EXECUTIVE CHAMBERS

HONOLULU

NEIL ABERCROMBIE
GOVERNOR

October 31, 2014

The Honorable Donna Mercado Kim
President
and Members of the Senate
Twenty-Seventh State Legislature
State Capitol, Room 409
Honolulu, Hawaii 96813

The Honorable Joseph M. Souki, Speaker
and Members of the House of
Representatives
Twenty-Seventy State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear President Mercado Kim, Speaker Souki, and Members of the Legislature:

For your information and consideration, I am transmitting a copy of the Department of Budget & Finance's report on Act 268, Part II, Section 12, Session Laws of Hawaii 2013. In accordance with Section 93-16, Hawaii Revised Statutes, I am also informing you that the report may be viewed electronically at http://budget.hawaii.gov/budget/reports-to-the-legislature/.

Sincerely,

/s/

NEIL ABERCROMBIE
Governor, State of Hawaii

Enclosures

DEPARTMENT OF BUDGET AND FINANCE

NEIL ABERCROMBIE
GOVERNOR
KALBERT YOUNG
DIRECTOR OF FINANCE

STUDY of POTENTIAL EUTF/ERS INVESTMENT CONSOLIDATION

October 2014

Prepared By:

PCA PENSION CONSULTING ALLIANCE

Department of Budget & Finance
B&F
Financing Hawaii's Future

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STUDY of POTENTIAL EUTF/ERS INVESTMENT CONSOLIDATION

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EXECUTIVE SUMMARY

This report explores the viability of consolidating the investment functions of the Hawaii Employer-Union Health Benefits Trust Fund ("EUTF") and the Hawaii Employees' Retirement System ("ERS"). Specifically, given that the EUTF does not currently retain dedicated investment resources while the ERS does, the consolidation question involves EUTF utilizing ERS's investment resources in an "outsourced" fashion.

The EUTF serves approximately 200,000 participants through seven local/municipal government entities as well as the State. Up until recently, the EUTF has been largely a pay-as-you-go (PAYGO) system, meaning that funding the EUTF addresses obligations only as they come due. In 2007, this approach began to change with EUTF's adoption of GASB 43. Given that the EUTF, is now an OPEB ("other post employment benefits") plan under GASB 43, its net assets and changes in net assets are now required to be reported through the financial reporting process. If assets are deemed to not address liabilities in a sufficient manner, then pre-funding of the liabilities must occur. As of June 30, 2014, EUTF's accrued liabilities amounted to approximately $11.5 billion while assets totaled approximately $626 million.[1] As a result, significant pre-funding must now be enacted.

In 2013, the State passed Act 268 (see Appendix). Act 268 establishes a framework for the State and EUTF's other seven sponsoring entities to begin pre-funding the EUTF. Based on this framework the EUTF's asset base will grow dramatically over the next several years. In fact, based on actuarial assumptions, over the next decade or so the EUTF asset portfolio is expected to begin taking on scale proportions that are analogous to the ERS's investment portfolio today.

Act 268 also directs the State to explore potential areas of enhancement within the EUTF. Given the projected rapid growth of EUTF's assets over the next several years, analyzing potential models for management of these assets is one area worthy of study. This report seeks to assess the viability of utilizing ERS's existing Investment Office resources (a dedicated staff of seven investment personnel) to jointly manage the EUTF-OPEB asset portfolio.

Scope of Review

Per Act 268, the State Department of Budget and Finance retained Pension Consulting Alliance, Inc. ("PCA") to develop this report. PCA serves as the general investment consultant for both the EUTF and the ERS. Under both existing contracts with each agency, PCA acts as an investment fiduciary, meaning PCA is required to provide analysis and opinions in the best interest of each system. Keeping this issue in mind, this review recognizes that an investment office consolidation could impact each system in different ways, possibly in a contrary manner. In this context, this report refrains from making specific recommendations in terms of consolidation and focuses primarily on developing key findings that should help both EUTF and ERS decision-makers make an informed decision.

Formally, this report is being developed under a contract amendment with the EUTF. Under this contract amendment, the report is expected to cover five key areas:

[1] According to the "Actuarial Valuation Report, Hawaii Employer-Union Health Benefits Fund (EUHBF), As of July 1, 2013," Gabriel Roeder Smith & Company, the present value of future benefits, another broader measure of future commitments, totaled $13.8 billion.

- Review the legal/regulatory structures of the EUTF and ERS systems as they pertain to managing the asset investments of each system;
- Assess and analyze how the custody (asset safekeeping and accounting) arrangement would change if consolidation were to occur;
- Develop an asset transfer framework assuming EUTF were to utilize ERS's existing investment resources;
- Outline a transition management plan for EUTF's assets if consolidation is approved; and
- Determine how governance of the EUTF's assets might change as a result of consolidation.

This report addresses all of these points and provides significant sensitivity analysis on the near-to-intermediate economic term impact of potentially consolidating the investment activities/resources of the two agencies/systems.

To develop findings for this report, several tasks took place:

- Gathered and organized detailed account-level information on both EUTF and ERS investments;
- Requested and received a letter from ERS's legal counsel outlining the regulatory/legal parameters for the ERS of a potential consolidation;
- Surveyed a select group of other State plans across the United States to determine industry standards with respect to governance and management of health plans similar to the EUTF;
- Reviewed the State statutes pertaining to managing these systems' assets, specifically Hawaii Revised Statutes ("HRS") chapters 87A and 88, as well as Act 268;
- Informally surveyed several of ERS's most significant managers to determine if they would apply ERS's larger-scale fee structures to EUTF's transitioned assets (all managers interviewed said they would);
- Had several discussions with ERS's existing custodian BNY/Mellon to develop pro forma cost and account structures associated with inheriting and managing EUTF's assets over the next several years;
- Utilizing all the information gathered above, developed three basic EUTF-to-ERS asset transition scenarios to determine how such a transition might jointly impact the EUTF and ERS over the next several years; and
- Developed key findings with respect to the Scope of Work requirements (see below).

Findings

In summary, this report finds that consolidation of EUTF's investment functions into the ERS Investment Office would likely provide positive marginal economic benefits while providing reasonable options for the EUTF to continue forward with its newly adopted investment strategy. While such economic benefits are expected to accrue to the EUTF, no benefits would accrue to the ERS. In fact, it is highly likely that ERS would be required to expend additional resources to effect the consolidation.

In light of these findings, some key qualitative benefits of consolidation include: (i) EUTF having immediate access to investment expertise versus having to incur a relatively long ramp-up phase, (ii) avoidance of inter-departmental redundancies if the EUTF had to establish a similarly-structured investment office, and (iii) over the longer-term, the ability to leverage the combined agencies' assets in the global marketplace on a more coordinated basis.

These above findings are subject to several key assumptions:

- That the State/local employer contribution schedule presented in Act 268 and modeled by EUTF's actuary (see Appendix) actually occur. Required contributions are projected to scale up to over $1 billion within the next five years. State and local budgetary pressures may introduce uncertainty in meeting these scheduled payments.

- The consolidation concept is able to address the Internal Revenue Code's prohibition against the ERS providing "preferential services" to another State agency (such as the EUTF). Legal analysis and opinions are beyond the scope of this report.

    - In order to address the above issue, it is likely that the EUTF will be required to develop a cost sharing arrangement with the ERS.

- Transition costs associated with shifting EUTF's accounts into accounts utilized by the ERS are expected to range between $0 and $1,000,000. Transition costs are highly uncertain. EUTF can avoid a significant amount of these costs by (i) pursuing cost-minimizing transition strategies (e.g., in-kind securities transfers) and/or (ii) avoiding a wider range of active strategies (i.e., keeping assets passively managed).

One caveat to this report is that some of the estimated economic benefits may not be totally dependent on consolidation. For example, in developing custody cost estimates, the custodian indicated that their estimates would hold even if EUTF pursued a new custody arrangement independently. In light of this caveat, the EUTF may decide to pursue such opportunities on its own.

<u>Findings Related to Governance and Structure</u>

- Whether consolidation takes place or not, the EUTF-OPEB and ERS investment portfolios are converging. A few years from now they will operate with similar managers and mandates and exhibit equivalent risk/return profiles. In fact, currently, both trustee groups exhibit very similar tolerances for taking investment risk.

- The report reviews the governance structures of the EUTF as well as health plans at several peer States. There is a wide variation of governance structures associated with the investment functions of these plans. Based on these comparisons, EUTF's decision-making structure is reasonable and appropriate and should remain intact following consolidation.

- Based on ERS counsel's views with respect to the fiduciary responsibility of the ERS trustees and consistent with fiduciary law, the trustees of the EUTF must maintain their fiduciary authority over EUTF's assets. Therefore, the ERS Investment Office must defer to the EUTF Board (or Investment Committee) in making investment decisions that impact the EUTF-OPEB investment portfolio. Post consolidation, it is highly likely that the ERS Investment Office would be required to develop a reporting line into the EUTF Investment Committee.

- Coincident with above, the EUTF's assets must remain separate and distinct from ERS assets for tax, trust, and regulatory reasons. Such separation, however, does not preclude either/both agencies from negotiating terms and conditions on a combined basis when interacting with investment asset-related service providers.

- From the EUTF's perspective, an attractive framework would be one that gives the EUTF the option, but not the requirement to utilize investment management services that are also retained by the ERS. This approach would allow the EUTF the ability to incrementally enter new classes (such as private equity and real estate) and retain new managers at its own pace, consistent with the recently-adopted phased implementation plan.

- Under the consolidation framework, day-to-day oversight of the EUTF-OPEB investment portfolio would be the responsibility of the ERS Investment Office (with assistance from EUTF's retained general investment consultant). The ERS Investment Office would report relevant investment activities into the EUTF Investment Committee. This new ERS responsibility will likely result in additional administrative burdens for the ERS Investment Office.

Findings Related to Custody

- BNY Mellon provided custody structure and cost estimates based on the three consolidation scenarios described in this report (see Appendix). Across all three scenarios, the BNY Mellon arrangement is more cost effective than EUTF's current custody setup.

- Under BNY Mellon's preliminary estimates, the EUTF would be able to capture incremental custody-related services (such as performance measurement) that are not currently part of the current EUTF custody arrangement. This service improvement is due to (i) the EUTF having direct access to BNY Mellon's institutional custody capabilities and (ii) the opportunity for the EUTF to leverage ERS's existing relationship with BNY Mellon.

- As the EUTF-OPEB investment portfolio becomes more complex, the cost savings versus EUTF's current setup diminish. However, at a certain minimum scale (say $1 billion to $2 billion) other sources of benefit (e.g., securities lending) may become material to EUTF, helping to offset custody costs.

- BNY Mellon has indicated that migrating to the initial account structure mapped out under Scenario 1 should take between 90 and 120 days. The most critical milestone in this transfer is likely to be finalizing a new servicing contract between the EUTF and BNY Mellon.

- BNY Mellon has indicated a preference for establishing a separate servicing agreement with the EUTF versus amending the ERS contract to include EUTF-related accounts. This approach is also consistent with the EUTF and ERS remaining separate and distinct for tax and regulatory purposes.

Findings Related to Asset Transitions and Transfers

- This report outlines a two-step EUTF-to-ERS asset transfer process to take advantage of certain pricing structures across ERS's managed account relationships while also seeking to preserve EUTF's recently-approved strategic allocation implementation plan. The initial phase of this transfer (i) shifts EUTF's passive equity institutional mutual funds into ERS's passive equity commingled funds and (ii) shifts assets out of EUTF's actively-managed TIPS portfolio into the ERS's actively-managed TIPS portfolio that is managed by the same advisor. The fee structures of the respective ERS accounts are a fraction of those currently utilized by the EUTF for the analogous mandates.

- Adjustments subsequent to these two key transfers are largely driven by manager searches that are currently in the queue at EUTF. In a couple of cases, EUTF may elect to retain managers already retained by the ERS (e.g., covered calls). In these cases, further fee improvements would likely occur due to the ERS's larger-scale fee arrangements. In addition, there will likely be instances where ERS and EUTF will be searching for the same mandate simultaneously. In these cases, the EUTF should be able to capitalize on negotiating favorable fees as a result of combining assets with the ERS, rather than pursuing the mandate on its own.

- There is the potential that one-time asset transition costs could be significant. Transition costs are highly uncertain. Such costs for transferring EUTF's public equity assets could range from $0 (if assets can be transferred in-kind) to $1,000,000 (the high end of the market impact range if EUTF is required to liquidate certain accounts and then reinvest the proceeds in new managed accounts).

- The estimated economic benefits associated with the EUTF-ERS consolidation are largely a function of whether EUTF maintains its passive exposure (which is a low-cost investment option). If the EUTF elects to increase its exposure to active management through the use of ERS's active managers, the incremental economic benefits associated with the EUTF consolidation decline as EUTF's structure becomes more aligned with ERS's investment structure. In addition, the more the EUTF mirrors the ERS in terms of utilizing a larger number of ERS-equivalent accounts, the higher the administrative burden on the part of the ERS Investment Office to maintain and monitor these accounts. The economic burden associated with this heightened administrative activity is hopefully accounted for via the report's assumed EUTF-to-ERS resource reimbursement amount.

- Once any legal and regulatory issues associated with the consolidation are resolved, it is expected that the initial stage of the account transfers associated with the consolidation would take 90 to 120 days. The most significant hurdle in the account transfer process is likely the resolution of EUTF's custody arrangement under consolidation.

BACKGROUND

The Hawaii Employer-Union Health Benefits Trust Fund ("EUTF") was established under Chapter 87A of the Hawaii Revised Statutes in 2003 to provide health and other benefits to public employees, retirees, and their dependents. Chapter 87A supplanted prior legislation (Chapter 87) and moved net assets from the previous Health Fund to the EUTF. As of the end of fiscal year 2013, the EUTF served nearly 200,000 participants.

In 2007, the EUTF adopted Governmental Accounting Standards Board ("GASB") Statement Nbr. 43 ("GASB 43"). GASB 43 establishes accounting and reporting standards for plans that provide other post employment benefits ("OPEB") other than pensions. GASB 43 requires a statement of plan net position and a statement of changes in plan net position for defined benefit OPEB plans that are administered as separate trusts or equivalent arrangements. Following the adoption of GASB 43, in 2012 the State Legislature signed into law the approved authority for the EUTF to administer a separate trust for the purpose of receiving employer contributions that would *prefund* OPEB costs for the EUTF's retiree participants and their beneficiaries. In 2013, the trustees of the EUTF created the Hawaii Employer-Union Trust Fund for Other Post-Employment Benefits ("EUTF-OPEB") to begin prefunding EUTF's promised benefits. The EUTF-OPEB took effect on June 30, 2013. As of June 30, 2014, the assets of the EUTF-OPEB amounted to approximately $626 million.

As of June 30, 2014, the present value of the EUTF's future benefit payments amounted to $13.8 billion, far exceeding the combined EUTF / EUTF-OPEB aggregate assets.[2] Given this disparity, the State Legislature signed into law Act 268, which seeks to reform the funding progress of the EUTF system. Specifically, Act 268 requires all employers that contribute to the EUTF/EUTF-OPEB trusts to meet their annual required contribution ("ARC") rates by fiscal 2018-2019.[3] In moving toward that objective, Act 268 also requires that each employer scale into their respective ARC rates in 20% increments beginning in fiscal year 2014-2015.[4] This means that each employer is expected to contribute at least 20% of its ARC rate into the EUTF/EUTF-OPEB in 2014-2015 with 20% step-ups in the subsequent fiscal years, until reaching 100% of the ARC rates in 2018-2019.

Based on the July 1, 2013 actuarial valuation report, the EUTF's actuary, Gabriel Roeder & Smith ("GRS"), estimates that projected prefunding contributions based on Act 268 will bring the EUTF system to full funding after approximately thirty years.[5] Over the next five years, GRS estimates prefunding contributions will total an estimated $1.6 billion. For every year beyond the fifth year and through the 32nd year of prefunding, annual prefunding contributions are approximately $500 million. Using the assumed actuarial investment rate of 7.0%, the EUTF-OPEB's assets are estimated to have a value of approximately $2.3 billion by the end of 2019, a four-fold increase from current levels. Based on GRS's projections, the EUTF-OPEB's asset base is expected to continue to grow materially, reaching nearly $12 billion in fifteen years.

Similarities to the Employees' Retirement System of the State of Hawaii ("ERS")

As highlighted above, a prefunding approach to the EUTF system requires a multi-decade planning/funding horizon. While asset liquidity will remain an important consideration due to the growth of scheduled benefit payments, under Act 268 contributions into the system are

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[2] Actuarial Valuation Report, Hawaii Employer-Union Health Benefits Fund (EUHBF), As of July 1, 2013, Gabriel Roeder Smith & Company.

[3] A Bill for An Act, Act 268, Signed into law on July 3, 2013.

[4] *Ibid.*, A Bill for An Act, Section 11.

[5] *Op Cit.*, Actuarial Valuation Report, EUHBF, Section C, See Appendix of this report.

projected to exceed benefits flowing out of the system for the next three decades. Given these conditions (longer planning horizon and net inflows into the system under Act 268), it is reasonable and prudent for the EUTF-OPEB assets to be invested to produce a reasonable real investment return (i.e., in excess of inflation) by incurring a tolerable level of investment risk. This approach (which is assumed to occur as implied by the GRS assumed actuarial return of 7.0%) should help the State save significant assets over the long term versus the current pay-as-you-go (PAYGO) scheme.

Investment risk is typically mitigated/managed by constructing and maintaining an investment portfolio that is diversified across an appropriate spectrum of investment classes and strategies. In fact, since mid-2011 the trustees of the EUTF system have implemented a diversified investment structure for the EUTF-OPEB assets. Since that time, this diversified portfolio has accumulated approximately 25% more assets through investment returns versus receiving very low cash returns that have been typically realized under a PAYGO-type system.[6]

As the above projections indicate, the EUTF-OPEB portfolio is expected to grow materially in the near future and continue to expand for several years. In this respect, within the near-to-intermediate term (three-to-five years), management of EUTF-OPEB assets are expected to become more critical to the long-term success of the overall EUTF system and become much larger in scale. Along these lines, the EUTF-OPEB portfolio is very likely to take on objectives, management, and risk characteristics that are exhibited by the State's other large asset pool: the investment portfolio of the ERS. Currently, the ERS investment portfolio (i) invests over a very long planning horizon, (ii) utilizes a diversified investment structure, (iii) at nearly $14 billion, is large scale, (iv) is able to establish and maintain customized investment mandates/strategies, (v) utilizes a dedicated multi-staff investment office to oversee the investment activities associated with the asset portfolio, and (vi) has achieved its long-term return objectives over the last twenty-five-plus years.

In contrast to the ERS, the EUTF currently (i) has no dedicated investment staff, (ii) has invested only in standardized, commingled funds, and (iii) has an established investment policy that exhibits a risk profile close to that of the ERS's investment policy. Further, on the last point, the investment management structure of the EUTF-OPEB portfolio is evolving toward a structure that is roughly analogous to the management structure of the ERS portfolio. This trend will likely continue as EUTF, over time, accommodates itself to the longer-term prefunding planning and investment horizons.

Given the above background, Act 268 empowers the State's director of budget and finance to lead a task force that "shall examine the unfunded liability of the…[EUTF](trust fund)…". Act 268 also allows the task force to examine "any other matters that are relevant to gaining a full and meaningful understanding of the circumstances of the trust fund."[7] Since the projected growth path of the EUTF's liabilities is heavily reliant upon the assumption of the EUTF-OPEB investment portfolio attaining a 7.0% long-term average annual compound investment return, the task force is seeking maximum assurance that the EUTF's investments will be managed in as prudent, cost-effective, and appropriate return-vs.-risk profile as possible going forward. Given the expected converging risk profiles between the two portfolios (EUTF-OPEB and ERS), the task force is seeking an objective analysis of the impact of potentially consolidating the EUTF-OPEB investment activities into the ERS Investment Office. From a more strategic standpoint, given the EUTF-OPEB investment portfolio's projected increase in size and scale, the task force is trying to determine whether it is more beneficial for the EUTF to "outsource" its investment activities to its peer

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6 4Q 2013 EUTF Performance Report, Pension Consulting Alliance, Inc. (PCA).

7 *Op Cit.*, A Bill For An Act, Act 268.

agency, the ERS, or whether to build the necessary investment resources internally. This report seeks to develop findings for the task force that will assist them in determining the most optimal outcome for this "buy-or-build" decision.

This report is divided into the following sections. The first section reviews the current investment structure of the EUTF-OPEB portfolio and how this structure is expected to change over the next five years. Following the EUTF discussion is a review of the ERS portfolio. While the ERS is broadly diversified and covers several different investment strategies, it is important to recognize that if EUTF elected to utilize ERS's investment capabilities, then the EUTF will likely transition deliberately into an ERS-like structure, utilizing only those strategies that are most consistent with EUTF's evolving risk profile.

Given the discussions of the differences between the EUTF and the ERS investment portfolios, capabilities, and structures, a subsequent section will analyze the impact of potentially moving EUTF's investments into the ERS investment structure. Expected usage of specific mandates, incremental costs/savings, and governance issues will be reviewed. A final section will introduce and discuss a series of required tasks that need to be undertaken if a decision is made to transition oversight and management of EUTF-OPEB assets to the ERS.

CURRENT INVESTMENT STRUCTURE OF THE EUTF-OPEB PORTFOLIO

The EUTF trustees adopted and began implementing a diversified portfolio structure within the EUTF-OPEB portfolio in mid-2011. This structure is allowed under HRS chapter 87A. Chapter 87A actually makes reference to HRS section 88-119, which governs the types of assets utilized by the ERS. 88-119 essentially allows the ERS to invest in a very broad spectrum of investment vehicles, as long as they meet appropriate prudence and fiduciary standards. Section 87A-24 includes many, but not all, of the investment types detailed under section 88-119.[8] Given that the EUTF-OPEB is now a separate dedicated trust and that the prefunding context allows for a long-term investment horizon (similar to that of the ERS), the EUTF is planning to seek a change to section 87A-24 to allow the EUTF-OPEB portfolio to invest in the same investment vehicles as the ERS. Assuming such a scenario occurs, it is highly likely that, over time, the allocation mixes of the EUTF-OPEB and ERS portfolios should converge.

Portfolio Allocation and Structure

It is expected that the EUTF-OPEB portfolio allocation mix will continue to evolve (see Figure 1 below):

Figure 1. Evolving EUTF-OPEB Portfolio Allocation Mix – 2011 to 2015

EUTF Class	6/30/2011	3/31/2014	Projected	Comments
Public Equity	41	45	41	Primary growth asset
Covered Calls			10	Growth asset with lower volatility
Microcap Equity			9	Private equity proxy
REITs	10	21	10	Private real estate proxy
Risk-taking assets	*51*	*66*	*70*	
Commodities			10	Inflation risk class
Infl-Linked Bds	15	19	5	Inflation risk class
Fixed Income	34	15	15	Stable class
Risk-diversifying assets	*49*	*34*	*30*	
Total Allocation - %	***100***	***100***	***100***	

As the table above shows, EUTF is gradually shifting its allocation mix toward more risk-taking investments. In addition, both now and in the recent past, certain classes (REITs and Microcap) are typically viewed as proxies for private markets classes. Since section 87A-24 currently precludes the EUTF-OPEB from investing in private markets, these positions reflect that intuition. Finally, as the EUTF-OPEB portfolio shifts towards more risk-taking, an attempt is being made to diversify the portfolio further, both among the risk-taking classes themselves (e.g., Covered Calls) as well as with Commodities within the risk-diversifying mix.

Additional Structural Considerations

To implement the allocation mixes discussed above, the EUTF-OPEB portfolio operates within several constraints/parameters (see Figure 2, next page). One significant observation is the number of managers utilized by the EUTF-OPEB portfolio versus the

[8] Hawaii Revised Statutes Chapter 87A, Part III.

amount of managers/accounts utilized by the ERS. The EUTF-OPEB portfolio invests currently in only five different externally-managed accounts. In contrast, the ERS utilizes 44 different managed accounts (not including an additional 165 private placement-type vehicles within the ERS private equity portfolio). One key driver of this difference is the EUTF-OPEB portfolio's current emphasis on passive management. Currently, the overwhelming majority (82%) of the EUTF-OPEB's assets are managed passively. Passive management seeks to gain exposure to particular type(s) of market(s) or macroeconomic factor(s) that should produce positive real returns over long-term investment horizons. Active management, on the other hand, seeks to capture added value above-and-beyond these market/macro risk premiums. Typically, the ability to capture added value is inconsistent and difficult to accumulate over time, particularly on a net-of-cost basis. Given the EUTF's position as a relatively new institutional investor across the various markets and risk factors, a prudent beginning/default position is to capture the market returns in as low as a cost structure as possible (i.e., with passive management). The EUTF has adopted and implemented this approach up to this point, resulting in an investment portfolio that incurs very low costs (see next section).

Figure 2. Selected Structural Comparisons – EUTF-OPEB vs. ERS

Fund	Statutory Investment Limits	HRS sec. 88-119 asset categories currently utilized	Account Structures Utilized	Custody of Assets	Number of Accounts	Active/ Passive
EUTF-OPEB	Governed by sec. 87A-24, which limits the investment scope allowed under sec. 88-119.	Real estate-related loans and obligations Government obligations Corporate obligations Preferred or common stocks Oblgations purchased by federal reserve banks Obligations issued by supra-national agencies Collateralized obligations	Institutional Mutual Funds Institutional Commingled Funds	Bank of Hawaii BNY/Mellon Custodians of Funds	5	18% Active / 82% Passive
ERS	governed by sec. 88-119	Real estate-related loans and obligations Government obligations Corporate obligations Preferred or common stocks Oblgations purchased by federal reserve banks Obligations issued by supra-national agencies Collateralized obligations Insurance company obligations Real property interests Other securities and futures contracts Private placements	Separate Accounts Institutional Commingled Funds Limited Partnerships Limited Liability Companies Group Trusts	BNY/Mellon Custodians of Funds	44 + 165 underlying PE funds/ private placements	81% Active / 19% Passive

Sources: Hawaii Revised Statutes; PCA.

A second structural consideration is the type of accounts utilized by the EUTF-OPEB portfolio. Up to this point, the EUTF has elected to place all of its assets in institutional-grade mutual/commingled funds because of (i) the EUTF-OPEB portfolio's smaller relative size (versus other institutions) and (ii) the limited amount of internal resources dedicated currently to the EUTF's investment activities. There are several tradeoffs associated with this type of account structure versus a separate account structure (where individual securities are actually kept in safekeeping accounts at EUTF's custodian).

First, the actual securities a specified investment manager (e.g., Vanguard) oversees are not held by EUTF's custodian. Instead, units of the manager's <u>fund</u> are held by the custodian. For each fund, the securities for that fund are held by a custodian that is very likely different than EUTF's custodian.

Second, because the EUTF holds units in a fund alongside other unit holders, instead of the securities themselves, the EUTF has virtually no direct control or governance rights associated with specific securities held in the fund on its behalf. A fund manager may attempt to express the concerns of the unit holders collectively, but there is no certainty that the fund will exercise its rights in a manner that is consistent with the interests of an individual unit holder such as the EUTF.

Third, separate accounts allow for significant customization, oversight, and direct control over the management of a portfolio of securities. Finally, there can be fee differences between fund accounts and separate accounts, although it is not a certainty that one type of account structure will always be priced more or less expensive than the other. Fee differentials can vary depending on the size of the fund, the relative size of the unit holder's position, the business model of the asset manager, among other factors. Careful consideration of fee costs must typically occur on a case-by-case basis.

A third structural consideration is the nature of the custodial relationship. Currently, the EUTF utilizes Bank of Hawaii/BNY-Mellon to custody and manage its investment and cash flow activities. Under this arrangement Bank of Hawaii and BNY-Mellon perform specific discrete functions: (i) collects and reports values on the five institutional mutual funds currently utilized within the EUTF-OPEB portfolio, (ii) oversees and helps manage EUTF operational cash flows, utilizing two money market/disbursement accounts, and (iii) provides unit accounting for each of the employer entities that contribute to the EUTF (currently seven local governmental entities and the State). Any potential shift in custody activities would need to account for these three major service areas.

<u>Costs of Managing and Administering the EUTF-OPEB Portfolio</u>

Under the structure discussed above, the EUTF-OPEB portfolio incurs various costs to support its investment activities. Figure 3 below breaks out several key cost components associated with the EUTF-OPEB investment program:

Figure 3. Estimated Annual Costs – EUTF-OPEB Investment Portfolio

Component	6/30/2014 AUM Level	Act 268 2017 Level
EUTF-OPEB Assets Under Management (AUM)	$626,000,000	$1,200,000,000
Investment Management Fees	$1,370,000 (22 bps)^	$3,566,400 (30 bps)**
Custody/Accounting Costs	$156,500^^	$330,000**
Consultant Fees	$134,000^^^	$250,000
Internal Administration	$77,000*	$165,000*
Total Annual Costs	$1,737,500	$4,311,400
Total Annual Costs as % of AUM	0.28%	0.36%

^Based on June 30, 2014 market values and Phase 1 policy structure (i.e., including Microcap).
^^Existing allocation; estimates based on EUTF staff input, Bank of Hawaii, and BNY/Mellon statements.
^^^Per current PCA contract for 2014-2015 fiscal year.
*Based on 0.5 FTEs in 2014; 1.5 FTEs in 2017 (includes fringe benefits 42%).
**Preliminary estimate based on new long-term strategic allocation and commensurate number of manager accounts/commingled funds under management and Bank of Hawaii's indicated offer dated 8/5/14.

Figure 3 shows that the Investment Management Fees component accounts for the largest proportion of overall costs, amounting to 78% of total annual costs. As a percent of assets, however, these costs are relatively low, amounting to only 0.22% of total assets under management. Figure 3 also shows that by 2017, EUTF-OPEB portfolio management costs are expected to rise materially. This projected increase is due largely to the expected increase in value of the EUTF-OPEB asset base and the investment management fees that are tied to that value. Costs are expected to more than double with significant increases coming in all cost components as the resources needed to manage are assumed to rise roughly commensurate with the expected change in assets.

Governance of EUTF-OPEB Investment Portfolio

Decision-making authority for investing EUTF's assets (including the EUTF-OPEB portfolio) resides with the EUTF's Board of Trustees (the Board). The Board consists of ten trustees, five of whom are employee representatives (including one retiree) and five of whom are employer representatives. In terms of making decisions, the philosophy reflected in the voting process is to push for Board consensus. Each trustee group (employee and employer) has one vote. In order to take action each respective group must have three trustee participants present (i.e., a quorum of six). In order for the Board to take action on a specific matter, both groups must vote in favor of the action. Also, in order for each group to vote for the action, a super-majority of trustee participants (at least 3) within the group must vote in favor of the action.

The Board, in turn, has established an Investment Committee consisting of a subset of the Board trustees. The Investment Committee utilizes both staff and a retained investment consultant to provide guidance and assistance on investment matters. Contractually, the investment consultant acts as an investment fiduciary on behalf of the trustees. The Investment Committee reviews reporting, recommendations, and requests originating with EUTF staff and EUTF's investment consultant. After reviewing such information, the Investment Committee recommends specific courses of action to the Board for approval/ratification.

As is industry practice, the Board delegates numerous investment activities (such as holding securities, buying and selling securities, creating and maintaining investment portfolios, etc.) to external organizations exhibiting institutional-quality capabilities. To source these organizations, the Board works with its staff and investment consultant to utilize a request-for-proposal (RFP) process that meets the State of Hawaii's procurement standards.

To determine whether the EUTF-OPEB investment governance model is sufficient and/or appropriate, PCA reviewed the investment governance models at several other states and municipalities. In summary, when compared to peers, the current EUTF-OPEB investment governance model is reasonable. Importantly, the State of Hawaii has elected to prefund its health care commitments and the EUTF is the agency responsible for overseeing this activity. Under this prefunding context, it is highly likely that the agency's funding balance sheet will begin to grow substantially, reflecting the collection of contributions that are earmarked for health benefits payable at some point in the distant future. In fact, EUTF's actuary (GRS) projects that, under Act 268, the EUTF-OPEB investment portfolio could have a value of close to $20 billion twenty years from now.[9]

Investment governance models for healthcare-related assets vary widely across other states and municipalities (see table, next page). The governance models appear dependent on three major factors. The first factor is the PAYGO/prefunded status of the system. If the system is PAYGO, then investment assets tend to be governed by entities other than a State's health funding agency (e.g., states of Florida and Wisconsin). Second, States that have segregated out the investment function to a distinct trustee-driven board (e.g., Florida, Wisconsin, Washington) tend to have those investment boards (rather than the health benefit system) provide investment oversight. Finally, certain States may have elected to close the benefits systems to future hires (e.g., Nevada and Oregon). In such instances, the scale of the benefits system may be managed downward over time, leading to governance frameworks that utilize other state agency functions. On the other hand, if the benefits system is (i) seeking prefunding over time, (ii) remains open to active employees, and (iii) the State in question does not utilize a state investment board function, then the health benefits system will likely utilize a separate and distinct investment governance framework for managing its investment assets (e.g., Missouri). Given that the EUTF system meets these three parameters, its current investment-committee-based governance structure is warranted and prudent.

Of course, as the assets of the prefunded EUTF-OPEB investment portfolio grow and it chooses to manage its investment activities internally, it will be critical that the EUTF provide the commensurate level of investment staffing and resources. From a staffing standpoint, a recent PCA survey indicates that an industry standard for professional investment staffing is one full-time investment officer per $1 billion of investable assets.[10] Additionally, institutional investors/boards with scale beyond $1 billion typically retain investment consultants to provide advice on strategic matters, act as a sounding board for the trustees, and serve as an extension of staff when needed.

[9] *Op Cit.*, Actuarial Valuation Report, EUHBF, Section C, See Appendix of this report.

[10] FPPA Peer Organization Staffing Survey, Linder, CFA, PCA, 2011.

Figure 4. Investment Governance Practices at Selected State and Municipal Health Benefits Systems

State/ Municipality	Investment Entity	Manage Health Insurance Assets?	Governance	Health Care Agency Comments
Florida	SBA - state investment board	Yes - but not prefunded	No specific Health Care governance rep at SBA	Managed by FRS, PAYGO system
Missouri	Missouri Consolidated Health Care Plan	Yes - funds on an actuarial basis, has unique investment policy	Separate board	Utilizes State Retiree Welfare Benefit Trust
Nevada	PERS/RBIB (separate board, but same members)	Yes- funded on an actuarial basis, similar allocation as PERS	No specific Health Care governance rep at PERS	Managed by Nevada PERS; one trust; not available for post-2011 hires
New Mexico	none	Yes - but not prefunded	Separate board	Paygo sytem managed by separate authority
Oregon	OIC - state investment board	Yes - funded on an actuarial basis, same allocation as OPERF	OIC governs investments; PERS	Managed by Oregon PERS; two separate trusts, not available to post 2003 hires
Washington	none	No	none	Managed privately through PEBB
Wisconsin	SWIB - state investment board	Yes - but not prefunded	No specific Health Care governance rep at SWIB	Managed by Dept. of Employee Trust Funds (ETF)
Los Angeles	LA FPP	Yes - funds on an actuarial basis, assets commingled with pension assets	No specific Health Care governance rep on LA FPP Board	Managed directly by LAFPP
Los Angeles	WPERP	Yes - funds on an actuarial basis, assets in separate trust	WPERP governs investments	Managed directly by WPERP

Sources: Various state agency websites, PCA, email communications between PCA and staffs at selected state agencies.

CURRENT INVESTMENT STRUCTURE OF ERS

The ERS has been managing a multi-class diversified portfolio for several decades. This structure is allowed under HRS section 88-119 of Hawaii's revised statutes. Section 88-119 allows the ERS to invest in a very broad spectrum of investment vehicles, as long as they meet appropriate prudence and fiduciary standards. Over time, the ERS has capitalized on these parameters through investments in non-U.S. securities, various forms of private real estate investments, a broad spectrum of private equity investments, and the recently-approved covered calls strategies. It is likely that the ERS will continue to diversify its portfolio by investing in other classes such as commodities, long-short strategies, and others.

Portfolio Allocation and Structure

As of June 30, 2014, the ERS investment portfolio exceeded $14 billion. These assets are allocated across a relatively wide array of strategies and mandates, utilizing both public-market and privately-held investments (see table below):

Figure 5. ERS Portfolio Allocation Mix (in %) – 6/30/2014

ERS Class	6/30/2014	Comments
Public Equity	62	Primary growth asset
Covered Calls	5	Growth asset with lower volatility
Private Equity	4	Partnerships investing in private companies
Real Estate	7	Separate accounts of direct property holdings & partnerships
Risk-taking assets	*78*	
Fixed Income	17	Stable class (both U.S. and non-U.S. bond holdings)
Inflation-Linked	4	Inflation risk class (includes inflation-linked bonds & timber)
Other/Internal	1	Stable class
Risk-diversifying assets	*22*	
Total Allocation - %	***100***	

Sources: ERS, PCA

As the table above shows, the ERS portfolio is tilted largely toward risk-taking assets. The ERS is planning on increasing its allocation to Private Equity over the next several years, bringing its allocation to seven percent of the Total Portfolio. In addition, the ERS is currently undertaking a major policy review that may result in further diversification of several strategic class portfolios as well as potentially adjusting the weighting of the classes themselves. This review should be completed by the end of the third quarter of 2014.

As discussed earlier (and shown in Figure 5 above), the ERS relies heavily on active management. The ERS utilizes active management for approximately 80% of its investment portfolio. Passive management is currently utilized exclusively within the Public Equity portfolio, where approximately one-third of Public Equity is passively-managed. Certain classes and/or underlying class components do not have viable passive management options, including Private Equity, Real Estate, and to some extent, the Inflation-Linked (Real Return) class. Excluding these classes, approximately 25% of the remaining ERS portfolio (which is invested entirely in publicly-traded markets where passive options are available) is passively managed.

Managers & Account Structures

Also highlighted in Figure 5 is that the ERS uses numerous managers and partnership vehicles to gain exposure to portfolio management expertise across its investment portfolio. At a more granular level, ERS retains various strategies (active vs. passive) and account structures to execute investment mandates across its six broad strategic classes (see Figure below).

Figure 6. ERS Portfolio – Manager & Account Structure Summary

ERS Class	Manager Type	Account Type	Number of Accounts	Number of Managers	Assets ($B)	% of Fund	Assets/ Account ($M)	Assets/ Manager ($M)
Public Equity	Active	Separate	13	13	5.9	43%	454	454
	Passive	Commingled	3	1	2.6	19%	867	2,600
Covered Calls	Active	Separate	1	1	0.3	2%	300	600
	Passive	Separate	1		0.3	2%	300	
Fixed Income	Active	Separate	6	6	2.4	18%	400	400
Inflation Linked	Active	Separate	2	2	0.6	4%	300	300
Total Public			*26*	*23*	*12.1*	*89%*	*465*	*526*
Real Estate	Active	Separate	2	2	0.7	5%	350	350
	Active	Commingled	14	10	0.2	1%	14	20
Private Equity	Active	Commingled	165	66	0.5	4%	3	8
Total Private			*179*	*76*	*1.4*	*10%*	*8*	*18*
Other					0.1	1%		
Total Fund			**205**	**99**	***13.6***	***100%***	**66**	**137**

Sources: PCA, ERS.

The above figure shows that the ERS currently maintains over 200 accounts and 99 manager relationships. The majority of this volume is evident within the private markets segments of the portfolio (Real Estate and Private Equity). While these two segments account for the majority of accounts and manager relationships, these segments only amount to 10% of Total Portfolio assets. The other 89% of the portfolio is managed by 23 managers across 26 accounts, aggregating to approximately $500 million per manager/account. This relatively large account/manager commitment level allows ERS to negotiate relatively attractive fees for managed accounts (see next section). The ERS has enhanced its policies and procedures to increase the scale of its manager relationships within the Private Equity portfolio. Given the nature of the Private Equity portfolio, it will take several years for this streamlining effort to bear fruit.

Cost Structure

Under the structure discussed above, the ERS portfolio incurs various costs to support its investment activities. The table below breaks out several key cost components associated with the ERS investment program:

Figure 7. Estimated Annual Costs – ERS Investment Portfolio

Component	6/30/2014 AUM Level
ERS Assets Under Management (AUM)	$14,117,000,000
Investment Management Fees	$52,650,000(37 bps)^
Custody/Accounting Costs	$300,000^^
Consultant Fees	$1,400,000^^^
Internal Administration	$1,040,000*
Total Annual Costs	$55,390,000
Total Annual Costs as % of AUM	0.39%

^Based on December 31, 2013 market values and current structure. Does not include estimates for carried interest within the Private Equity and Real Estate classes.
^^BNY Mellon charges a flat custody, accounting & performance fee. BNY Mellon's earnings from the securities lending program was taken into account when negotiating this flat fee structure. Since inception (11 months ending 6/30/2014) ERS has earned approximately $3,415,000 from the securities lending program, while BNY Mellon has earned approximately $465,000.
^^^Represents fees for PCA, Hamilton Lane, and Courtland.
*Based on 7 FTEs in 2014 (CIO, 3 Investment Officers, 2 Investment Specialists, and 1 administrative assistant (includes fringe benefits 42%).

Similar to the EUTF-OPEB investment portfolio's cost structure, ERS's investment portfolio's costs are dominated by the Investment Management Fees component. Investment fees account for 95% of the costs associated with managing the ERS investment portfolio. ERS's management fees, at 0.37% of assets under management (AUM), are 68% higher than the EUTF-OPEB's investment fee component (0.22% of AUM). This differential is explained by ERS's higher use of active management versus passive management and ERS's allocation to private markets investments (private equity and real estate) which, by their very nature, are more resource intensive that traditional investments and, as a result, cost more to manage. We do note that by 2017, the overall AUM-% fee differential between the EUTF-OPEB and ERS investment portfolios is expected to decline dramatically. This expected convergence is due to the EUTF-OPEB moving toward its recently approved change in strategic allocation, which is more risk-seeking in nature.

Governance of ERS Investment Portfolio

Decision-making authority for investing ERS's assets is quite similar to the governance authority applied at the EUTF. As with the EUTF, decision-making authority for investing ERS's assets resides with the ERS's Board of Trustees (the ERS Board). The ERS Board, however, is not structured like the EUTF Board. In addition, the ERS Board applies a different voting approach for taking action. The ERS Board consists of eight trustees (versus ten for the EUTF Board), four of who are employee representatives (including one retiree) and three of whom are State citizens appointed by the Governor. An additional trustee is the current Director of Finance. In terms of voting to make decisions, each trustee carries one vote. Decisions are made by majority. This voting setup is in sharp contrast to that of the EUTF, which is based on voter blocks and reaching consensus among the entire Board. While the ERS Board typically acts as a consensus board, the ERS's eight-member Board could take action on a decision with up to three dissenting votes.

Similar to the EUTF, the ERS Board has established an Investment Committee consisting of a subset of ERS Board trustees. The ERS Investment Committee utilizes both staff and retained investment consultants to provide guidance and assistance on investment matters. Contractually, the investment consultants act as investment fiduciaries on behalf of the trustees. The ERS Investment Committee reviews reporting, recommendations, and requests originating with ERS staff and ERS's investment consultants. After reviewing such information, the ERS

Investment Committee recommends specific courses of action to the ERS Board for approval/ratification.

As is industry practice, the ERS Board delegates numerous investment activities (such as holding securities, buying and selling securities, creating and maintaining investment portfolios, etc.) to external organizations exhibiting institutional-quality capabilities. To source these organizations, the ERS Board works with its staff and investment consultants to typically utilize a request-for-proposal (RFP) process that meets the State of Hawaii's procurement standards.

The governance framework utilized by the ERS is consistent with the frameworks utilized by many statewide pension systems. For example, both CalSTRS and CalPERS, two of the country's largest public pension funds, have governance frameworks that are equivalent to ERS's governance framework.

IMPACT OF CONSOLIDATING EUTF INVESTMENT STRUCTURE INTO ERS INVESTMENT STRUCTURE

The prior two sections of this report reviewed the asset, cost, and governance structures of both the EUTF-OPEB and ERS investment portfolios. As these reviews highlighted, there are both similarities and differences between how each State agency manages their own respective assets.

In this section, we review several aspects associated with a considered consolidation of these two agencies' investment activities. More specifically, given that the EUTF does not currently have a dedicated investment office while the ERS does, the analysis focuses strictly on consolidating EUTF's investment activities into the ERS's. In other words, can or should the EUTF consider "outsourcing" its asset investment activities to the ERS; is this shift even possible? And, how will such a shift impact the ERS Investment Office? Or, should the EUTF consider creating its own investment office? Given Act 268's mandate for the EUTF's sponsors to begin making material contributions to the EUTF-OPEB balance sheet, decisive action will need to be taken one way or the other. As discussed earlier, it is highly likely that EUTF-OPEB's assets are going to grow materially over the next several years and oversight of these assets will be critical and essential.

Governance Considerations Under a Potential Consolidation Framework

The primary advantage of consolidation (or "outsourcing") is maximizing the use of existing capabilities in a cost effective manner. Investment fiduciary standards, laws, and regulations, however, require that governing bodies (i.e., plan trustees) maintain their fiduciary authority over the assets entrusted to them even if they rely on the capabilities of another provider. In the specific context of the EUTF, the trustees responsible for the EUTF-OPEB investment portfolio cannot abdicate or transfer their fiduciary obligations and/or decision-making authority to another party or agency (such as the ERS).[11] While EUTF's trustees can delegate certain functions (such as investment management) to third parties, it must maintain a mechanism and/or process to ensure appropriate oversight of all material decisions. Therefore, practically speaking, under an investment consolidation arrangement between the EUTF and the ERS's Investment Office, it is highly likely that the ERS Investment Office would need to report and/or seek action approval from EUTF trustees for any decision that would have material impact upon the EUTF-OPEB investment portfolio. This requirement naturally leads to needing to develop a process that would facilitate regular communication from the ERS Investment Office into the EUTF Board (or, at a minimum, into the EUTF Investment Committee). Such activities would likely result in additional administrative responsibilities on the part of the ERS Investment Office.

The Internal Revenue Code also prohibits the ERS from providing preferential services/resources to another State agency, such as the EUTF.[12] Based on discussions with ERS's legal counsel, the EUTF would need to, at a minimum, establish a servicing agreement with the ERS to compensate the ERS accordingly for any services rendered to the EUTF.

Finally, assets for both of the ERS portfolio and the EUTF-OPEB portfolio must remain separated for tax qualified status and other trust/fiduciary reasons.[13] While actual investments by the ERS and the EUTF may mirror one another, segregation of accounts and ownership must be explicit. As a

[11] *Op Cit*., Hawaii Revised Statutes Chapter 87A.; also, the Uniform Prudent Investors Act and other fiduciary law.

[12] Internal Revenue Code § 503(b), per letter from State of Hawaii Department of Attorney General, Administration, July 19, 2014, Re: EUTF/ERS Investment Consolidation Study (Letter from ERS counsel).

[13] *Ibid*., Letter from ERS counsel.

result, an important priority will be that, regardless of any joint business negotiations that might seek to enhance the EUTF's and ERS's individual positions, both EUTF and ERS must maintain separate and distinct contractual relationships and agreements with the investment-related vendors they might collectively choose to conduct business with on their behalf.

Given the above concerns of (i) EUTF maintaining its fiduciary authority, (ii) the prohibition against providing preferential services, and (iii) the requirement to keep EUTF-OPEB and ERS investment assets separated, there are some important rationales that decision-makers might take into consideration:

- <u>It is highly likely that the EUTF's tolerance for investment risk will converge toward the risk tolerance of the ERS</u>. While there are marginal differences in expectations for the two portfolios because they serve different constituents, the EUTF-OPEB now has an investment horizon (several decades) that is similar to the investment horizon utilized by the ERS. In addition, EUTF trustees have begun implementing an investment policy that exhibits similar expected risk levels as the ERS portfolio (see Asset Structure section below). Given these trends, there is a reasonable likelihood that both portfolios could utilize very similar (if not the same) investment classes and strategic allocation policies.

- <u>The ERS utilizes a broad spectrum of passive and active managers that may prove of interest to the EUTF</u>. Utilizing an already existing pool of investment managers would likely save the EUTF considerable effort in terms of the time and expense involved in selecting managers to manage EUTF-OPEB assets.

- <u>The EUTF may be able to exploit ERS's larger scale to its advantage in the pricing of manager contracts</u>. Currently, the ERS investment portfolio is approximately twenty times the size as the EUTF-OPEB portfolio. Over the next several years, this scale differential will likely decline dramatically. The scale of assets is important because nearly all investment managers use account size as the key determinant for setting their fee levels. The EUTF negotiates its investment manager contracts utilizing largely commingled fund vehicles as a result of its smaller relative size in the institutional marketplace. The ERS, as a larger pool of capital, is able to attract generally lower fee arrangements for managers investing under similar mandates. For example, the EUTF's passive equity exposure currently costs the EUTF 0.070% of managed assets/year. The commensurate passive global equity mandate utilized by the ERS costs 0.015%/year, 4½ times less expensive (on a percent-of-assets basis) than the EUTF cost. Similar differentials exist for more active-oriented investment mandates. Given these differentials, the potential to jointly negotiate investment manager contracts may prove highly beneficial, particularly to the EUTF. A preliminary cost analysis is provided below of the EUTF-OPEB investment portfolio managed using ERS's investment managers.
- EUTF's utilization of the ERS Investment Office could provide several positive qualitative aspects:
    - In the near-term, it would provide the EUTF with immediate access to investment expertise and resources that are already in place, rather than developing/building its own investment department from scratch, which could take years to procure;
    - Having one investment office serving multiple agencies instead of having multiple investments offices performing virtually the same functions eliminates potentially significant governmental redundancies;
    - Long-term, if assumptions are met, the combined EUTF/ERS investment portfolio could approach $50 billion. Having one investment office representing this scale

of assets in the global marketplace provides certain advantages (with respect to pricing, servicing, etc.).

- It is expected that the ERS Investment Office would manage the day-to-day middle/back-office portfolio management functions of the EUTF-OPEB investment portfolio. Such management and oversight would free up EUTF resources for other EUTF mission-critical functions/services. In contrast, such an increase in ERS Investment Office activities should be considered additional burdens that ERS must undertake.

From a governance/oversight perspective, given the potential benefits that may accrue to the EUTF, the challenge of examining and refining the EUTF's and ERS's governance/management procedures may prove beneficial to the EUTF. The sections below attempt to quantify several of the cost-benefit tradeoffs in order to better gauge the economic value of consolidation.

Asset Management Considerations Under a Potential Consolidation Framework

In considering EUTF's potential use of ERS's existing investment structure, two main considerations deserve examination: (i) the degree to which the EUTF and the ERS have similar investment mandates/strategies and (ii) the breadth of investment expertise offered by the ERS and whether such expertise can and should prove satisfactory to the EUTF. As highlighted elsewhere in this report, despite some initial differences, the EUTF-OPB portfolio appears to be converging toward a structure that would end up similar to that of the ERS investment portfolio (regardless of whether consolidation occurs or not). Presented below are several factors that enter into determining the viability of consolidating EUTF's asset management functions into the ERS:

- Both systems (the EUTF and the ERS) approve key assumptions in order determine the systems' long-term financial viability. GRS, the retained actuary for both systems, has developed separate long-term investment assumptions for both the EUTF-OPEB and ERS investment portfolios. Currently, the assumed annual compound long-term investment return for the EUTF-OPEB is 7.0%.[14] The analogous assumption for the ERS investment portfolio is 7.75%.[15] ERS's trustees are currently reviewing their return assumption. They have asked GRS to study the potential impact(s) of various expected return reduction options. Taking these findings into account, long-term investment return expectations for each of the systems' portfolios are quite similar.

- Similar long-term investment return expectations/assumptions typically reflect risk profiles that are also consistent with one another. This concept was analyzed by comparing the asset allocation policies of each system's portfolio utilizing PCA's 2014 capital market assumptions (2014 CMAs).[16] Utilizing the 2014 CMAs allows for the development of forward-looking expected returns and estimated risk/volatility levels for each portfolio. The risk level (described using an expected annual standard deviation of annual returns) is a quantitative representation of the amount of risk the respective board of trustees is willing to accept to seek a desired level of long-term investment return. As shown below, the expected return and risk characteristics of both systems' investment portfolios are quite close:

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[14] *Op Cit.*, Actuarial Valuation Report, EUHBF.

[15] Employees' Retirement System of the State of Hawaii, Report to the Board of Trustees on the 88th Annual Actuarial Valuation, Year ending June 30, 2013, Gabriel Roeder Smith & Company.

[16] See Appendix for PCA's 2014 Capital Market Assumptions.

Figure 8. Return and Risk Comparisons, EUTF-OPEB vs. ERS Investment Portfolios
Based upon PCA's 2014 Capital Market Assumptions*

Expectations based upon PCA's 2014 CMAs	EUTF-OPEB	ERS
Expected annual return	7.5%	7.9%
Expected SD of annual returns	13.2%	13.4%
Expected 10-year annualized compound return	6.8%	7.1%
Range of annual returns (+/- 1 SD)	(6.4%) to 20.0%	(6.3%) to 20.6%
Range of 10-year compound returns (+/- 1SD)	2.6% to 10.9%	2.9% to 11.4%

*Figures in table reflect GRS's inflation assumption of 3.0%/year

As the table above shows, the expected risks of both portfolios are virtually equivalent (13.2% vs. 13.4%). <u>This leads to the conclusion that both sets of respective decision-making bodies are willing to accept similar risk levels within their investment portfolios</u>. The ERS's annual and longer-term 10-year returns are slightly higher than those of the EUTF-OPEB portfolio. This differential largely reflects ERS's commitment to private markets investments (Real Estate and Private Equity), which are total-return-oriented and expected to capture a reasonable return premium for bearing risk associated with illiquidity. Note that the ranges of both the annual expected returns and long-term expected returns are also virtually equivalent.

- <u>On a more intuitive level, both the EUTF-OPEB and ERS investment portfolios have similar proportions allocated to risk-taking versus risk-mitigating assets</u> (see table below):

Figure 9. Comparison of EUTF-OPEB and ERS Allocation Policy Structures

Asset class	EUTF-OPEB	ERS	Difference (EUTF-ERS)
US Equity	15%	30%	-15%
Non-US Equity	26%	26%	0%
Private RE/REITs	10%	7%	+3%
Private Equity/Microcap	9%	7%	+2%
Covered Calls	10%	5%	+5%
Total Risk-Taking	*70%*	*75%*	*-5%*
Inflation-Linked Assets*	15%	5%	+10%
Fixed Income	15%	20%	-5%
Total Risk-Mitigating	*30%*	*25%*	*+5%*
Total	100%	100%	-

*EUTF's Inflation-Linked assets currently include two discrete allocations to TIPS (5%) and Commodities (10%).

The EUTF's current policy seeks to invest 70% of its assets in risk-taking investments, while the ERS seeks to invest 75% of investments similarly. The largest contributors to this differential are the ERS's emphasis on U.S. Equity versus the EUTF's emphasis on Inflation-Linked investments. As these are policy portfolios, they reflect current intentions and not actual investments. The EUTF is still in the process of implementing its current policy while the ERS has reached its allocation levels across all of its strategic classes.

<u>In summary, both the EUTF and ERS are pursuing very similar return objectives and risk profiles across their investment portfolios. It is highly likely these characteristics would continue to converge over time assuming the EUTF-OPEB grows as projected by GRS</u>.

- Based on GRS's analysis of the contribution schedule mandated by Act 268, fiscal year contributions into the EUTF-OPEB investment portfolio should exceed fiscal benefit payments for the next 30 years. In this respect, ongoing positive cash flows should flow into the EUTF-OPEB investment portfolio, keeping liquidity concerns to a minimum. These excess contributions are, when combined with the contribution of investment returns, meant to eliminate the large unfunded liability that exists within the EUTF system. In contrast, the ERS system has produced annual cash flow deficits in the range of ($200M) to ($300M). Over the last two-to-three years, the ERS has instituted several reforms that should bring the system to a more cash flow neutral position over time. Despite these dynamics, the ERS has been willing to invest a proportion of its investment portfolio in illiquid, private markets investments. As of December 31, 2013, approximately 8% (or $1.1 billion) of the ERS investment portfolio consisted of private markets investments. One important conclusion to draw from the above findings is that as the EUTF-OPEB scales up over time, and given EUTF-OPEB's long investment horizon, EUTF decision-makers should likely consider private markets investments for the EUTF-OPEB portfolio. Under such a scenario, ERS's long track record and experience in private markets would likely prove valuable.

- The ERS retains a broad spectrum of active and passive managers that may prove beneficial to the EUTF (see Figure 10 below):

Figure 10. EUTF-OPEB vs. ERS Manager Structure Layout Comparison (by Strategic Class)

System	EUTF-OPEB		ERS	
Strategic Class	**Active**	**Passive**	**Active**	**Passive**
US Equity	none	Vanguard - LC	JP Morgan - LG Sands - LG Barrow Hanley - LV SC Mckee - LV CM Bidwell - LC (2) Jennison - SC T Rowe Price - SC	Mellon - LV Mellon - LV Mellon - LC
Non-US Equity	none	Vanguard - LC	Franklin Templeton - LC JP Morgan - LC Mecator - LC QMA - EM Research Affiliates - EM	Mellon - LC
Private RE/REITs	none	Vanguard - REIT	Invesco - Core Heitman - Core Non-core LPs (14)	none
Fixed Income	none	Vanguard -Core	WAMCO - Core Plus PIMCO - Core Plus Bradford & Marzec - Core Plus First Hawaiian - Core Pacific Income - Core Oeschle - Non-US	none
Inflation-Linked	Blackrock - TIPS Commodities (pending)	none	Blackrock - TIPS Hancock -Private Timber Infrastructure (pending)	none
Private Equity/Microcap	Microcap - pending	none	Private Equity LPs (165)	none
Covered Calls	Pending	none	Gateway	Gateway

Close analysis of the above matrix reveals two key findings: (i) both the EUTF-OPEB and ERS utilize Blackrock to manage the same mandate: actively-managed TIPS and (ii) both funds utilize passive management across the U.S. Equity and Non-U.S. Equity classes.

Other observations worth noting are: (i) the ERS is very active within the private markets, having invested in nearly 180 partnerships across both Real Estate and Private Equity, (ii) the ERS already employs both active and passive management within the Covered Calls class, (iii) the ERS relies exclusively on a pool of six long-standing active fixed income managers, and (iv) the ERS utilizes a pool of twelve active public equity (U.S. and Non-U.S.) in addition to having significant exposure to passive management. All of these manager line-ups are under continuous monitoring and reviewed on a regular basis.

Under a consolidation framework, it is highly likely that the EUTF-OPEB could take advantage of all, or a part of, ERS's pool of investment managers. The two potential opportunities that present themselves immediately are (i) the potential access to ERS's passive management at (very likely) a lower cost structure and (ii) EUTF-OPEB's/ERS's current joint relationship with Blackrock. As discussed elsewhere in this report, it is highly likely that EUTF-OPEB and ERS assets must remain segregated. <u>Given that condition, to the extent that the EUTF was able to develop a framework to allow ERS to negotiate investment manager/vendor contracts on its behalf, there appears to be significant potential to capitalize on ERS's larger scale</u> (see cost analysis in the next section).

Estimated Financial and Cost Impact Under a Potential Consolidation Framework

<u>In summary, consolidation of EUTF investment activities through utilization of ERS's Investment Office would likely produce near-term cost savings</u>. Such savings are largely the result of the smaller-scale EUTF being able to exploit the scale advantage that the larger ERS investment pool provides. Farther out in time (ten years and longer) these differentials would likely narrow for two basic reasons: (i) the EUTF-OPEB portfolio will be of significant scale itself (approximately $5 billion) and (ii) it is highly likely that the EUTF-OPEB and ERS portfolios will have very similar allocation policies. However, if the State is able to refine and streamline its ability to manage the two investment pools jointly, continued savings would accrue versus if each pool operated separately.

As discussed in prior sections, there are three major cost components to managing an institutional pool of assets: (i) fees for external advisors (investment managers and consultants), (ii) costs associated with safekeeping and tracking the massive collection of investment securities held in each pool, and (iii) internal agency overhead/resources expended to manage and oversee the investment pool. To recap, based on these three cost areas, the current and projected cost structures of the respective EUTF-OPEB and ERS investment programs are presented in Table A of Figure 11 (next page).

Table A shows that EUTF's current all-in annual ongoing costs to manage its investment program amount to approximately $1.9 million or 0.31% of total assets. Just over 75% of this cost is related to external advisor costs. Based on projections of EUTF-OPEB's growth and structure, these costs are expected to rise to $4.1 million per year (0.37% of assets) by the end of fiscal 2017. In contrast, ERS's investment management costs aggregate to approximately 0.39% per year. Currently, the ERS utilizes significantly more active management and has significant exposure to the private markets. These factors, offset by ERS's larger scale, explain the differences in cost as a percent of assets under management between the two systems. The important point of Table A is that, as the EUTF-OPEB investment portfolio seeks to diversify both across different asset types and through the utilization of certain active management for specific mandates, its cost structure will come close to matching that of the ERS. Given its smaller scale, it is likely that beyond the three-year point, EUTF-OPEB's cost levels (on a %-of-assets basis) would exceed ERS's investment cost levels.

Analysis of Potential Consolidation Scenarios

To mitigate this potential rising cost trend, EUTF, through the consolidation framework, may be able utilize specific ERS managers and mandates to capitalize on ERS's scale in specific areas. For example, both the EUTF and the ERS utilize Blackrock (a manager of inflation-protected bond portfolios) for virtually the same mandate. Blackrock currently charges the EUTF 0.43%/year to manage the mandate through an institutional mutual fund. At the ERS, Blackrock charges 0.16%/year for the same mandate through a separate account structure. In addition, because of this structure, the ERS receives a better securities lending income split arrangement than the EUTF, providing marginally higher levels of income. While this example highlights the largest single manager fee differential, there are other similar opportunities and choices that the EUTF might adopt given access to the ERS's investment management structure.

To quantify the potential cost savings associated with consolidation, this report has "mapped" a few potential account restructuring scenarios assuming the EUTF-OPEB portfolio could access the ERS's account structure on the same general cost terms as the ERS. Several of the ERS's largest existing managers have indicated that such terms conditions are feasible.

In addition to the major cost areas presented in Figure 11, we also noted earlier that the ERS is not permitted to make "services available on a preferential basis" to another State agency. As a result, our interpretation (which should not be viewed in a legal/regulatory context) is that the EUTF must enter into an explicit cost-for-service agreement with the ERS to allow the ERS to provide the required services. While the legal merits and structure of such an agreement is beyond the scope of this report, it is likely that the EUTF would be required to reimburse the ERS for resources expended on EUTF's behalf. We believe an appropriate figure for such cost sharing is approximately two full-time-equivalent ERS employees (FTEs), assuming one FTE dedicated to EUTF investment activities and one FTE dedicated to EUTF accounting and record-keeping activities. We assume each FTE, on average, amounts to an annual expenditure of approximately $140,000/year including employee benefits. The impact of recognizing this specific cost-sharing requirement is that, in aggregate, the EUTF is likely to bear the incremental costs associated with shifting internal resources among the two agencies.

Figure 11.

Table A - Comparative & Combined Cost Structures of EUTF and ERS Investment Offices – Operating as Separate Entities

	EUTF-OPEB				ERS				Aggregate			
	6/30/2014		6/30/2017		6/30/2014		6/30/2017		6/30/2014		6/30/2017	
Assets Under Management	$626M		$1,200M		$14,117M		$17,500M		$14,743M		$18,700M	
Cost Component	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets
Fees to External Advisors	1,504	0.24	3,816	0.32	54,050	0.38	66,500	0.38	55,554	0.38	70,316	0.38
Internal Resource Expenditures	77	0.01	165	0.01	1,040	0.01	1,300	0.01	1,117	0.01	1,465	0.01
Asset Pool Safekeeping Costs	157	0.03	330	0.03	300	0.00	350	0.00	457	0.00	680	0.00
EUTF/ERS Cost Sharing	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
Total Costs	$1,737	0.28%	$4,311	0.36%	55,390	0.39	68,150	0.39	57,128	0.39	72,461	0.39

*differences due to rounding

Table B - Comparative & Combined Cost Structures of EUTF and ERS Investment Offices – Consolidated Framework (Scenarios 1 & 2)

	Consolidated EUTF-OPEB				ERS				Consolidated Aggregate			
	6/30/2014 (S1)		6/30/2017 (S2)		6/30/2014 (S1)		6/30/2017 (S2)		6/30/2014 (S1)		6/30/2017 (S2)	
Assets Under Management	$626M		$1,200M		$14,117M		$17,500M		$14,743M		$18,700M	
Cost Component	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets
Fees to External Advisors	1,134	0.18	3,352	0.28	54,050	0.38	66,500	0.38	55,184	0.37	69,852	0.37
Internal Resource Expenditures	0	0.00	0	0.00	1,320	0.01	1,580	0.01	1,320	0.01	1,580	0.01
Asset Pool Safekeeping Costs	138	0.02	303	0.03	300	0.00	350	0.00	438	0.00	653	0.00
EUTF/ERS Cost Sharing	280	0.04	280	0.02	(280)	0.00	(280)	0.00	0	0.00	0	0.00
Total Costs	$1,551	0.25%	$3,934	0.33%	55,390	0.39	68,150	0.39	56,942	0.38	72,085	0.39

*differences due to rounding

Table C - Differences

	EUTF-OPEB				ERS				Aggregate			
	6/30/2014		6/30/2017		6/30/2014		6/30/2017		6/30/2014		6/30/2017	
Assets Under Management	$626M		$1,100M		$14,117M		$17,500M		$14,743M		$18,700M	
Cost Component	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets	$ (000)	% of assets
Fees to External Advisors	(370)	(0.06)	(464)	(0.04)	0	0.00	0.00	0.00	(370)	0.00	(464)	0.00
Internal Resource Expenditures	(77)	(0.01)	(165)	(0.02)	280	0.00	280	0.00	203	0.00	115	0.00
Asset Pool Safekeeping Costs	(20)	(0.00)	(27)	(0.00)		0.00	0.00	0.00	(189)	0.00	(27)	0.00
EUTF/ERS Cost Sharing	280	0.05	280	0.03	(280)	0.00	(280)	0.00	0	0.00	0	0.00
Total Costs	($186)	(0.03%)	($377)	(0.03%)	0	0.00	0	0.00	($356)	0.00	($376)	0.00

*differences due to rounding

Keeping the above factors in mind, this report maps three consolidation scenarios (Scenarios 1, 2, and 2a). A fourth Scenario (Scenario 3) compares the cost-effectiveness of Scenario 2 versus the potential rates that EUTF would face in the institutional marketplace if it elected to pursue similar strategies on its own.

- Scenario 1: Initial Adoption of Selected ERS Accounts
- Scenario 2: New EUTF Allocation and Adoption of Additional ERS Accounts
- Scenario 2a: Scenario 2 Utilizing Additional ERS Active Managers
- Scenario 3: Hypothetical Comparison – Scenario 2 vs. EUTF paying standard rates

Scenario 1

In Scenario 1, EUTF transfers its current allocation structure into the appropriate ERS accounts/vehicles in as seamless an approach as possible (see Figure 12, below). Where there are major differences in mandates, EUTF's accounts are merely transferred over to ERS's custodian for recordkeeping purposes.

Figure 12.

SCENARIO 1: Initial Adoption - Years 1 & 2

EUTF Maintains Separate Status				EUTF Utilizes Selected ERS Vehicles		
EUTF Class	**Current EUTF Asset Structure (using 6/30 MVs + July contribution)**	**Current Estimated Manager Fees**	**from-to**	**ERS Class**	**Current EUTF Asset Structure (using ERS accounts)**	**Pro Forma Estimated Manager Fees**
US Equity	150,240,000	60,096	→	Global Equity	269,180,000	80,754
Intl Equity	118,940,000	142,728				
Fixed	93,900,000	65,730		Fixed Income	93,900,000	65,730
Covered Calls	-	-		Covered Calls	-	-
TIPS	106,420,000	457,606	→	TIPS	106,420,000	209,647
REITs	100,160,000	80,128		REITs	100,160,000	80,128
Commodities	-	-		Commodities	-	-
MicroCap	56,340,000	563,400		MicroCap	56,340,000	563,400
Totals	**626,000,000**	**1,369,688**		**Totals**	**626,000,000**	**999,659**

Investment Cost Structure Analysis

	Est. Annual Cost	% of Assets	Est. Annual Cost	% of Assets	Est. Savings
Manager Fees (from above)	**1,369,688**	0.22%	**999,659**	0.16%	370,029
Consultant Fees	134,000	0.02%	134,000	0.02%	-
Fees to External Advisors	1,503,688	0.24%	1,133,659	0.18%	370,029
Asset Pool Safekeeping	156,500	0.03%	137,500	0.02%	19,000
Internal Resources	77,000	0.01%	-	0.00%	77,000
EUTF/ERS Cost Sharing	-	0.00%	280,000	0.04%	(280,000)
Estimated Total Costs	1,737,188	0.28%	1,551,159	0.25%	**186,029**

As shown in the table above, the EUTF has two mandates that are virtually equivalent to those utilized by the ERS. In addition, management fees under the ERS mandates are a fraction of those incurred by the commensurate EUTF mandates. The mandates highlighted are Global Equity (here EUTF transfers its passive equity mandates to ERS's existing passive mandate) and TIPS (where ERS and EUTF utilize the same manager for virtually the same mandate). These shifts result in approximately $370,000 of annual savings. In terms of other cost impacts, the consolidation assumes EUTF staff is no longer required to dedicate approximately ½ of an FTE to investments (those activities are now subsumed by the ERS Investment Office), but that the EUTF is required to compensate the

ERS for services rendered. In total, this initial consolidation scenario produces approximately $186,000 in annual savings.

<u>Custodial Account Structure</u>
Under this Scenario, the EUTF-OPEB portfolio is expected to move from utilizing its five existing institutional mutual funds (and one pending separate account) to utilizing one institutional commingled fund, two separate accounts, and keeping two of its existing institutional mutual funds for the short-term (up to two years). Please see the Appendix for account mapping assumptions/details. Subsequent to the appropriate legal approvals to consummate the consolidation framework, the transfer process could likely occur between 90 and 120 days. As shown in the table above, the incremental custody cost (on top of the current custody fees being paid by the ERS already) would be $137,500.[17] This amount is modestly lower than the new custody fees negotiated recently EUTF's current custodian.

Scenario 2

In Scenario 2, EUTF utilizes the two transfers discussed under Scenario 1 but builds upon Scenario 1 in two ways. First, Scenario 2 reflects the new asset allocation structure recently adopted by the EUTF for the EUTF-OPEB portfolio. Second, Scenario 2 assumes the EUTF utilizes additional ERS investment capabilities across several of the new EUTF classes, but leaves public equity in passive management (see table below).

Figure 13.

SCENARIO 2: Adoption of Addiitonal ERS Accounts Under New EUTF Allocation in Year 3

EUTF Maintains Separate Status				EUTF Utilizes Selected ERS Vehicles - Maintains Passive Global Equity		
EUTF Class	**New EUTF Allocation (assuming Act 268 contributions)**	**Estimated Manager Fees**	**from-to**	**ERS Class**	**New EUTF Allocaiton (using ERS accounts)**	**Pro Forma Estimated Manager Fees**
US Equity	180,000,000	72,000		Global Equity	492,000,000	147,600
Intl Equity	312,000,000	374,400				
Fixed	180,000,000	126,000	→	Fixed Income	180,000,000	306,000
Covered Calls	120,000,000	600,000	→	Covered Calls	120,000,000	300,000
TIPS	60,000,000	258,000		TIPS	60,000,000	118,200
REITs	120,000,000	96,000	→	Core Real Estate	120,000,000	600,000
Commodities	120,000,000	960,000	→	Commodities	120,000,000	600,000
MicroCap	108,000,000	1,080,000		same as EUTF	108,000,000	1,080,000
Totals	**1,200,000,000**	**3,566,400**		**Totals**	**1,200,000,000**	**3,151,800**

Investment Cost Structure Analysis

	Est. Annual Cost	**% of Assets**	**Est. Annual Cost**	**% of Assets**	**Est. Savings**
Manager Fees (from above)	**3,566,400**	0.30%	**3,151,800**	0.26%	414,600
Consultant Fees	250,000	0.02%	200,000	0.02%	50,000
Fees to External Advisors	3,816,400	0.32%	3,351,800	0.28%	464,600
Asset Pool Safekeeping	330,000	0.03%	302,500	0.03%	27,500
Internal Resources	165,000	0.01%	-	0.00%	165,000
EUTF/ERS Cost Sharing	-	0.00%	280,000	0.02%	(280,000)
Estimated Total Costs	4,311,400	0.36%	3,934,300	0.33%	**377,100**

The assumption here is that it may take two-to-three years to fully adopt this structure when the EUTF-OPEB portfolio's asset base has grown substantially; but it might be

[17] This the proposed $125,000 annual custody flat fee proposed by BNY Mellon increased by 10% to account for potential unforeseen custody charges.

implemented sooner, depending on the ability to address potential procurement and legal hurdles associated with the consolidation. This Scenario also assumes that, after two-plus years of operating under a consolidated framework, the EUTF would be relying upon the ERS Investment Office to source managers in the real estate and commodities areas. A commingled fund investment in real estate would be the EUTF's first private market investment.

Based on utilization of the allocation and manager structure in Scenario 2, EUTF's projected annual savings are estimated to approximate $377,000 per year. Again, this Scenario assumes the State is making its Act 268 contributions into the EUTF and that the EUTF-OPEB portfolio grows to an actuarially-assumed level. Also note that as the EUTF-OPEB grows, the default position is to begin increasing investment staff levels if consolidation does not occur. The assumption above assumes a doubling of investment personnel (to one dedicated FTE, up from one-half an FTE currently).

<u>Custodial Account Structure</u>
Under this Scenario, the EUTF-OPEB portfolio is expected to have evolved from its current five institutional mutual fund structure to beginning to utilize separate accounts for three new mandates contemplated under the recently-approved strategic allocation policy. Consolidating into the ERS Investment Office is expected to make further use of the separate account format, but would result in fewer accounts (8 versus 7). The final expected outcome is that the EUTF would retain five separate accounts and two commingled fund accounts. The use of institutional mutual fund structures would discontinue (see Appendix). This scenario assumes the Scenario 1 process has already occurred. Due to the increased complexity, incremental annual custody costs would be an estimated $302,000, approximately $27,000 per year less than the new contract proposed by the Bank of Hawaii.[18]

The additional transfer activities would occur as normal operating procedures. In the case of the account transfers in the fixed income and covered calls, ERS already retains existing managers, so the transfer process only requires approving management contracts that mirror what already exists at the ERS and opening additional accounts under the new custody framework. Transfers within the core real estate and commodities areas would involve searching for new managers jointly on behalf of both the EUTF and ERS utilizing normal operating procedures. The search for and retention of new managers typically takes 90 to 120 days.

Scenario 2a

In Scenario 2a, EUTF utilizes the same manager and allocation structure in Scenario 2, with one addition: the EUTF elects to utilize active management in the Global Equity and Fixed Income classes, more fully reflecting the active/passive mix of managers that the ERS utilizes in these classes (see Figure 14, next page):

[18] The custody cost estimate applies the same logic as under Scenario 1. Custody costs are quoted fees + 10% to account for transaction-related costs, which both Bank of Hawaii and BNY/Mellon apply in their estimates.

Figure 14.

SCENARIO 2a: Scenario 2 Utilizing Additional ERS Active Managers in Year 3

EUTF Maintains Separate Status			**EUTF Utilizes Selected ERS Vehicles - Scenario 2 + More Active Mgmt.**			
EUTF Class	**New EUTF Allocation (assuming Act 268 contributions)**	**Estimated Manager Fees**	**ERS Class**	**New EUTF Allocation (using ERS accounts)**	**Pro Forma Estimated Manager Fees**	
US Equity	180,000,000	72,000	Active/Passive Global Equity	492,000,000	1,328,400	**Multiple Active & Passive Managers**
Intl Equity	312,000,000	374,400				
Fixed	180,000,000	126,000	Multi Mgr. Fixed	180,000,000	324,000	**Multiple Active Managers**
Covered Calls	120,000,000	600,000	Covered Calls	120,000,000	300,000	
TIPS	60,000,000	258,000	TIPS	60,000,000	118,200	
REITs	120,000,000	96,000	Core Real Estate	120,000,000	600,000	
Commodities	120,000,000	960,000	Commodities	120,000,000	600,000	
MicroCap	108,000,000	1,080,000	same as EUTF	108,000,000	1,080,000	
Totals	**1,200,000,000**	**3,566,400**	**Totals**	**1,200,000,000**	**4,350,600**	

Investment Cost Structure Analysis

	Est. Annual Cost	**% of Assets**	**Est. Annual Cost**	**% of Assets**	**Est. Savings**
Manager Fees (from above)	**3,566,400**	0.30%	**4,350,600**	0.36%	(784,200)
Consultant Fees	250,000	0.02%	200,000	0.02%	50,000
Fees to External Advisors	3,816,400	0.32%	4,550,600	0.38%	(734,200)
Asset Pool Safekeeping	330,000	0.03%	330,000	0.03%	-
Internal Resources	165,000	0.01%	-	0.00%	165,000
EUTF/ERS Cost Sharing	-	0.00%	280,000	0.02%	(280,000)
Estimated Total Costs	4,311,400	0.36%	5,160,600	0.43%	**(849,200)**

More fully adopting the active approach utilized by the ERS results in an $850,000 <u>*increase*</u> in costs versus what EUTF would incur to implement its portfolio on its own. Clearly, the dramatic difference here is that the EUTF currently relies upon passive management for virtually all of its major class (equity and fixed income) mandates. Shifting to a higher proportion of active management in these areas has a material impact upon manager fees, despite the expectation that the EUTF will be able to capture the lower institutional manager fee rates paid by the ERS.

<u>Custodial Account Structure</u>

From a custody perspective, this scenario would build upon the structure established under Scenario 2. Since this scenario assumes an increased use of specific ERS active managers, the EUTF would open a separate account for each manager utilized. Here, the assumption is that EUTF would utilize four of ERS's active public equity managers and an additional active fixed income manager. In total, the EUTF-OPEB portfolio would retain twelve custody accounts – ten separate accounts and two institutional commingled funds (see Appendix). These new accounts represent managers ERS already utilizes, so the transfer process only requires approving management contracts that mirror what already exists at the ERS and opening additional accounts under the new custody framework. Under this even more complex account structure (getting much closer to that utilized by the ERS), the savings in custody costs are eliminated.

Scenario 3

In Scenario 3, EUTF utilizes the same manager and allocation structure as in Scenario 2, but is modeled utilizing fee structures that EUTF would likely face if it operated on its own in the institutional marketplace (see Figure 15, next page):

Figure 15.

SCENARIO 3: Adoption of Addiitonal ERS Accounts Under New EUTF Allocation in Year 3 (ERS Fees vs. EUTF-only Fees)

EUTF Utilizes Vehicles Similar to ERS - Apply Standard Fees			EUTF Utilizes Selected ERS Vehicles - Maintains Passive Global Equity		
EUTF Class	**New EUTF Allocation (assuming Act 268 contributions)**	**Estimated Manager Fees**	**ERS Class**	**New EUTF Allocaiton (using ERS accounts)**	**Pro Forma Estimated Manager Fees**
Global Equity	492,000,000	265,680	Global Equity	492,000,000	147,600
Fixed Income	180,000,000	405,000	Fixed Income	180,000,000	306,000
Covered Calls	120,000,000	540,000	Covered Calls	120,000,000	300,000
TIPS	60,000,000	258,000	TIPS	60,000,000	118,200
Core Real Estate	120,000,000	900,000	Core Real Estate	120,000,000	600,000
Commodities	120,000,000	960,000	Commodities	120,000,000	600,000
MicroCap	108,000,000	1,080,000	MicroCap	108,000,000	1,080,000
Totals	**1,200,000,000**	**4,408,680**	**Totals**	**1,200,000,000**	**3,151,800**

Investment Cost Structure Analysis

	Est. Annual Cost	of Assets	Est. Annual Cost	% of Assets	Est. Savings
Manager Fees (from above)	**4,408,680**	0.37%	**3,151,800**	0.26%	1,256,880
Consultant Fees	250,000	0.02%	200,000	0.02%	50,000
Fees to External Advisors	4,658,680	0.39%	3,351,800	0.28%	1,306,880
Asset Pool Safekeeping	330,000	0.03%	302,500	0.03%	27,500
Internal Resources	165,000	0.01%	-	0.00%	165,000
EUTF/ERS Cost Sharing	-	0.00%	280,000	0.02%	(280,000)
Estimated Total Costs	5,153,680	0.43%	3,934,300	0.33%	**1,219,380**

To estimate institutional fees assuming EUTF would operate independently, standard fee structures were applied across several classes and then applied a modest fee discount assuming EUTF would be somewhat successful at negotiating lower costs. Under these assumptions, the matrix above indicates that EUTF could likely realize fee savings of approximately $1.1 million per year if they would be able to leverage ERS' fee structures to their benefit.

Managing Frictional Costs Associated with Portfolio Transitions

In a normal institutional investment setting, changing mandates and portfolios involves incurring potential one-time costs, normally termed "transition costs." Transition costs typically occur when institutions change from one manager to another or when rebalancing across accounts, managers, and/or asset classes. For transitioning large amounts of assets (e.g., more than $50 million), institutions typically engage in transition programs that seek to utilize specialist managers that focus solely on minimizing the costs associated moving large amounts of assets.

If a decision was made to consolidate EUTF-OPEB investment activities with those of the ERS Investment Office, based on the analyses above, the EUTF-OPEB investment portfolio would likely incur approximately $0 to $1,000,000 of one-time incremental transition costs. In fact, in Scenario 1, both Vanguard and Blackrock (EUTF's existing managers) have indicated they would utilize in-kind transfers, allowing transition costs for the purpose of this analysis to be effectively zero. Virtually all of the transition costs would be due to transitioning EUTF's portfolio to the more active accounts in Scenario 2a (keep in mind, Scenario 2a is very much an optional strategy). The bulk of these costs would be implicit in nature, i.e., during the transition the value of the transitioned assets would be diminished by the above amount as a result of moving the assets across the markets. This buying and selling of units in the market is where the market frictions occur. Strategies such as in-kind crossing help mitigate these costs (e.g., in-kind transfers of securities from one fund complex to another).

Summary of Consolidation Scenario Findings

The above analyses suggest that there may be marginal economic benefits associated with consolidating the EUTF's investment activities alongside/into the ERS Investment Office. To implement a consolidated framework, EUTF could also incur initial one-time transition costs. In summary, the estimated cost-benefits of making such a shift are detailed in Table C of Figure 11 and then simplified as follows:

Figure 16. Cost/Benefit Summary of EUTF/ERS Investment Office Consolidation

	$ Estimated Projected Cost	$ Estimated Projected Benefit
Year 1	(0 – 1,000,000)	186,000
Year 2*		282,000
Year 3		377,000
Year 4 and thereafter		375,000

*Year 2 is interpolated from Year 1 savings and Year 3 savings.

Assuming the consolidation effort would incur one-time embedded transition costs of approximately ($0 – $1,000,000) based on whether EUTF utilizes Scenario 2a), these costs would likely be recouped in less than one year. The estimated savings in Year 4 and beyond become less precise and will be impacted by EUTF's decisions to alter the EUTF-OPEB portfolio's strategic allocation and use of managers. In addition, as the EUTF-OPEB portfolio itself scales up over time, some of the benefits of associated with ERS's current larger scale would tend to decline because EUTF may be able to capture those benefits as its own entity. Interestingly, the point here is that EUTF's scale may eventually prove beneficial to the ERS. Over time, consolidating investment activities would likely double the economies of scale in the institutional investment marketplace for both agencies.[19] As noted elsewhere, in light of these estimated economic/savings benefits, it is likely that the ERS will be required to expend more time and effort providing services to the EUTF. While we attempted to quantify the economic impact of that resource impact through our EUTF-to-ERS cost sharing line item, we note the qualitative impact upon ERS' resources would also likely be material.

[19] For example, GRS estimates that the assets of the EUTF-OPEB portfolio will be approximately $12B by the end of 2029 (fifteen years from now). GRS also estimates the actuarial value of ERS's assets at that time to be about $35B. Would it be preferable for both ERS/EUTF to approach the investment marketplace as a $50B entity or as two smaller entities?

TASKS TO EFFECT INITIAL STAGES OF CONSOLIDATION FRAMEWORK

Assuming consolidation between the EUTF and ERS Investment Office is approved, a series of investment-related tasks that likely need to be executed in order for the consolidation to take effect is outlined below (see table).

Figure 17. Preliminary Outline of Tasks EUTF-OPEB/ERS Investment Office Consolidation

Consolidation Task	Main Responsibility
Develop/establish servicing agreement and/or legislation for ERS to provide investment services to EUTF	EUTF Staff/ERS Staff/Legal
Determine Custodian account structure/modify custodian servicing agreement(s)	EUTF Staff/ERS Staff/Legal/Custodian
Develop contract/procurement process for EUTF/ERS new managers	EUTF Staff/Legal
Negotiate new management agreements with Mellon Capital and Blackrock for initial EUTF/ERS mandates	ERS Staff/EUTF Staff/PCA
Adjust other existing manager agreements to account for change in custodian where needed	EUTF Staff/Legal
Provide EUTF verified portolio asset list to Custodian	EUTF Staff
Adjust EUTF Investment policy/guidelines	PCA
Determine ERS Investment Office reporting procedures into the EUTFInvestment Committee	EUTF Staff/ERS Staff/PCA
Establish account structure for receiving assets	Custodian
Ensure all stakeholders (EUTF, ERS, and PCA) have transparency into accounts	Custodian
Request and receive pre-trade analysis on x-fer of Vanguard to Mellon & Blackrock to Blackrock accounts	ERS Staff/PCA
Map and transfer EUTF assets into appropriate accounts	Custodian
Gain approval to conform Hawaii RS 87-24A with Hawaii RS 88-119	EUTF Staff
Prioritize future manager search activities to account for both ERS and EUTF	All Staff/PCA
Expand manager accounts, if needed	Custodian
Determine extent of additional transitions into existing ERS accounts, if needed	All Staff/PCA
Amend PCA contract to adjust EUTF services, if needed	EUTF Staff/PCA

As the list of tasks highlight, cooperation and collaboration among five groups (EUTF Staff, Legal Counsel, ERS Staff, Custodian, and general investment consultant) are required for various tasks. A key foundation to the entire process is the adjustment of the ERS custodial relationship to include the EUTF account structure and eliminate redundancies from having two custodians. Once the custody structure is in place, the key milestone in this process is the transferring of EUTF assets to the new account structure. An important objective of all these tasks, of course, is to leverage ERS's investment expertise to the benefit of the EUTF-OPEB portfolio. This means that policies, guidelines, and communications between and among appropriate EUTF and ERS staff will be critical, particularly in the early stages of the process.

APPENDIX

GRS EUTF Act 268 Contribution Projections

GRS ERS Actuarial Projections

PCA 2014 Capital Market Assumptions

EUTT-OPEB to ERS Account Mapping

ERS Legal Counsel Letter Re: EUTF/ERS Investment Consolidation

BNY Mellon Preliminary EUTF Custody Services Assumptions and Cost Estimates

Act 268

GRS EUTF Act 268 Contribution Projections

Minimum Contribution Required by ACT 268

Over the next 31 years, the additional cost of prefunding is $12.9 billion.
However, at the end of the prefunding period, the projected assets are $43.8 billion.

Fiscal Year Ending	Payroll	Actuarial Accrued Liability (AAL)	Beginning of Year Assets	Unfunded AAL (UAAL)	Funded Ratio	Annual Required Contribution	Actual Contribution	Contribution as % of Payroll	Benefit Payment Total	Benefits as % of Payroll	Additional Cost of Prefunding
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)
2014	$ 3,881,223,000	$ 11,477,633,000	$ 296,124,000	$ 11,181,509,000	2.6%	$ 925,814,000	$ 481,737,000	12.4%	$ 384,537,000	9.9%	$ 97,200,000
2015	3,996,787,000	12,187,041,000	414,052,000	11,772,989,000	3.4%	952,205,000	520,416,000	13.0%	412,469,000	10.3%	107,947,000
2016	4,123,137,000	12,922,295,000	554,760,000	12,367,535,000	4.3%	985,529,000	666,762,000	16.2%	454,252,000	11.0%	212,510,000
2017	4,256,271,000	13,673,316,000	813,541,000	12,859,775,000	5.9%	1,040,458,000	824,049,000	19.4%	499,438,000	11.7%	324,611,000
2018	4,396,561,000	14,438,601,000	1,206,461,000	13,232,140,000	8.4%	1,074,636,000	969,345,000	22.0%	548,186,000	12.5%	421,159,000
2019	4,542,595,000	15,216,077,000	1,726,814,000	13,489,263,000	11.3%	1,143,052,000	1,143,052,000	25.2%	599,770,000	13.2%	543,282,000
2020	4,695,955,000	16,004,459,000	2,409,988,000	13,594,471,000	15.1%	1,181,650,000	1,181,650,000	25.2%	654,240,000	13.9%	527,410,000
2021	4,855,793,000	16,802,236,000	3,124,555,000	13,677,681,000	18.6%	1,228,691,000	1,228,691,000	25.3%	710,742,000	14.6%	517,949,000
2022	5,021,783,000	17,608,827,000	3,879,352,000	13,729,475,000	22.0%	1,271,091,000	1,271,091,000	25.3%	769,248,000	15.3%	501,843,000
2023	5,193,927,000	18,423,526,000	4,670,315,000	13,753,211,000	25.3%	1,315,330,000	1,315,330,000	25.3%	824,056,000	15.9%	491,274,000
2024	5,370,780,000	19,251,514,000	5,505,705,000	13,745,809,000	28.6%	1,361,497,000	1,361,497,000	25.4%	873,958,000	16.3%	487,539,000
2025	5,553,058,000	20,099,644,000	6,395,707,000	13,703,937,000	31.8%	1,409,638,000	1,409,638,000	25.4%	924,468,000	16.6%	485,170,000
2026	5,740,742,000	20,969,569,000	7,345,556,000	13,624,013,000	35.0%	1,459,947,000	1,459,947,000	25.4%	975,326,000	17.0%	484,621,000
2027	5,934,186,000	21,863,439,000	8,361,327,000	13,502,112,000	38.2%	1,512,462,000	1,512,462,000	25.5%	1,026,680,000	17.3%	485,782,000
2028	6,133,458,000	22,783,427,000	9,449,405,000	13,334,022,000	41.5%	1,567,360,000	1,567,360,000	25.6%	1,078,508,000	17.6%	488,852,000
2029	6,338,941,000	23,732,044,000	10,616,826,000	13,115,218,000	44.7%	1,624,865,000	1,624,865,000	25.6%	1,163,088,000	18.3%	461,777,000
2030	6,551,484,000	24,678,724,000	11,837,943,000	12,840,781,000	48.0%	1,684,902,000	1,684,902,000	25.7%	1,219,822,000	18.6%	465,080,000
2031	6,770,474,000	25,653,359,000	13,147,958,000	12,505,401,000	51.3%	1,747,550,000	1,747,550,000	25.8%	1,276,623,000	18.9%	470,927,000
2032	6,996,600,000	26,659,051,000	14,555,727,000	12,103,324,000	54.6%	1,812,925,000	1,812,925,000	25.9%	1,334,803,000	19.1%	478,122,000
2033	7,229,803,000	27,697,876,000	16,069,485,000	11,628,391,000	58.0%	1,881,097,000	1,881,097,000	26.0%	1,394,155,000	19.3%	486,942,000
2034	7,468,941,000	28,772,242,000	17,698,335,000	11,073,907,000	61.5%	1,952,142,000	1,952,142,000	26.1%	1,453,288,000	19.5%	498,854,000
2035	7,715,315,000	29,886,227,000	19,453,530,000	10,432,697,000	65.1%	2,026,294,000	2,026,294,000	26.3%	1,511,145,000	19.6%	515,149,000
2036	7,969,888,000	31,045,455,000	21,348,457,000	9,696,998,000	68.8%	2,103,604,000	2,103,604,000	26.4%	1,567,869,000	19.7%	535,735,000
2037	8,232,714,000	32,255,775,000	23,397,334,000	8,858,441,000	72.5%	2,184,313,000	2,184,313,000	26.5%	1,625,897,000	19.7%	558,416,000
2038	8,504,657,000	33,521,093,000	25,613,108,000	7,907,985,000	76.4%	1,957,648,000	1,957,648,000	23.0%	1,685,503,000	19.8%	272,145,000
2039	8,786,975,000	34,845,338,000	27,687,696,000	7,157,642,000	79.5%	2,034,402,000	2,034,402,000	23.2%	1,745,869,000	19.9%	288,533,000
2040	9,079,112,000	36,233,563,000	29,924,466,000	6,309,097,000	82.6%	2,114,481,000	2,114,481,000	23.3%	1,807,281,000	19.9%	307,200,000
2041	9,381,664,000	37,690,988,000	32,337,132,000	5,353,856,000	85.8%	2,150,894,000	2,150,894,000	22.9%	1,870,175,000	19.9%	280,719,000
2042	9,694,981,000	39,222,828,000	34,891,276,000	4,331,552,000	89.0%	2,236,279,000	2,236,279,000	23.1%	1,934,404,000	20.0%	301,875,000
2043	10,019,537,000	40,834,820,000	37,646,105,000	3,188,715,000	92.2%	2,325,397,000	2,325,397,000	23.2%	2,000,424,000	20.0%	324,973,000
2044	10,355,642,000	42,532,814,000	40,617,679,000	1,915,135,000	95.5%	2,418,513,000	2,418,513,000	23.4%	2,068,364,000	20.0%	350,149,000
2045	10,704,417,000	44,323,061,000	43,823,322,000	499,739,000	98.9%	973,545,000	973,545,000	9.1%	2,138,511,000	20.0%	(1,164,966,000)
2046	11,065,984,000	46,211,970,000	45,685,214,000	526,756,000	98.9%	1,020,497,000	1,020,497,000	9.2%	2,211,481,000	20.0%	(1,190,984,000)

The projection includes liabilites for future employees.

The 2014 entry in Column (l) was not required by ACT 268. However, the County of Maui's FYE14 prefunding contributions impacted the County's FYE15 ARC and ACT 268 minimum.

Projection Results Based on June 30, 2013 Actuarial Valuation

Valuation as of June 30,	Employer Contribution Rate for Fiscal Year Following Valuation Date	Compensation (in Millions)	Employer Contributions (in Millions)	Actuarial Accrued Liability (AAL, in Millions)	Actuarial Value of Assets (AVA, in Millions)	Unfunded Actuarial Accrued Liability (UAAL, in Millions)	Funded Ratio
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
2013	16.77%	$ 3,885.9	$ 652	$ 21,244	$ 12,749	$ 8,495	60.0%
2014	17.32%	3,995.9	692	22,140	13,438	8,701	60.7%
2015	17.87%	4,098.0	732	23,034	14,156	8,878	61.5%
2016	17.87%	4,207.3	752	23,924	14,900	9,024	62.3%
2017	17.86%	4,326.2	773	24,808	15,649	9,159	63.1%
2018	17.86%	4,452.9	795	25,686	16,405	9,281	63.9%
2019	17.86%	4,588.4	819	26,558	17,171	9,387	64.7%
2020	17.85%	4,731.8	845	27,423	17,947	9,476	65.4%
2021	17.85%	4,883.6	872	28,281	18,738	9,543	66.3%
2022	17.84%	5,043.9	900	29,133	19,546	9,587	67.1%
2023	17.84%	5,213.0	930	29,978	20,374	9,604	68.0%
2024	17.83%	5,390.5	961	30,817	21,227	9,590	68.9%
2025	17.83%	5,576.1	994	31,649	22,108	9,541	69.9%
2026	17.82%	5,770.3	1,028	32,472	23,018	9,453	70.9%
2027	17.81%	5,973.9	1,064	33,286	23,964	9,322	72.0%
2028	17.81%	6,187.2	1,102	34,093	24,951	9,142	73.2%
2029	17.80%	6,411.2	1,141	34,893	25,986	8,907	74.5%
2030	17.80%	6,645.4	1,183	35,688	27,077	8,611	75.9%
2031	17.80%	6,890.4	1,226	36,482	28,233	8,248	77.4%
2032	17.79%	7,146.2	1,272	37,274	29,464	7,811	79.0%
2033	17.79%	7,413.3	1,319	38,069	30,778	7,290	80.8%
2034	17.79%	7,692.9	1,368	38,868	32,189	6,679	82.8%
2035	17.79%	7,985.2	1,420	39,677	33,710	5,967	85.0%
2036	17.78%	8,290.5	1,474	40,498	35,353	5,144	87.3%
2037	17.78%	8,609.7	1,531	41,334	37,135	4,200	89.8%
2038	17.78%	8,944.2	1,591	42,193	39,071	3,121	92.6%
2039	17.79%	9,293.5	1,653	43,077	41,181	1,896	95.6%
2040	17.79%	9,658.4	1,718	43,994	43,484	510	98.8%
2041	17.79%	10,039.1	1,786	44,950	46,002	(1,052)	102.3%
2042	17.79%	10,436.3	1,856	45,950	48,755	(2,806)	106.1%
2043	17.79%	10,850.3	1,930	47,002	51,771	(4,769)	110.1%

PCA 2014 Capital Market Assumptions

2014 Ten-Year Return, Risk, and Correlation Assumptions Last revision: 1/2014

Summary of Investment Class Assumptions

	Expected Arithmetic Average Nominal Annual Return	Expected Geometric[1] Compound Nominal Annual Return	Expected Risk of Nominal Returns (Annl. SD)	Cash	TIPS	CoreFxd	IntlBds	GlblBds	RealEst	RealRet	USEq	IntlEq	GlblEq	HIntlEq	PrivEq
Cash	2.25	2.25	1.00												
Treasury Infl. Protected Securities	3.50	3.30	6.00	0.20											
Domestic US Fixed Income	3.10	3.00	4.50	0.30	0.60										
International Fixed Income	3.10	2.60	10.00	-0.10	0.40	0.40									
Global Fixed Income	3.10	2.80	8.00	0.00	0.50	0.60	0.95								
Core Real Estate	6.25	5.90	9.00	0.30	0.00	0.00	-0.20	-0.20							
Real Return	6.00	5.70	8.00	0.30	0.60	0.30	0.00	0.00	0.25						
Domestic Equity	8.50	6.90	18.50	0.00	0.00	0.30	0.00	0.00	0.40	0.25					
International Equity	9.00	6.90	21.50	0.00	0.00	0.10	0.10	0.10	0.40	0.25	0.85				
Global Equity[2]	8.75	7.10	19.00	0.00	0.00	0.20	0.05	0.05	0.40	0.25	0.90	0.90			
Hedged International Equity	8.90	7.00	20.00	0.10	0.00	-0.10	-0.10	-0.10	0.50	0.35	0.90	0.90	0.90		
Private Equity/Venture Capital	11.75	8.70	26.00	0.00	0.00	0.00	0.00	0.00	0.40	0.25	0.90	0.80	0.85	0.90	
Inflation	2.75	2.75	1.50	0.50	0.50	-0.20	-0.10	-0.15	0.40	0.60	0.20	0.20	0.20	0.20	0.10

EUTF-OPEB to ERS Account Mapping by Account Type

SCENARIO 1: Initial Adoption - Years 1 & 2

EUTF Maintains Separate Status				EUTF Utilizes Selected ERS Vehicles		
EUTF Class	Account Type	**Current EUTF Asset Structure (using 6/30 MVs + July contribution)**	**from-to**	**ERS Class**	Account Type	**Current EUTF Asset Structure (using ERS accounts)**
US Equity	Inst. Mutual Fund	150,240,000	→	Global Equity	Commingled Fund	269,180,000
Intl Equity	Inst. Mutual Fund	118,940,000				
Fixed	Inst. Mutual Fund	93,900,000		Fixed Income	Inst. Mutual Fund	93,900,000
Covered Calls		-		Covered Calls		-
TIPS	Inst. Mutual Fund	106,420,000	→	TIPS	Separate Account	106,420,000
REITs	Inst. Mutual Fund	100,160,000		REITs	same as EUTF	100,160,000
Commodities		-		Commodities		-
MicroCap	Separate Account(s)	56,340,000		MicroCap	same as EUTF	56,340,000

Account Structures	**Nbr. of Accounts**	**Market Value**	**Account Structures**	**Nbr. of Accounts**	**Market Value**
Institutional Mutual Funds	5	569,660,000	Institutional Mutual Funds	2	194,060,000
Commingled Funds			Commingled Funds	1	269,180,000
Separate Accounts	1	56,340,000	Separate Accounts	2	162,760,000
Totals	**6**	**626,000,000**	**Totals**	**5**	**626,000,000**

SCENARIO 2: Adoption of Addiitonal ERS Accounts Under New EUTF Allocation in Year 3

EUTF Maintains Separate Status				EUTF Utilizes Selected ERS Vehicles - Maintains Passive Global Equity		
EUTF Class	Account Type	**New EUTF Allocation (using 6/30 MVs + July contribution)**	**from-to**	**ERS Class**	Account Type	**New EUTF Allocaiton (using ERS accounts)**
US Equity	Inst. Mutual Fund	165,000,000		Global Equity	Commingled Fund	451,000,000
Intl Equity	Inst. Mutual Fund	286,000,000				
Fixed	Inst. Mutual Fund	165,000,000	→	Fixed Income	Separate Account(s)	165,000,000
Covered Calls	Separate Account(s)	110,000,000	→	Covered Calls	Separate Account(s)	110,000,000
TIPS	Inst. Mutual Fund	55,000,000		TIPS	Separate Account	55,000,000
REITs	Inst. Mutual Fund	110,000,000	→	Core Real Estate	Commingled Fund	110,000,000
Commodities	Separate Account(s)	110,000,000	→	Commodities	Separate Account(s)	110,000,000
MicroCap	Separate Account(s)	99,000,000		same as EUTF	same as EUTF	99,000,000
Totals		**1,100,000,000**		**Totals**		**1,100,000,000**

Account Structures	**Nbr. of Accounts**	**Market Value**	**Account Structures**	**Nbr. of Accounts**	**Market Value**
Institutional Mutual Funds	5	781,000,000	Institutional Mutual Funds		
Commingled Funds			Commingled Funds	2	561,000,000
Separate Accounts	3	319,000,000	Separate Accounts	5	539,000,000
Totals	**8**	**1,100,000,000**	**Totals**	**7**	**1,100,000,000**

SCENARIO 2a: Scenario 2 Utilizing Additional ERS Active Managers in Year 3

EUTF Maintains Separate Status			EUTF Utilizes Selected ERS Vehicles - Scenario 2 + More Active Mgmt.		
EUTF Class	**Account Type**	**New EUTF Allocation (using 6/30 MVs + July contribution)**	**ERS Class**	**Account Type**	**New EUTF Allocation (using ERS accounts)**
US Equity	Inst. Mutual Fund	165,000,000	Active/Passive Global Equity	Commingled Fund + 4 Separate Accounts	451,000,000
Intl Equity	Inst. Mutual Fund	286,000,000			
Fixed	Inst. Mutual Fund	165,000,000	Multi Mgr. Fixed	2 Separate Accounts	165,000,000
Covered Calls	Separate Account(s)	110,000,000	Covered Calls	Separate Account(s)	110,000,000
TIPS	Inst. Mutual Fund	55,000,000	TIPS	Separate Account	55,000,000
REITs	Inst. Mutual Fund	110,000,000	Core Real Estate	Commingled Fund	110,000,000
Commodities	Separate Account(s)	110,000,000	Commodities	Separate Account(s)	110,000,000
MicroCap	Separate Account(s)	99,000,000	same as EUTF	same as EUTF	99,000,000
Totals		**1,100,000,000**	**Totals**		**1,100,000,000**

Account Structures	**Nbr. of Accounts**	**Market Value**	**Account Structures**	**Nbr. of Accounts**	**Market Value**
Institutional Mutual Funds	5	781,000,000	Institutional Mutual Funds		
Commingled Funds			Commingled Funds	2	361,000,000
Separate Accounts	3	319,000,000	Separate Accounts	10	739,000,000
Totals	**8**	**1,100,000,000**	**Totals**	**12**	**1,100,000,000**

NEIL ABERCROMBIE
GOVERNOR

DAVID M. LOUIE
ATTORNEY GENERAL

RUSSELL A. SUZUKI
FIRST DEPUTY ATTORNEY GENERAL

STATE OF HAWAII
DEPARTMENT OF THE ATTORNEY GENERAL
ADMINISTRATION DIVISION
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HONOLULU, HAWAII 96813
(808) 586-1500

June 19, 2014

Mr. Neil Rue
411 NW Park Avenue, Suite 401
Portland, OR 97209

Re: EUTF/ERS Investment Consolidation Study

Dear Mr. Rue:

This is in response to your inquiry as to whether the Employees' Retirement System of the State of Hawaii (the "ERS") and the Employer-Union Health Benefits Trust Fund ("EUTF") are allowed to "commingle their investment assets." The undersigned is one of the Deputy Attorneys General assigned to advise the ERS. Therefore, this response is solely with respect to the authority of the ERS.

We understand that your question arises out of a study that the Director of Finance is conducting, as required by Act 268, 2013 Session Laws of Hawaii, ("Act 268") to develop "an implementation plan [and proposed legislation] to execute the . . . [j]oint use of any investment information, advice, and services provided by fund managers retained by the board of trustees of the employees' retirement system with the board of trustees of the employer-union health benefits trust fund for the purpose of investing moneys contained in the separate trust fund established under section 87A-42, Hawaii Revised Statutes . . . ." *See*, Act 268 § 12.

For the reasons discussed below, we believe that the ERS may not commingle its investments assets with the EUTF, i.e., the investment assets of the ERS and the investment assets of the EUTF cannot be invested as a single pool of assets. This does not mean that there cannot be a vehicle that would permit joint investment by the ERS and the EUTF or that some form of investment cooperation between the ERS and the EUTF is precluded.

FACTUAL BACKGROUND

Employees' Retirement System

The ERS was established by statute as a "retirement system for the purpose of providing retirement allowances and other benefits for employees" of the State of Hawaii and its counties. Hawaii Revised Statutes ("HRS") § 88-22; *see also,* HRS § 88-21 for definition of "employee." Generally, ERS benefits are paid from four sources: contributions from employers; pick-up

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contributions from employers for employees in the two contributory plans; after-tax and other contributions/transfers by employees to purchase service credit; and earnings from investment of the contributions. HRS §§ 88-112, 88-113 and 88-114; citations to relevant definitions are intentionally omitted.

The ERS has the powers and privileges of a corporation. HRS § 88-22. The general administration and the responsibility for the proper administration of the ERS are vested in a board of trustees (the "ERS Board"). HRS § 88-22. The ERS Board is the trustee for the funds of the ERS and has the authority to "invest and reinvest such funds as authorized by [part II of HRS chapter 88] and by law from time to time provided." HRS § 88-110. The investments that the ERS is permitted to make are primarily described in HRS § 88-119.

The ERS is a tax-qualified governmental pension plan that meets the requirements of section 401(a) of the Internal Revenue Code (the "Code") and that is exempt from federal tax under section 501(a) of the Code.[1] In order to maintain its tax-qualified status, the ERS must comply with various federal tax rules, including the exclusive benefit rule in section 401(a)(2) of the Code and the prohibited transaction rules in section 503(b) of the Code.

The exclusive benefit rule prohibits "any part of . . . corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of . . . employees or their beneficiaries." Code § 401(a)(2). The exclusive benefit rule is codified in State law. HRS § 88-22.5(a)(1). In addition, HRS § 88-127 declares that all funds of the ERS "shall be held in trust by the board for the exclusive use and benefit of the [ERS] and for the members of the [ERS] and shall not be subject to appropriation for any other purpose whatsoever."

The prohibited transaction rules contain a number of specific prohibitions, including a prohibition against making "any part of [the ERS's] services available on a preferential basis" to the State of Hawaii or a corporation controlled by the State, and a general prohibition against the engagement by the ERS in any transaction that results in a "substantial diversion of its income or corpus" to the State of Hawaii or a corporation controlled by the State. Code § 503(b).

EUTF

The EUTF was established by statute as a trust fund "outside of the state treasury." HRS § 87A-30. The purpose of the EUTF is to provide health and other benefit plans to "employee-beneficiaries and dependent-beneficiaries." HRS § 87A-31. Generally, "employee-beneficiaries and dependent-beneficiaries" are active and retired employees of the State and its counties and certain of their dependents, family members and survivors. See HRS §§ 87A-1 and 87A-21.

[1] The ERS may also be exempt from federal tax under other provisions of the Code, such as section 115 of the Code. For purposes of this analysis, we focus on sections 401(a) and 501(a) of the Code, which provide favorable tax treatment for the ERS's members and beneficiaries.

The EUTF is administered by a board of trustees (the "EUTF Board'). HRS § 87A-15. The EUTF Board has established, pursuant to HRS § 87A-42, "a separate trust fund for the purpose of receiving employer contributions that will prefund other post-employment health and other benefit plan costs for retirees and their beneficiaries" (the "post-employment benefits trust"). The EUTF Board's investment authority with respect to the post-employment benefits trust is established by HRS § 87A-24(2), which incorporates by reference some, but not all, of the provisions of HRS § 88-119.[2]

Insofar as this letter is limited to the authority of the ERS, we do not address the status of the EUTF under federal tax law. However, we do not believe that the EUTF is subject to the same federal tax rules as the ERS. For example, we do not believe that the EUTF is a tax-qualified plan under section 401(a) of the Code or that it is exempt from federal tax under section 501(a) of the Code.

DISCUSSION

We believe that the exclusive benefit rule and the prohibited transactions rules prohibit the commingling of the ERS's and EUTF's investment assets as a single pool of investment assets.

The ERS and the EUTF are separate entities, with different governing boards, different funding statuses, different contribution rates, different funding requirements, different beneficiaries,[3] different cash flow needs, different tax statuses and different investment authority. In addition, the EUTF's post-retirement trust fund does not include beneficiary contributions; ERS's investment fund does. Under the relevant federal tax rules, the ERS Board must be able to make investment decisions for the exclusive benefit of its members and beneficiaries, without regard to what might or might not be appropriate for EUTF beneficiaries. In light of the differences between the ERS and the EUTF, the ERS Board may not be able to exercise its responsibility to act for the exclusive benefit of ERS members and beneficiaries if the ERS's investment assets were included in the same investment pool as the EUTF's investment assets. A simple pooling of the assets of the ERS and the EUTF for investment purposes would therefore threaten the tax qualification of the ERS.

We note, however, that to the extent that certain types of investments meet the needs of both the ERS and the EUTF, a joint investment vehicle (e.g., a group trust) that might include some of the ERS's assets may not necessarily be precluded, provided that the structure of such joint investment vehicle satisfies the federal tax qualification requirements to which the ERS is subject.

[2] The EUTF Board may "[i]nvest moneys in the same manner specified in section 88-119(1)(A), (1)(B), (1)(C), (2), (3), (4), (5), (6), and (7). " HRS § 87A-24.

[3] We understand that, although there is considerable overlap between the recipients of ERS benefits and the recipients of EUTF retiree or survivor benefits, not all recipients of ERS benefits receive EUTF retiree or survivor benefits and not all recipients of EUTF retiree or survivor benefits receive ERS benefits.

Please call me if you have any questions regarding this matter.

Very truly yours,

cc via email: Mr. Wesley K. Machida, Executive Director
Employees' Retirement System of the State of Hawaii
Ms. Sandra L. Yahiro, Administrator
Mr. Derek M. Mizuno, Assistant Administrator
Ms. Donna A. Tonaki, Finance Director
Employer-Union Health Benefits Trust Fund
Kyle K. Chang, Deputy Attorney General
Patricia T. Ohara, Supervising Deputy Attorney General

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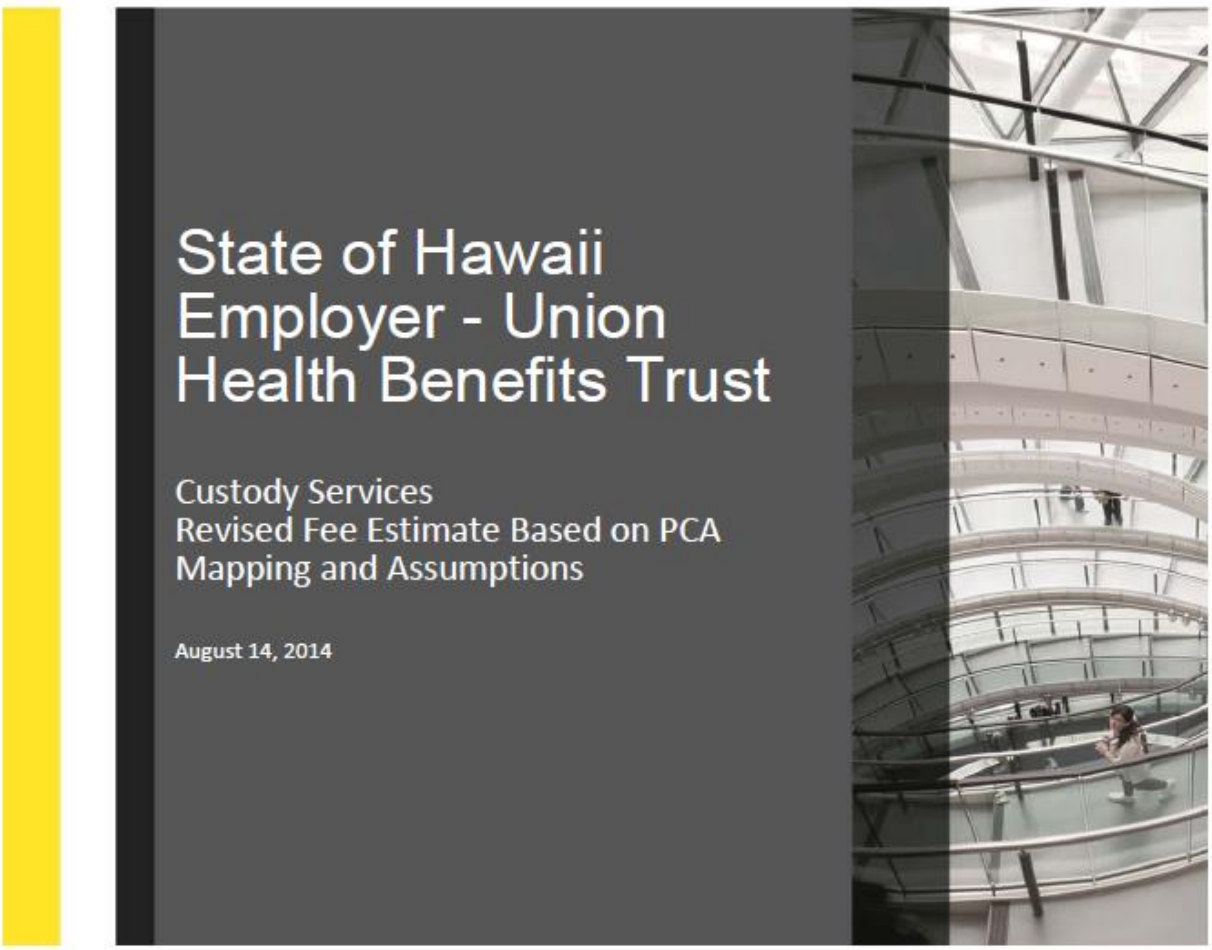
BNY Mellon Preliminary EUTF Custody Services Assumptions and Cost Estimates



Estimated Fees - Based on PCA Mapping and Assumptions - Revised August 14, :

	Assets	Annual Flat Fee
Administrative Fee (annual fees)		
Domestic		
Scenario 1 / Year(s) 1-2:		
US Assets Under Custody	$162,760,000	
US Assets Under Administration	$463,240,000	
Total Assets	$626,000,000	**$125,000**
Scenario 2 / Year(s) 3-4:		
US Assets Under Custody	$539,000,000	
US Assets Under Administration	$561,000,000	
Total Assets	$1,100,000,000	**$275,000**
OR		
Scenario 2A / Year(s) 3-4: (with Securities Lending)*		
US Assets Under Custody	$651,750,000	
US Assets Under Administration	$335,500,000	
Non US Assets Under Custody	$112,750,000	
Total Assets	$1,100,000,000	**$300,000**

***Comments:**
Scenario 2A: Annual Flat Fee $350,000 without Securities Lending

	Charge Per Item	Items	Charge Per Item x Item = Charge
Structural Charges (annual fees based on monthly valuation)			
Investment Pool Accounting			
Per Separate Account	$2,500.00	-	included in flat fee
Per Separate Account with any OTC Derivatives	$3,500.00	-	included in flat fee
Per Line Item (Commingled Fund /Mutual Fund)	$1,000.00	-	included in flat fee
Per Line Item (Real Estate, Hedge Fund, LP, Gift Processing)	$1,500.00	-	included in flat fee
Per Collateral Account	$2,000.00	-	included in flat fee
Per Cash Portfolio	$500.00	-	included in flat fee
Plan Accounting			
Per Plan Account	$1,000.00	-	included in flat fee
Per Unitization	$2,000.00	-	included in flat fee
Transaction Fee			
Domestic *			
Per Depository Eligible Transaction (includes purchases, sales, free receipts, free deliveries and maturities)	$7.00	-	included in flat fee
Per P&I, Payup/Paydown	$10.00	-	included in flat fee
Per Repo Transaction/Collateral	$15.00	-	included in flat fee
Per Leg of Futures, Options or Swap Transaction	$25.00	-	included in flat fee
Per Physical trades and Mutual Fund Transactions (Non NSCC)	$25.00	-	included in flat fee
Per Other Transaction (i.e. Not-in-bank)	$25.00	-	included in flat fee

* Cancels will be treated as a transaction and charged as such (if arising from action of client or investment manager)

Global Asset and Transaction Fees	Please see attached		included in flat fee

Other			
Per Incoming/Outgoing US Wire	$10.00	-	included in flat fee
Per Manual Check Request	$35.00	-	included in flat fee
Per Non USD Wire Transfer	$35.00	-	included in flat fee
Per Margin Variation	$12.00	-	included in flat fee
Per Third Party Securities Lending Agent (Applicable Transaction fees would also apply)	$100,000.00	-	-
Per F/X Not Executed At BNY Mellon	$15.00	-	-
Per Manual Transaction where automated solution exists (in addition to transaction fee)	$100.00	-	-
Proxy Services			
Per Ballot Issue	$5.00	-	included in flat fee
Per Incoming Vote	$10.00	-	included in flat fee
Per Manual Instruction	$25.00	-	included in flat fee
Any other Proxy Service Charges	Pass through + 10%		included in flat fee
Performance Measurement Fees (per account or consolidation/per year)			
Monthly Performance (Sector/Country Level)	$1,500.00	-	included in flat fee
Monthly Performance (Sector/Country Level) Per Consolidation	$750.00	-	included in flat fee
Monthly Performance (Security Level)	$2,000.00	-	-
Monthly Performance (Security Level) Per Consolidation	$1,000.00	-	-
Monthly Performance Per Single Line Item	$500.00	-	included in flat fee
Monthly Flash Performance (Incremental Fee)	$250.00	-	-
Monthly Flash Performance (Incremental) Per Consolidation	$125.00	-	-
Monthly After Tax Performance (Incremental Fee)	$500.00	-	-
Daily Performance (Incremental Fee)	$500.00	-	-
Daily Performance (Incremental Fee) Per Consolidation	$250.00	-	-
Daily Valuation Security Level Performance	$5,000.00	-	-
Monthly Non-lagged Performance			
1 -20 LPs and Hedge Funds	$5,000.00	-	-
21 - 50	$10,000.00	-	-
51- 100	$15,000.00	-	-
101 - 150	$20,000.00	-	-
> 150	Negotiated		
Monthly Blended Benchmarks (each)	$250.00	-	-
Global Analytics (per account or consolidation/per year)			
Monthly Analytics	$1,500.00	-	-
Monthly Analytics Consolidation	$750.00	-	-
Daily Analytics	$2,000.00	-	-
Daily Analytics Consolidation	$1,000.00	-	-
Monthly Look Through Analytics	$2,000.00	-	-
Monthly Trade Cost Measurement (Avg Price) - US Equity	$250.00	-	-
Monthly Trade Cost Measurement (Avg Price) - US Equity per Consolidation	$125.00	-	-
Trade Cost - VWAP	$500.00	-	-
Trade Cost - VWAP - per Consolidation	$250.00	-	-
Performance Attribution (per account/per year)			
Per Account	$1,500.00	-	-
Per Consolidation	$1,500.00	-	-
Total Fund	$5,000.00	-	-

Universe Comparison (annual fees)			
Universes (Per Portfolio - Minimum Fee $15,000 - Maximum Fee $30,000)	$1,000.00	-	-
Custom Universe	$10,000.00	-	-
Trust Universe Comparison Service (TUCS)*	$1,200.00	-	-
Investment Metrics Universe (annual flat fees)			
All Asset Classes (flat fee)	$20,000.00	-	-
US Equity, US Fixed Income or Global Equity (per set)	$11,000.00	-	-
International Fixed Income or Global Fixed Income (per set)	$8,000.00	-	-
US and Global Balanced Funds and TAA (per set)	$8,000.00	-	-
All REIT or Canadian Universes (per set)	$5,000.00	-	-

* Only available for subscribers of the monthly performance service (The $1,200 is a per account charge with a minimum subscription level of $15,000 and maximum fee of $50,000).

Compliance Monitoring (annual fee)			
Compliance Monitoring Service (per portfolio; minimum fee $25,000**)	$2,500.00	-	-
Monitoring requires subscription to Monthly and/or Daily Analysis			
Compliance Monitoring Implementation Fee (One Time Charge, Per portfolio)	$500.00	-	-

*** Minimum fee for monthly Compliance Monitoring Service when BNY Mellon monitors your plan guidelines. This fee varies depending upon plan guidelines and frequency.*

Monitoring requires subscription to monthly and/or daily analytics.

Private Equity Support (annual fees)			
Private i (Annual Fee Based on Commitment Level)	Custom Pricing	-	-
Data Management Per LP - Requires Subscription to Private i 5.0	$500.00	-	-
Capital Call Support (per LP)	$75.00	-	-
Private i Data Exchange	$10,000.00	-	-
Load Fee Per Hour for Private i	$195.00	-	-
PrivateInformant			
Fee per LP: 1-50	$480.00	-	-
51- 100	$460.00	-	-
101-200	$440.00	-	-
201-400	$400.00	-	-
401- Unlimited	$340.00	-	-
One-time Set-up Fee Per LP	$100.00	-	-
Fee to Load Historical Information Per LP Per Year of Historical Data Collected	Please see Private Informant tiered schedule above for backfill	-	-
Private Equity Look Through (using Private Informant)		-	
1- 50 LPs	$3,500.00	-	-
51 -100 LPs	$5,000.00	-	-
101 - 200 LPs	$7,500.00	-	-
Over 200 LPs	$10,000.00	-	-
Private iQ (Up to 5 Users, Add'l Users $2,500 each)	$17,250.00	-	-
Private Equity Vintage Year Benchmark Report	$5,000.00	-	-
Private i Front Office (Per User)			
1-3 Users	$2,041.00	-	-
4-10 Users	$1,717.00	-	-
11-19 Users	$1,394.00	-	-
Over 20 Users	$1,069.00	-	-

Private i Docs Module	20% of Private i fee above		
Document Management Support (Per LP)	$100.00	-	-
Unfunded Commitment Reconciliation (Per LP)	$150.00	-	-
Wilshire Services	Custom Pricing		
Enhanced global equity and fixed income attribution analysis; available on a daily or monthly reporting basis. Fee to be determined based on number of portfolios, report content, frequency of reporting and type of securities held.			
Advanced Risk Analysis	Custom Pricing		
Multiple asset class ex-ante risk services for institutional clients. Fee to be determined based on number of portfolios, report content, frequency of reporting and type of securities held.			
Data extract - automated or custom (annual fee)			
Minimum Fee	$20,000.00	-	-
Customized	Negotiated		
Vendor Costs (annual fee)			
Base fee for standard vendor	$2,500.00	-	-
Additional fee for premium vendor	$2,500.00	-	-
Access to individual vendor information may require additional licenses and/or fees depending on the specific data being requested.			
Independent Valuation (OTC Derivative Pricing)			
Fees to be determined depending on securities held & pricing frequency.	$350.00	-	-
Sub Fund Accounting (annual fees)			
0-500 Sub-Fund Accounts	$20,000.00	-	-
501-1,501 Sub-Fund Accounts Each	$25.00	-	-
1,502+ Sub-Fund Accounts Each	$10.00	-	-
Per Investment Fund	$1,000.00	-	-
Cash Investment Sweep			
STIF	TBD basis points		
For management of amounts invested in one or more short-term collective investment funds (STIF) maintained by BNY Mellon or its affiliate, a fee of TBD basis points per annum is charged on the STIF investment. The fee accrues daily and is netted against the income distributed from the STIF to accounts invested in the STIF each month. STIF fees, while quoted here, are independent of the Fee Schedule; BNY Mellon reserves the right to amend the fees, upon prior notice to the client.			
Dreyfus Cash Management Funds	See Prospectus		
Per 3rd Party Cash Management (STIF) Sweep (Waived for sweeps into BNY Mellon supported funds)	$100,000.00	-	-

Securities Lending

BNY Mellon has been asked to include securities lending with Scenario 2A, however, without actual assets to review in each portfolio for information expected to be put in place in year(s) 3-4; estimates are based on PCA Mapping and assumptions only. Based on discussions and assumptions it may be reasonably $250K - $300K in total ***gross*** securities lending income, assuming the same collateral guidelines as Hawaii ERS. However, the true estimates is unknown at this time.

Standard Regulatory Support Fee (Per legal entity/per year) The Standard Regulatory Support Fee partly covers BNY Mellon ongoing maintenance and investments in products, technology and servicing capabilities to keep up with the regulatory changes and to develop capabilities to provide additional materials and reporting support to clients. (for example, 1099 cost basis reporting, FAS 157, 5500 support, etc.).	$5,000.00		included in flat fee
Programming / Information Technology			
Custom Programming and Reporting Requirements - per hour rate	$150.00	-	-
TOTAL			**$0**

ACT 268

HOUSE OF REPRESENTATIVES
TWENTY-SEVENTH LEGISLATURE, 2013
STATE OF HAWAII

H.B. NO. 546 H.D. 2 S.D. 2 C.D. 1

A BILL FOR AN ACT

RELATING TO THE HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF HAWAII:

PART I

SECTION 1. The purpose of this part is to convene a task force in the department of budget and finance to examine the unfunded liability of the Hawaii employer-union health benefits trust fund.

SECTION 2. (a) There is established a Hawaii employer-union health benefits trust fund task force within the department of budget and finance for administrative purposes to consist of the following members:

(1) Two members from the house of representatives selected by the speaker of the house of representatives;

(2) Two members from the senate selected by the senate president;

(3) The director of finance, or the director's designee;

(4) One member from the Hawaii Council of Mayors;

(5) One member from the Hawaii State Association of Counties;

(6) Four members representing public sector unions who shall be invited to participate by the director of finance;

(7) One member representing public employee retirees who shall be invited to participate by the director of finance; and

(8) Four members representing the respective interests of the four counties who shall be selected by the governor.

The director of finance, or the director's designee, shall serve as the chairperson of the task force. The task force shall cease to exist on June 30, 2014.

(b) The members of the task force shall serve without compensation, but shall be reimbursed for expenses, including travel expenses, necessary for the performance of their duties. No member shall be made subject to chapter 84, Hawaii Revised Statutes, solely because of that member's participation as a member of that task force.

SECTION 3. The Hawaii employer-union health benefits trust fund task force shall examine the unfunded liability of the Hawaii employer-union health benefits trust fund (trust fund), including:

(1) The current and projected unfunded actuarial accrued liability of the trust fund;

(2) The availability of medical benefits plans other than plans that pay or reimburse medical services providers under a fee-for-service model;

(3) The costs and benefits of alternative medical benefits plans in relation to the medical benefits plans currently offered by the trust fund;

(4) An evaluation of the costs and process of transitioning from the current medical benefits plans to an alternative medical benefits plan, including recommended proposed legislation;

(5) An evaluation of the current structure of state and county public employers paying a percentage of health insurance policy premiums and providing recommendations for a benefits plan for prospective employees; and

(6) Any other matters that are relevant to gaining a full and meaningful understanding of the circumstance of the trust fund.

SECTION 4. The director of finance, in consultation with the task force, shall submit a report to the legislature, including findings, recommendations, and proposed legislation, no later than twenty days prior to the convening of the regular session of 2014.

SECTION 5. There is appropriated out of the general revenues of the State of Hawaii the sum of $185,750 or so much thereof as may be necessary for fiscal year 2013-2014 to support the work of the Hawaii employer-union health benefits trust fund task force, including necessary travel expenses for task force members who reside outside of Oahu and consulting services of persons knowledgeable in relevant issues.

The sum appropriated shall be expended by the department of budget and finance for the purposes of this part.

PART II

SECTION 6. Chapter 87A, Hawaii Revised Statutes, is amended by adding two new sections to part IV to be appropriately designated and to read as follows:

"**§87A-A Public employers; defined.** For the purposes of this part, "public employer" means a governmental entity whose employees', beneficiaries', and retirees' health benefits coverage is provided through the fund.

§87A-B Payment of public employer contributions to the other post-employment benefits trust. (a) Commencing with fiscal year 2018-2019, each of the counties and all other public employers shall make annual required contributions in accordance with section 87A-42 for the benefit of their retirees and beneficiaries.

(b) The board shall determine the annual required contribution owed by each public employer under this part for each fiscal year, beginning with fiscal year 2018-2019."

SECTION 7. Section 87A-24, Hawaii Revised Statutes, is amended to read as follows:

"**§87A-24 Other powers.** In addition to the power to administer the fund, the board may:

(1) Collect, receive, deposit, and withdraw money on behalf of the fund;

(2) Invest moneys in the same manner specified in section 88-119(1)(A), (1)(B), (1)(C), (2), (3), (4), (5), (6), and (7);

(3) Hold, purchase, sell, assign, transfer, or dispose of any securities or other investments of the fund, as well as the proceeds of those investments and any money belonging to the fund;

(4) Appoint, and at pleasure dismiss, an administrator and other fund staff. The administrator and staff shall

be exempt from chapter 76 and shall serve under and at the pleasure of the board;

(5) Make payments of periodic charges and pay for reasonable expenses incurred in carrying out the purposes of the fund;

(6) Contract for the performance of financial audits of the fund and claims audits of its insurance carriers;

(7) Retain auditors, actuaries, investment firms and managers, benefit plan consultants, or other professional advisors to carry out the purposes of this chapter[~~;~~], including the retaining of an actuary to determine the annual required public employer contribution for the separate trust fund established under section 87A-42;

(8) Establish health benefits plan and long-term care benefits plan rates that include administrative and other expenses necessary to effectuate the purposes of the fund; and

(9) Require any department, agency, or employee of the State or counties to furnish information to the board to carry out the purposes of this chapter."

SECTION 8. Section 87A-42, Hawaii Revised Statutes, is amended to read as follows:

"[~~[~~]§87A-42[~~]~~]] **Other post-employment benefits trust.** (a) Notwithstanding sections 87A-31 and 87A-31.5, the board, upon terms and conditions set by the board, [~~may~~] shall establish and administer a separate trust fund for the purpose of receiving employer contributions that will prefund other post-employment health and other benefit plan costs for retirees and their beneficiaries. [~~If a fund is established, it~~] The separate trust fund shall meet the requirements of the Government Accounting Standards Board regarding other post-employment benefits trusts. The board shall establish and maintain a separate account for each public employer within the separate trust fund to accept and account for each public employer's contributions. Employer contributions to the separate trust fund shall be irrevocable, all assets of the fund shall be dedicated exclusively to providing health and other benefits to retirees and their beneficiaries, and assets of the fund shall not be subject to appropriation for any other purpose and shall not be subject to claims by creditors of the employers or the board or plan administrator. The board's powers under section

87A-24 shall also apply to [~~any~~] the fund established pursuant to this section.

(b) Public employer contributions shall be paid into the fund in each fiscal year, and commencing with the 2018-2019 fiscal year, the amount of the annual public employer contribution shall be equal to the amount of the annual required contribution, as determined by an actuary retained by the board.

(c) In any fiscal year subsequent to the 2017-2018 fiscal year in which the state public employer's contributions into the fund are less than the amount of the annual required contribution, the amount that represents the excess of the annual required contribution over the state public employer's contributions shall be deposited into the appropriate account of the separate trust fund from a portion of all general excise tax revenues collected by the department of taxation under section 237-31.

If any general excise tax revenues are deposited into the separate trust fund in any fiscal year as a result of this subsection, the director of finance shall notify the legislature and governor whether the general fund expenditure ceiling for that fiscal year would have been exceeded if those revenues had been legislatively appropriated instead of deposited without appropriation into the trust fund. The notification shall be submitted within thirty days following the end of the applicable fiscal year.

(d) In any fiscal year subsequent to the 2017-2018 fiscal year in which a county public employer's contributions into the fund are less than the amount of the annual required contribution, the amount that represents the excess of the annual required contribution over the county public employer's contributions shall be deposited into the fund from a portion of all transient accommodations tax revenues collected by the department of taxation under section 237D-6.5(b)(3). The director of finance shall deduct the amount necessary to meet the county public employer's annual required contribution from the revenues derived under section 237D-6.5(b)(3) and transfer the amount to the board for deposit into the appropriate account of the separate trust fund.

(e) In any fiscal year subsequent to fiscal year 2017-2018 in which a public employer's contributions into the fund are less than the amount of the annual required contribution and the public employer is not entitled to transient accommodations tax revenues sufficient to satisfy the total amount of the annual required contribution, the public employer's contributions shall be deposited into the fund from portions of any other revenues collected on behalf of the public employer or held by the State. The director of finance shall deduct the amount necessary to meet the public employer's annual required contribution from any revenues collected on behalf of the public employer held by the State and transfer the amount to the board for deposit into the appropriate account of the separate trust fund.

(f) For the purposes of this section, "annual required contribution" means a public employer's required contribution to the trust fund established in this section that is sufficient to cover:

(1) The normal cost, which is the cost of other post-employment benefits attributable to the current year of service; and

(2) An amortization payment, which is a catch-up payment for past service costs to fund the unfunded actuarial accrued liability over the next thirty years."

SECTION 9. Section 237-31, Hawaii Revised Statutes, is amended to read as follows:

"§237-31 **Remittances.** All remittances of taxes imposed by this chapter shall be made by money, bank draft, check, cashier's check, money order, or certificate of deposit to the office of the department of taxation to which the return was transmitted. The department shall issue its receipts therefor to the taxpayer and shall pay the moneys into the state treasury as a state realization, to be kept and accounted for as provided by law; provided that:

(1) The sum from all general excise tax revenues realized by the State that represents the difference between $45,000,000 and the proceeds from the sale of any general obligation bonds authorized for that fiscal year for the purposes of the state educational facilities improvement special fund shall be deposited in the state treasury in each fiscal year to the credit of the state educational facilities improvement special fund;

(2) A sum, not to exceed $5,000,000, from all general excise tax revenues realized by the State shall be deposited in the state treasury in each fiscal year to the credit of the compound interest bond reserve fund; [~~and~~]

(3) A sum from all general excise tax revenues realized by the State that is equal to one-half of the total amount of funds appropriated or transferred out of the

hurricane reserve trust fund under sections 4 and 5 of Act 62, Session Laws of Hawaii 2011, shall be deposited into the hurricane reserve trust fund in fiscal year 2013-2014 and in fiscal year 2014-2015; provided that the deposit required in each fiscal year shall be made by October 1 of that fiscal year[~~.~~]; and

(4) Commencing with fiscal year 2018-2019, a sum from all general excise tax revenues realized by the State that represents the difference between the state public employer's annual required contribution for the separate trust fund established under section 87A-42 and the amount of the state public employer's contributions into that trust fund shall be deposited to the credit of the State's annual required contribution into that trust fund in each fiscal year, as provided in section 87A-42."

SECTION 10. Section 237D-6.5, Hawaii Revised Statutes, is amended by amending subsection (b) to read as follows:

"(b) Revenues collected under this chapter, except for revenues collected under section 237D-2(b), shall be distributed as follows, with the excess revenues to be deposited into the general fund:

(1) 17.3 per cent of the revenues collected under this chapter shall be deposited into the convention center enterprise special fund established under section 201B-8; provided that beginning January 1, 2002, if the amount of the revenue collected under this paragraph exceeds $33,000,000 in any fiscal year, revenues collected in excess of $33,000,000 shall be deposited into the general fund;

(2) 34.2 per cent of the revenues collected under this chapter shall be deposited into the tourism special fund established under section 201B-11 for tourism promotion and visitor industry research; provided that for any period beginning on July 1, 2012, and ending on June 30, 2015, no more than $71,000,000 per fiscal year shall be deposited into the tourism special fund established under section 201B-11; provided further that beginning on July 1, 2012, and ending on June 30, 2015, $2,000,000 shall be expended from the tourism special fund for development and implementation of initiatives to take advantage of expanded visa programs and increased travel opportunities for international visitors to Hawaii; and provided further

that beginning on July 1, 2002, of the first $1,000,000 in revenues deposited:

(A) Ninety per cent shall be deposited into the state parks special fund established in section 184-3.4; and

(B) Ten per cent shall be deposited into the special land and development fund established in section 171-19 for the Hawaii statewide trail and access program;

provided that of the 34.2 per cent, 0.5 per cent shall be transferred to a sub-account in the tourism special fund to provide funding for a safety and security budget, in accordance with the Hawaii tourism strategic plan 2005-2015; provided further that of the revenues remaining in the tourism special fund after revenues have been deposited as provided in this paragraph and except for any sum authorized by the legislature for expenditure from revenues subject to this paragraph, beginning July 1, 2007, funds shall be deposited into the tourism emergency trust fund, established in section 201B-10, in a manner sufficient to maintain a fund balance of $5,000,000 in the tourism emergency trust fund; and

(3) 44.8 per cent of the revenues collected under this chapter shall be transferred as follows: Kauai county shall receive 14.5 per cent, Hawaii county shall receive 18.6 per cent, city and county of Honolulu shall receive 44.1 per cent, and Maui county shall receive 22.8 per cent; provided that for any period beginning on July 1, 2011, and ending on June 30, 2015, the total amount transferred to the counties shall not exceed $93,000,000 per fiscal year[~~.~~]; provided that commencing with fiscal year 2018-2019, a sum that represents the difference between a county public employer's annual required contribution for the separate trust fund established under section 87A-42 and the amount of the county public employer's contributions into that trust fund shall be retained by the state director of finance and deposited to the credit of the county public employer's annual required contribution into that trust fund in each fiscal year, as provided in section 87A-42, if the respective county fails to remit the total amount of the county's

required annual contributions, as required under section 87A-B.

Revenues collected under section 237D-2(b) shall be deposited into the general fund. All transient accommodations taxes shall be paid into the state treasury each month within ten days after collection and shall be kept by the state director of finance in special accounts for distribution as provided in this subsection.

As used in this subsection, "fiscal year" means the twelve-month period beginning on July 1 of a calendar year and ending on June 30 of the following calendar year."

SECTION 11. Notwithstanding the amount of a public employer annual required contribution determined in any fiscal year by an actuary retained by the board for this purpose, for the five-year fiscal period from 2014-2015 to 2018-2019, public employer contributions into the separate trust fund established under section 87A-42, Hawaii Revised Statutes, shall be at the specified percentages of the respective annual required contributions, as follows:

	Fiscal Year	Annual Required Contribution
(1)	2014-2015	Twenty per cent;
(2)	2015-2016	Forty per cent;

(3) 2016-2017 Sixty per cent;

(4) 2017-2018 Eighty per cent; and

(5) 2018-2019 One hundred per cent.

SECTION 12. Not less than twenty days prior to the convening of the regular session of 2015, the director of finance, in order to maximize the efficient use of resources and public funds, shall submit an implementation plan and any proposed legislation to the legislature to execute the following:

(1) Joint use of any investment information, advice, and services provided by fund managers retained by the board of trustees of the employees' retirement system with the board of trustees of the employer-union health benefits trust fund for the purpose of investing moneys contained in the separate trust fund established under section 87A-42, Hawaii Revised Statutes; and

(2) Procedures to accept and deposit employer contributions from county public employers into the separate trust fund established under section 87A-42, Hawaii Revised Statutes.

SECTION 13. There is appropriated out of the general revenues of the State of Hawaii the sum of $500,000 or so much thereof as may be necessary for fiscal year 2013-2014 and the same sum or so much thereof as may be necessary for fiscal year 2014-2015 for the department of budget and finance to conduct a study and develop an implementation plan to have both the employer-union health benefits trust fund and the employees' retirement system jointly share investment information and services.

The sums appropriated shall be expended by the department of budget and finance for the purposes of this Act.

SECTION 14. In codifying the new sections added by section 6 of this Act, the revisor of statutes shall substitute appropriate section numbers for the letters used in designating the new sections in this Act.

SECTION 15. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

SECTION 16. This Act shall take effect on July 1, 2013; provided that the amendments made to section 237D-6.5, Hawaii Revised Statutes, in section 10 of this Act shall not be repealed when section 237D-6.5, Hawaii Revised Statutes, is repealed and reenacted on June 30, 2015, pursuant to Act 61, Session Laws of Hawaii 2009, and Act 103, Session Laws of Hawaii 2011.

Report Title:
Hawaii Employer-union Health Benefits Trust Fund; Task Force; Annual Required Contribution; OPEB

Description:
Establishes the Hawaii employer-union health benefits trust fund (EUTF) task force to examine the unfunded liability of the EUTF. Requires the EUTF to establish a separate trust fund for public employer contributions with separate accounts for each public employer. Requires the annual public employer contribution to be equal to the amount determined by an actuary commencing with FY 2018-2019. Requires the use of a portion of the general excise tax revenues to supplement deficient state public employer contribution amounts commencing with FY 2018-2019. Requires the use of a portion of the transient accommodations tax revenues to supplement deficient county public employer contribution amounts commencing with FY 2018-2019. Establishes a schedule to phase-in the annual required state public employer contribution requirement. Requires the director of finance to report to the legislature on an implementation plan to have both the EUTF and the ERS jointly sharing investment information and services for the benefit of the trust fund and to establish disbursement channels for county public employer contributions into the trust fund. Makes appropriations. (CD1)

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