the standards established in Statement No. 87, Leases, as amended. The requirements of this Statement No. 96 are effective for fiscal years beginning after June 15, 2022. 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.

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Fiduciary net position as of June 30, 2021 are as follows:

Pension accumulation reserve	\$ 18,574,542,162
Annuity savings reserve	3,337,854,144
Expense reserve	<u>23,395,405</u>
Total fiduciary net position	<u>\$ 21,935,791,711</u>

(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

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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 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, 2021, the ERS was strategically invested in the following classes:

	Strategic Allocation (functional/risk-based classes)
Broad Growth	72%
Diversifying Strategies	28%
Total	100%

During FY 2021, the Broad Growth strategic asset class includes sub-asset classes or components of Public Growth (Traditional Equity, Stabilized Equity, and Global Credit), Private Growth, and Real Assets (Core Real Estate, Non-Core Real Estate, Infrastructure and Timber). The Diversifying Strategies asset class includes Illiquid Diversifying (Idiosyncratic Return Capture, and Insurance Linked), Liquid Defensive (Defensive Return Capture, Systematic Trend Following and Treasury Agency Duration Capture), and Liquid Diversifying (Alternative Return Capture Strategies, and Relative Value Arbitrage). 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 transitioned to two major strategic classes (rather than four). Prevailing classes and sub-classes were remapped to the two major strategic classes where applicable. It is

**EMPLOYEES' RETIREMENT SYSTEM
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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.

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.

The Board manages the expected return/risk posture of the Plan as part of the formal asset-liability studies that are completed every three-to-five years. Based on the most recent asset-liability study the Total Fund was repositioned to achieve a long-term report of approximately 7.0% with an annualized volatility of approximately 9.4%-11.4% (dependent on modeling approach) over a horizon of 20-30 years. It is expected that a new asset-liability study will commence in the 2023 fiscal year.

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 volatility
Broad growth	63 %	8.0 %	15.8 %
Diversifying Strategies	37 %	5.1 %	5.8 %
Total portfolio	100 %	7.2 %	10.7 %

* Uses an expected inflation of 2.1%

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The implementation plan for long-term strategic policy established in 2020 is expected to be completed by the end of the FY 2022 as follows.

Implementation Plan for Long-term Strategic Policy				
	6/30/20	7/1/2020	Long-term 7/1/2021	Long-term 7/1/2022
Broad growth	68%	72%	68%	63%
Principal protection	8%	0%	0%	0%
Real return	8%	0%	0%	0%
Crisis risk offset	16%	0%	0%	0%
Diversifying Strategies	0%	28%	33%	37%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Rate of Return

For the year ended June 30, 2021, the annual money-weighted return on pension plan investments, net of pension plan investment expense, was 26.9%. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for changing amounts actually invested.

(b) Deposits

Cash and cash equivalents include 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, 2021, the carrying amount of deposits totaled approximately \$1,122,056,083 and the corresponding bank balance was \$1,129,770,560, all of which was exposed to custodial credit risk.

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(c) Investments

The following table shows the investments of the ERS by investment type as of June 30, 2021.

Cash and short-term investments:	
Cash and cash equivalents	\$ 1,122,056,083
Short-term bills and notes	927,027,771
Pooled and others	677,939,551
Fixed-income securities:	
U.S. Treasury bonds and notes	2,984,625,708
U.S. government agencies bonds	14,993,804
U.S. government agency mortgage backed	255,052,216
U.S. government-sponsored agency mortgage backed	18,372,532
Asset backed securities	43,551,836
U.S. corporate bonds	2,160,646,024
Non-U.S. government/agency bonds	8,556,172
Non-U.S. corporate bonds	210,551,984
Pooled and others	650,141,159
Derivatives:	
Forwards – cash and short-term investments	(302,605)
Forwards – debt securities	5,140,885
Futures – debt securities	27,181,306
Options – equities	(17,982,734)
Options – debt securities	703,775
Swaps – equity securities	13,076,423
Warrants – equities	29,928,751
Equities	7,475,604,435
Real estate	1,871,180,686
Alternative investments	<u>3,600,762,896</u>
Total investments	<u>\$ 22,078,808,658</u>
Short-term instruments for securities lending collateral pool	\$ 1,003,664,522

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).

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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.

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,

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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.

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, 2021.

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

		Fair value measurement using		
		Active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
	Total			
Investments by fair value level:				
Short-term investments:				
Short-term bills and notes	\$ 927,027,771	926,727,771	300,000	—
Total short-term investments	927,027,771	926,727,771	300,000	—
Equity securities:				
Common stocks	5,466,422,474	5,466,422,474	—	—
Preferred shares and other	484,332,937	350,541,260	28,593,467	105,198,210
Total equity securities	5,950,755,411	5,816,963,734	28,593,467	105,198,210
Fixed-income securities:				
U.S. Treasury bonds and notes	2,984,625,708	2,509,720,816	474,904,892	—
U.S. government agencies bonds	14,993,804	—	14,993,804	—
U.S. government agency mortgage backed	255,052,216	—	255,052,216	—
U.S. government-sponsored agency mortgage backed	18,372,532	—	18,372,532	—
Asset backed securities	43,551,836	—	43,551,836	—
U.S. corporate bonds	2,160,646,024	—	1,987,722,240	172,923,784
Non-U.S. government/agency bonds	8,556,172	—	8,314,225	241,947
Non-U.S. corporate bonds	210,551,984	—	113,942,138	96,609,846
Pooled and others	406,922,573	—	406,919,858	2,715
Total fixed-income securities	6,103,272,849	2,509,720,816	3,323,773,741	269,778,292
Real estate (direct investment)	733,019,181	—	—	733,019,181
Alternative investments (direct investment)	175,472,222	—	—	175,472,222
Total assets at fair value level	13,889,547,434	9,253,412,321	3,352,667,208	1,283,467,905
Liabilities:				
Notes payable (on real estate-direct)	254,058,000	—	—	254,058,000
Total investments (excluding derivatives), net of notes payable measured by fair value level	\$ 13,635,489,434	9,253,412,321	3,352,667,208	1,029,409,905

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

		Fair value measurement using		
		Active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
	Total			
Investment derivative instruments:				
Currency purchases	\$ (302,605)	—	(302,605)	—
To Be Announced (TBAs) forwards	5,140,885	—	5,140,885	—
Bond futures	(11,885,171)	(11,885,171)	—	—
Commodity futures	30,577,925	30,577,925	—	—
Currency futures	11,285,278	11,285,278	—	—
Index fixed income futures	(2,371,723)	(2,371,723)	—	—
Interest rate futures	2,816,269	2,816,269	—	—
Options	(17,982,734)	(3,083,648)	(14,899,086)	—
Options on debt securities	703,775	—	(31,923)	735,698
Credit default swaps	(1,026,730)	—	(1,026,730)	—
Total return swaps	5,649,017	—	5,649,017	—
Interest rate swaps	5,212,864	—	(359,656)	5,572,520
Warrants	29,928,751	29,807,531	114,023	7,197
Total investment derivative instruments	\$ 57,745,801	57,146,461	(5,716,075)	6,315,415
Invested securities lending collateral:				
Short-term instruments:				
Certificate of deposits	\$ 17,421,902	—	17,421,902	—
Repurchase agreements	447,427,935	—	447,427,935	—
Global commercial paper	50,100,566	—	50,100,566	—
Global asset backed notes	14,632,062	—	14,632,062	—
Global corporate notes	474,082,057	—	474,082,057	—
Total invested securities lending collateral	\$ 1,003,664,522	—	1,003,664,522	—
Investments measured at NAV:				
Short-term investments			\$ 677,939,551	
Equity securities			1,524,849,024	
Fixed income			243,218,586	
Real estate			1,138,161,505	
Alternative investments			3,425,290,674	
Total investments measured at NAV			\$ 7,009,459,340	

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	<u>June 30, 2021</u>	<u>Unfunded commitments</u>	<u>Redemption frequency (if currently eligible)</u>	<u>Redemption notice period (days)</u>
Short-term investments (a)	\$ 677,939,551	—	Daily	1 Day
Equity securities (b)	1,524,849,024	—	Daily	2 Days
Fixed income (c)	243,218,586	126,001,000	Various	Various
Real estate (d)	1,138,161,505	1,133,754,000	Not eligible	N/A
Alternative investments (e)	<u>3,425,290,674</u>	<u>1,988,583,000</u>	Not eligible	N/A
Total investments measured at NAV	<u>\$ 7,009,459,340</u>	<u>3,248,338,000</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. 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 two funds, including 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 eight 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.
- (d) Real estate consists of 56 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.

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- (e) Alternative investments consist of 261 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					
	Investments by Fair Value Level	Investments Measured by the NAV	Derivative Investments by Fair Value Level	Invested Securities Lending Collateral by Fair Value Level	Statement of Fiduciary Net Position
Assets:					
Short-term investments	\$ 927,027,771	677,939,551	(302,605)	—	1,604,664,717
Equity securities	5,950,755,411	1,524,849,024	11,946,017	—	7,487,550,452
Fixed income securities	6,103,272,849	243,218,586	46,102,389	—	6,392,593,824
Real estate investments	733,019,181	1,138,161,505	—	—	1,871,180,686
Alternative investments	175,472,222	3,425,290,674	—	—	3,600,762,896
Invested securities lending collateral	—	—	—	1,003,664,522	1,003,664,522
	<u>\$ 13,889,547,434</u>	<u>7,009,459,340</u>	<u>57,745,801</u>	<u>1,003,664,522</u>	<u>21,960,417,097</u>
Liabilities:					
Notes payable	\$ 254,058,000	—	—	—	254,058,000
	<u>\$ 254,058,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>254,058,000</u>

(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 Credit Portfolio consists of investment strategies and assets that are largely exposed to and/or susceptible to various collateral types (corporate cash flows, mortgages, various credit receivables, etc.) that produce relatively high levels of income. These investments may be traded in public markets or sourced through private issuance. Such investments typically contain relatively lower levels of risk and exhibit lower volatility than other Broad Growth components but do have exposure to growth-related characteristics. In addition, periodic income will likely be a material portion of the Credit Portfolio's investment return. The overall objectives of the Diversifying Strategy strategic class are to provide stability, diversification, and liquidity complements to the Broad Growth strategic class. This class can help diversify the Broad Growth Class during challenging periods, such as material equity market drawdowns. Individual investment managers have specific investment policy guidelines, limits,

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and/or requirements for their portfolio, that may include limits on, but not limited to, security type, sectors, currency, duration, credit rating and issue amounts.

The ERS may invest, across the Broad Growth and Diversifying Strategies asset classes, in directly held securities, Partnerships/Fund of Ones or commingled funds which invest in liquid and less liquid corporate credit across the capital structure as well as opportunistically provide private financing. Investment instruments and/or strategies include but are not limited to the purchase and/or origination of investment grade, broadly syndicated high yield bonds, broadly syndicated leveraged loans, narrowly syndicated private debt ("club deals"), collateralized loan obligations ("CLO") debt and equity, municipal securities, capital solutions and convertibles. Other investment instruments and/or strategies include but are not limited to U.S. Treasuries and government-backed, high-quality, very liquid agencies, the purchase and/or origination of legacy non-agency residential mortgage-backed securities, asset backed securities, agency risk transfer, FNMA/Freddie preferred equity, non-qualified mortgage, origination, re-performing loans, credit tenant leases, bridge financings, and other types. Derivatives may be used for managing interest rate, volatility, term structure, country, currency, sector exposures, etc. as authorized by their mandate.

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A table of the ERS' fixed-income securities as of June 30, 2021 is below. Securities below investment grade of BAA and nonrated issues (average rating by S&P, Moody's, and/or Fitch) amounted to \$2,736,907,999 or 42.8% 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, 2021								
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	\$ 14,993,804	—	996,627	254,911,144	—	356,064	3,377,700	274,635,339
AA1	—	—	8,977,845	141,072	—	—	—	9,118,917
AA2	—	—	2,009,679	—	—	—	—	2,009,679
AA3	—	—	7,546,504	—	—	1,885,951	—	9,432,455
A1	—	—	8,884,137	—	3,124,446	217,982	—	12,226,565
A2	—	863,256	34,192,214	—	3,905,935	—	—	38,961,405
A3	—	—	16,799,458	—	3,717,924	—	—	20,517,382
BAA1	—	3,753,676	67,168,060	—	7,149,299	—	4,075,264	82,146,299
BAA2	—	—	54,378,564	—	7,276,453	694,437	8,870,863	71,220,317
BAA3	—	—	46,242,375	—	15,565,826	2,208,624	22,300,013	86,316,838
BA1	—	4,462,567	30,077,587	—	11,133,545	—	11,325,359	56,999,058
BA2	—	—	36,257,790	—	14,435,182	—	19,780,218	70,473,190
BA3	—	3,917,616	33,350,280	—	11,097,168	1,060,400	—	49,425,464
B1	—	—	77,891,604	—	17,549,059	—	—	95,440,663
B2	—	—	212,843,440	—	20,502,636	735,371	3,863,400	237,944,847
B3	—	—	76,860,221	—	9,884,148	—	5,321,744	92,066,113
CAA1	—	—	67,400,320	—	6,019,692	954,936	—	74,374,948
CAA2	—	—	43,086,300	—	3,940,063	—	—	47,026,363
CAA3	—	—	2,665,864	—	87,000	—	—	2,752,864
CA	—	—	784,992	—	—	—	—	784,992
DEF	—	—	—	—	—	—	—	—
Not rated	—	30,554,721	1,332,232,163	—	75,163,608	442,407	571,226,598	2,009,619,497
	<u>\$ 14,993,804</u>	<u>43,551,836</u>	<u>2,160,646,024</u>	<u>255,052,216</u>	<u>210,551,984</u>	<u>8,556,172</u>	<u>650,141,159</u>	<u>3,343,493,195</u>
US Treasury Bonds and Notes								2,984,625,708
US Government agency - Government National Mortgage Association (GNMAs) mortgage backed subtotal								<u>\$ 6,346,491,435</u>
Derivatives (debt securities)								<u>46,102,389</u>
Total fixed income securities in Investments								<u>\$ 6,392,593,824</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 \$1,122,056,083 in cash and securities exposed to custodial credit risk as of June 30, 2021.

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(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.

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, 2021, 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, 2021, 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:

	Fair value	Weighted Modified Duration (years)
Fixed income securities:		
U.S. Treasury bonds and notes	\$ 2,984,625,708	8.0
U.S. government agencies bonds	14,993,804	4.6
U.S. government agency mortgage backed	255,052,216	23.4
U.S. government-sponsored agency mortgage backed	18,372,532	25.3
Asset backed securities	43,551,836	0.2
U.S. corporate bonds	2,160,646,024	6.3
Non-U.S. government/agency bonds	8,556,172	9.3
Non-U.S. corporate bonds	210,551,984	7.7
Pooled and others	650,141,159	5.5
Total	\$ <u>6,346,491,435</u>	8.1

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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, 2021: (Securities denominated in U.S. dollars are not presented.)

	Cash and Short Term						
	Instruments	Debt Securities	Derivatives	Equities	Alternative	Real Estate	Grand Total
Argentine peso	\$ 45,844	—	—	—	—	—	45,844
Australian dollar	(725,520)	79,560,390	356,064	63,265,139	—	—	142,456,073
Brazilian real	54,170	9,042,819	—	26,907,575	—	—	36,004,564
Canadian dollar	1,346,608	246,618,155	1,339,998	94,393,513	—	—	343,698,274
Chilean peso	59,120	4,613,320	—	1,146,431	—	—	5,818,871
Chinese Yuan Renminbi	721,508	94,976,120	—	15,610,859	—	—	111,308,487
Colombian peso	36,039	(984,671)	—	28,154	—	—	(920,478)
Czech koruna	10,302	10,249,091	—	2,042,387	—	—	12,301,780
Danish krone	201,471	25,427	—	50,892,279	—	—	51,119,177
Euro currency unit	(892,161)	(430,203,497)	37,591,680	498,204,038	—	—	104,700,060
Hong Kong dollar	5,089,241	(1,445,766)	—	187,627,985	—	—	191,271,460
Hungarian forint	24,871	31,927,393	—	4,538,808	—	—	36,491,072
Indian Rupee	803,840	(36,151,950)	—	102,299,950	—	—	66,951,840
Indonesian rupiah	6,999	234,959	5,972,880	2,499,276	—	—	8,714,114
Israeli shekel	70,594	24,913,206	—	9,570,645	—	—	34,554,445
Japanese yen	2,617,679	(330,653,496)	—	361,651,645	—	—	33,615,828
Malaysian ringgit	687,181	(5,539)	—	9,328,800	—	—	10,010,442
Mexican peso	451,853	48,564,911	—	5,992,937	—	—	55,009,701
New Taiwan dollar	709,716	13,550,088	—	160,269,500	—	—	174,529,304
New Zealand dollar	(844,212)	35,902,347	—	4,878,761	—	—	39,936,896
Norwegian krone	750,593	76,662,628	—	8,789,775	—	—	86,202,996
Philippine peso	—	1,732,745	—	4,459,763	—	—	6,192,508
Polish zloty	39,972	24,339,062	—	1,401,003	—	—	25,780,037
Pound sterling	(1,907,525)	186,588,905	11,522,836	259,819,074	—	—	456,023,290
Russian ruble (new)	57,872	19,490,049	694,437	1,658,299	—	—	21,900,657
Singapore dollar	454,505	78,102,902	—	12,871,693	—	—	91,429,100
South African rand	290,891	42,133,206	—	32,430,786	—	—	74,854,883
South Korean won	2,768,076	39,724,429	—	58,188,932	—	—	100,681,437
Swedish krona	1,238,849	45,662,471	—	66,623,170	—	—	113,524,490
Swiss franc	(1,792,929)	(121,305,221)	—	123,417,754	—	—	319,604
Thai baht	(142,139)	(9,918,379)	—	5,639,339	—	—	(4,421,179)
Turkish lira	55,230	(17,372,767)	—	2,497,540	—	—	(14,819,997)
Various Countries	—	—	—	1,416,730,743	—	—	1,416,730,743
Total	\$ 12,288,538	166,573,337	57,477,895	3,595,676,553	—	—	3,832,016,323

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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, 2021 was 94 days.

At June 30, 2021, 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.

Securities lent for collateral	Fair value of underlying securities	Collateral received	
		Cash	Noncash
U.S. fixed income	\$ 870,937,833	516,288,619	368,438,682
U.S. equities	538,653,880	448,559,550	110,922,283
International equities	252,299,324	36,686,682	244,010,816
International fixed income	2,659,255	2,129,671	704,678
	<u>\$ 1,664,550,292</u>	<u>1,003,664,522</u>	<u>724,076,459</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, 2021 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, 2021 with the related maturity information:

Asset categories	Notional values	Market value	Maturity (range from)
Forwards:			
Currency purchases	\$ —	(302,605)	0.0 yrs
To Be Announced (TBAs)	—	5,140,885	30.1 yrs
Total forwards	—	4,838,280	
Futures:			
Bond contracts	(46,125,509)	(11,885,171)	0.3 yrs
Commodity contracts	787,441,392	30,577,925	0.2 yrs to 1.3 yrs
Currency contracts	(464,272,346)	11,285,278	0.1 yrs to 0.3 yrs
Index contracts	796,617,435	(2,371,723)	0.1 yrs to 1.5 yrs
Interest rate contracts	1,754,162,983	2,816,269	0.1 yrs to 4.3 yrs
Futures total	2,827,823,955	30,422,578	
Options:			
Options	—	(17,982,734)	0.0 yrs to 1.7 yrs
Options on debt securities	—	703,775	0.0 yrs to 0.5 yrs
Options total	—	(17,278,959)	
Swaps:			
Credit default swaps	—	(1,026,730)	0.1 yrs
Total return swaps	—	5,649,017	0.1 yrs
Interest rate swaps	—	5,212,864	0.3 yrs to 30.3 yrs
Swaps total	—	9,835,151	
Warrants	—	29,928,751	
Grand total	\$ 2,827,823,955	57,745,801	

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, 2021.

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, 2021, 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, 2021, credit ratings of the counterparty for ERS' investments in derivatives were as follows:

Counterparty	S&P's rating	Fair value
Bank of America Corp	A-	\$ 18,605
Bank of America Merrill Lynch	A-	3,694,596
Barclays PLC	BBB	994,425
BNP Paribas SA	A+	10,204
Citibank Global Markets Inc.	BBB+	(236,694)
Citibank NA	A+	523,476
Citigroup Inc	BBB+	21,820
CME Group Inc	AA-	(239,522)
Credit Suisse Group AG	BBB+	(1,377)
Credit Suisse Securities (USA) LLC	A+	4,595,941
Deutsche Bank Securities Inc	BBB+	(209,721)
Goldman Sachs & Co LLC	BBB+	3,434,165
HSBC Holdings PLC	A-	1,945
Intercontinental Exchange Inc	BBB+	1,507,798
JPMorgan Chase & Co	A-	(3,311,836)
London Stock Exchange Group PLC	A	(117,420)
Morgan Stanley & Co LLC	BBB+	11,891,152
SG Americas Securities LLC	A	11,125,776
UBS Securities LLC	A-	(5,095,380)
Exchange traded derivatives		29,137,848
Total		\$ 57,745,801

(7) Pension Liability

(a) Net Pension Liability

The components of the net pension liability of the ERS at June 30, 2021 were as follows:

Total pension liability	\$ 34,139,165,472
Plan fiduciary net position	<u>21,935,791,711</u>
Net pension liability	<u>\$ 12,203,373,761</u>
Plan fiduciary net position as a percentage of total pension liability	64.3%
Net pension liability as a percentage of covered payroll	261.5%

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, 2021. 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.

Summary of Actuarial Valuation as of June 30, 2021 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:

	General employees Male and Female	Teachers Male and Female	Police officers and firefighters Male and Female
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, 2021, are summarized in the following table:

Classes	Strategic class weights	Long-term expected geometric rate of return	Volatility
Broad growth:			
Private Equity	13.5%	9.9%	28.0%
Global Equity	20.0%	7.3%	18.0%
Low Volatility Equity	4.0%	6.5%	14.0%
Global Options	4.0%	4.8%	13.0%
Credit	6.0%	5.7%	12.3%
Core Real Estate	6.0%	5.6%	12.0%
Non-Core Real Estate	4.5%	9.3%	23.5%
Timber/Agriculture/Infrastructure	5.0%	7.6%	12.4%
Diversifying Strategies:			
TIPs	2.0%	1.8%	7.0%
Global Macro	4.0%	6.1%	15.0%
Reinsurance	4.0%	6.0%	12.0%
Alternative Risk Premia	8.0%	6.1%	10.0%
Long Treasuries	5.0%	2.6%	12.0%
Intermediate Government	4.0%	1.4%	3.0%
Systematic Trend Following	10.0%	5.5%	18.0%

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%)
\$	16,810,511,423	12,203,373,761	8,405,054,565

(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, 2021. 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.

(c) Workers' Compensation Policy

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

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(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 \$3,618,229,000 as of June 30, 2021, consisting of \$495,892,000 in fixed income, \$1,333,754,000 in real estate investments, and \$1,988,583,000 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.

(11) Subsequent Events

The ERS has evaluated subsequent events from the statement of fiduciary net position date through November 23, 2022, the date at which the financial statements were available to be issued, and determined there are no other items to disclose.

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Required Supplementary Information – Unaudited

Schedules of Changes in the Employers' Net Pension Liability and Related Ratios

June 30, 2021

		Fiscal year Ended June 30							
		2014	2015	2016	2017	2018	2019	2020	2021
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	642,140,242
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	2,252,271,074
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	228,048,119
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)	(1,675,049,807)
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	1,447,409,628
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	32,691,755,844
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	34,139,165,472
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	1,281,558,696
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	299,473,128
2. Contributions – employee		1,306,327	1,595,560	1,721,893	1,492,316	2,133,901	2,458,908	3,255,037	1,153,318
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	4,662,225,761
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)	(1,675,049,807)
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)	(19,049,861)
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	4,550,311,235
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	17,385,480,476
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	21,935,791,711
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	12,203,373,761
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 %	64.25 %
E. Covered 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	4,667,346,006
F. Net pension liability as a percentage of covered payroll		209.38 %	209.38 %	218.57 %	325.11 %	305.18 %	312.94 %	341.55%	261.46%

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

See accompanying notes to the required supplementary information and independent auditors' report.

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

Required Supplementary Information – Unaudited
Schedule of the Employers' Net Pension Liability
June 30, 2021

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
2021		34,139,165,472	21,935,791,711	12,203,373,761	64.25	4,667,346,006	261.46

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

See accompanying notes to the required supplementary information and independent auditors' report.

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

Required Supplementary Information – Unaudited

Schedule of Investment Returns

June 30, 2021

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
2021	26.9

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

See accompanying notes to the required supplementary information and independent auditors' report.

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

Notes to Required Supplementary Information – Unaudited

June 30, 2021

(1) Description

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

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, 2021

- 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, 2021

	Pension accumulation reserves	Annuity reserves	Expense reserves	Total
Additions: Appropriations and contributions: Employers Members Net investment income Total additions	 \$ 1,281,558,696 — 4,662,225,761 <u>5,943,784,457</u>	 \$ — 300,626,446 — <u>300,626,446</u>	 \$ — — — <u>—</u>	 \$ 1,281,558,696 300,626,446 4,662,225,761 <u>6,244,410,903</u>
Deductions: Benefit payments Refunds of member contributions Administrative expenses Total deductions	 1,651,431,372 — — <u>1,651,431,372</u>	 — 23,618,435 — <u>23,618,435</u>	 — — 19,049,861 <u>19,049,861</u>	 1,651,431,372 23,618,435 19,049,861 <u>1,694,099,668</u>
Other changes in net position restricted for pension benefits: Transfer due to retirement of members Transfer of interest allocation Transfer to pay administrative expenses Return of unrequited funds due to savings in administrative expenses Net increase	 228,639,061 (124,832,809) (19,151,883) — — <u>84,654,369</u>	 (228,639,061) 124,832,809 — — — <u>(103,806,252)</u>	 — — 19,151,883 — — <u>19,151,883</u>	 — — — — — <u>—</u>
Fiduciary net position restricted for pensions: Beginning of year End of year	 14,197,534,708 \$ <u>18,574,542,162</u>	 \$ 3,164,652,385 <u>3,337,854,144</u>	 \$ 23,293,383 <u>23,395,405</u>	 17,385,480,476 <u>21,935,791,711</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, 2021

Assets	Beginning balance	Additions	Deductions	Ending balance
Receivable from employers	\$ —	255,504,128	255,504,128	—
Total assets	\$ —	255,504,128	255,504,128	—
Liabilities				
Due to employers	\$ —	255,504,128	255,504,128	—
Total liabilities	\$ —	255,504,128	255,504,128	—

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, 2021

Personnel services:	
Salaries and wages	\$ 7,322,910
Fringe benefits	3,713,786
Net change in unused vacation credits	27,394
Total personnel services	<u>11,064,090</u>
Professional services:	
Actuarial	149,881
Auditing and tax consulting	614,208
Disability hearing expenses	26,676
Legal services	727,030
Medical	383,256
Total professional services	<u>1,901,051</u>
Communication:	
Postage	301,748
Printing and binding	84,242
Telephone	77,930
Travel	1,928
Total communication	<u>465,848</u>
Rentals:	
Rental of equipment	112,624
Rental of premises	30,767
Total rentals	<u>143,391</u>
Other:	
Armored car service	1,234
Computer and office automation systems	160,309
Repairs and maintenance	2,828,353
Stationery and office supplies	29,245
Miscellaneous	147,389
Total other	<u>3,166,530</u>
Depreciation	<u>2,308,951</u>
	<u><u>\$ 19,049,861</u></u>

See accompanying independent auditors' report.

Schedule 4

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

Other Supplementary Information – Schedule of Investment Expenses

Year ended June 30, 2021

Real estate and alternative investment expenses:

Operating expenses	\$ 27,766,848
Mortgage interest	<u>6,755,009</u>
Total real estate and alternative investment expenses	<u>34,521,857</u>

Investment expenses:

Investment manager/advisor fees	62,744,373
Bank custodian fees	298,906
Other investment expenses	<u>22,382,033</u>
Total investment expenses	<u>85,425,312</u>

Securities lending expenses:

Borrower rebates	(198,831)
Management fees	<u>674,709</u>
Total securities lending expenses	<u>475,878</u>

\$ 120,423,047

See accompanying independent auditors' report.