State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

Hammond Room – Centennial Hall
101 Egan Drive
Juneau, Alaska

February 17, 2016

ATTENDANCE

Committee Present:	Martin Pihl, *chair* Kristen Erchinger Gayle Harbo
Committee Absent:	None

Department of Revenue Staff Present:
Pamela Leary (Treasury Division director)
Gary Bader (chief investment officer)
Bob Mitchell (deputy chief investment officer)
Scott Jones (state comptroller)
Judy Hall (board liaison)
James McKnight (senior compliance officer)

Department of Administration Staff Present:
Commissioner Sheldon Fisher
John Boucher (deputy commissioner)
Jim Puckett (chief operations officer, Retirement & Benefits Division)
Kevin Worley (chief finance officer, Retirement & Benefits Division)
Melanie Helmick (senior audit and review analyst, Retirement & Benefits Division) *on-line*
Nimeri Denis (audit and review analyst, Retirement & Benefits Division) *on-line*

Others Present:
Mike Hayhurst (KPMG) *on-line*
Melissa Beedle (KPMG) *on-line*
ARMB trustee Sam Trivette
ARMB trustee Sandi Ryan
Joy Wilkinson (Office of Management & Budget)

CALL TO ORDER
CHAIR PIHL called the meeting to order at 11:00 a.m.

ROLL CALL
All three committee members were present.

PUBLIC MEETING NOTICE
MS. HALL confirmed that public meeting notice requirements had been met.

APPROVAL OF AGENDA
MS. HARBO moved to approve the agenda and MS. ERCHINGER seconded. The agenda was approved without objection.

APPROVAL OF MINUTES – December 2, 2015
MS. HARBO moved to approve the minutes of the December 2, 2015 meeting. MS. ERCHINGER seconded.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
There were no public appearances, and MS. HALL reported that there were no communications to the Audit Committee.

REPORTS

A. Update Employer Audit Program
Chief operations officer of the Division of Retirement and Benefits, JIM PUCKETT, referred to the summary report dated February 5, 2016 *(included in the meeting packet and on file at the ARMB office)*. He reported that Melanie Helmick hit the ground running. At the beginning of the new fiscal year, she completed the audits that had been started toward the end of FY2015. She also recruited for somebody to take her former position, and has been updating the processes and procedures for the employer audit team. With the change in personnel, it seemed the ideal time to make sure that everything they are doing is up to the standards in the GOA Yellow Book.

MR. PUCKETT gave a brief background on Nimeri Denis, who joined the Audit Unit at the end of October. He said a summary of the employer audits that the team has completed this year was included in the report, as well as a list of audits that are in progress. Ms. Helmick and Mr. Denis are in Anchorage this week conducting a couple of audits. They made a trip to Barrow and completed field audits for some of the employers on the North Slope. They also did an audit on the University of Alaska system statewide, which they are still wrapping up. That encompassed a universe of almost 12,000 employees on which the team did their analysis, which was quite an undertaking. The audit of the university system has been a relatively clean audit so far: major topics found are temporary employees, rehired retirees, and some social security issues that are not related to the retirement plan.

MS. HARBO remarked that probably 50% or more of the University's teaching faculty are now adjuncts. She asked how an audit treats these faculty members, who will not have any retirement benefits.

MR. PUCKETT said that because of the high number of adjunct people, the audit team takes a closer look at any red flag that comes up in the screening to confirm that people are indeed a temporary and not eligible for the benefits in the retirement system.

MS. HARBO asked if the Division of Retirement and Benefits (DRB) knew how many of the 12,000 university employees were under PERS (Public Employees' Retirement System) or TRS (Teachers' Retirement System).

MELANIE HELMICK replied that she could provide that number but did not have it at hand. She added that 800 of the adjunct employees are rehired retirees.

CHAIR PIHL asked if that would be the reason for the substantial drop in the University's reported payroll. He noticed that it gets the base year 2008 billing amount, and that is probably all somewhat related. So at least to the extent of meeting the base year, the University is paying into the retirement system on that basis.

MR. PUCKETT said as far as he knew. He added that DRB is aware that the number of adjuncts has increased, so when the audit team created a database to do the screening they included items to pay particular attention to that. However, that practice is something they do for any employer audit: if there are past issues they check to see those have been fixed, or if the audit team hears any recent news they will look for what they found out.

Responding to Ms. Harbo, MR. PUCKETT said he imagined that some of the adjuncts are not in a retirement plan if they are in what is considered a temporary position.

CHAIR PIHL stated that, to the extent that the University has replaced people that were in the PERS or TRS systems with adjuncts, the way the base year billing applies, the University is contributing for those employees that have gone from being in the system to being out.

MR. PUCKETT said he assumed the University was meeting the 2008 salary floor threshold.

MS. ERCHINGER observed that if 800 adjuncts are rehired retirees, it seemed very unlikely that those are temporary positions. She asked how the audit team determined that an adjunct was not really temporary because they were coming back year after year.

MR. PUCKETT said one screening is to check how many consecutive years a person is in a position. A misclassification would show up in an audit finding, and if a contribution should be coming in, then DRB would ask for it. It is an issue the audit team is aware of, and they are working on it diligently.

Continuing with his report, MR. PUCKETT said there are 23 audits scheduled for the remainder of the fiscal year. That does not mean the auditors will get to all of them, because it depends on some of the work that is already in the pipeline. He said the three most common issues arising from the employer audits so far this fiscal year are temporary, casual or on-call employees; rehired retirees; and seasonal employees.

MR. PUCKETT told committee members that he would continue providing them with the shorter updates to keep them abreast of the employer audits.

Addressing seasonal employees, MS. ERCHINGER asked if the division gives advice to a city where it sees that this problem exists, when this city had the ability to exempt seasonal employees from participation in PERS, and where their legislative body has to make that definition. She further asked if DRB has any other options if a city is not properly paying for those employees.

MR. PUCKETT replied that an employer can exclude a crew, if their governing board approves a change to their participation agreement.

MS. ERCHINGER said seasonal employees could be either abused as a way for the employer to avoid paying benefits for them, or the employer really believes these people are seasonal and does not believe they are doing anything wrong. It depends on the perspective whether the employer is doing anything wrong, because the State defines what seasonal employees are, but the employers can also opt those folks out. It seemed that, if there is a large misunderstanding, one way for the employer to deal with it is to just opt those seasonal folks out, if they are not paying for them anyway and they do not want to pay for them. She asked if DRB has other ways for getting compliance on those issues.

MR. PUCKETT said that if the employer is willing to go ahead and make the change in their participation agreement to exclude seasonal employees, that is one way of complying. If the employer wants to keep calling employees seasonal when they fit the statutory definition of it, then they have to pay contributions for them. That is the next step that the division would go for.

CHAIR PIHL asked about the state plan with respect to employers that are not reporting and paying, and some of them unable to pay. He suggested looking at bringing the base year 2008 up to a more current date. He understood the Department of Administration was looking at termination studies. Some municipalities have shrunk and need some relief in that area.

KEVIN WORLEY, chief finance officer in the Division of Retirement and Benefits, stated that there is a bill in the legislature to deal with population decreases of 25% or more. It is referred to as the Galena bill because that community lost the air force base. There are currently five communities within PERS that meet the 25% population loss criteria, with Galena being the largest of that group. The bill states that, if a community meets that criteria, their base floor would shift from the 2008 floor, and the salary that was in effect at 2010 would become the new floor. In Galena's case, if the bill passes, he thought that provision would wipe out much of what they owe. Two other communities could wind up with credits.

CHAIR PIHL asked if the State had a position of supporting or resisting the Galena bill.

COMMISSIONER FISHER said he thought the State was on the record as believing that some reform on the termination studies is appropriate.

B. Updates: Legislation re Employer Compliance, GASB 68, and DRB Audit Staff

CHAIR PIHL asked if there was any legislation to strengthen DRB's ability to enforce employer compliance and get the money coming in.

Deputy commissioner JOHN BOUCHER responded that there is no active legislation, and the department does not have any plans to seek legislative remedies. He believes that the efforts of Mr. Puckett and his team have increased the frequency of employer audits. That is where the focus has been in the last fiscal year.

MR. WORLEY related that former deputy commissioner Mike Barnhill had gone on record as saying that he had been informed that the department already has legislation in statute about being able to garnish other state money that is available. He added that, as reported at a prior meeting, the opportunities to do that are quite slim at this juncture.

CHAIR PIHL remarked that the committee's question is based on the ARMB's interest in the funding of the retirement systems.

MS. ERCHINGER said she understood the dilemma the State was in, in that regard. However, she hoped that for the employers who are not paying that the State at least could prioritize that the contribution that the employee is paying to the employer gets to the retirement funds. She believes it rises to the level of fraud if those contributions are not sent in. Some employers are very small and have a lot of staff turnover, so they may not understand the full legal implications of what they are doing to their employees and that they are essentially stealing their employees' money and keeping it. If those employers could at least forward those contributions so that the employee's time is being credited, whether or not the employer is contributing, that addresses a major component of the issue.

MR. PUCKETT stated that the division sent an auditor on a specific trip to visit some of those employers that had quit contributing, to see if there was any evidence of that type of activity happening. The employers cooperated and provided the information that was requested. The auditor did not find any evidence that employers (in that particular group on the delinquent list) were holding the contributions that the employees were making.

MS. ERCHINGER asked if staff could let the committee know which employers were audited for that issue.

COMMISSIONER FISHER asked if DRB learned whether the employers were representing to their employees, one way or the other, whether the employees are participating in PERS.

MR. PUCKETT replied that the auditor did not ask for any of the employees. The group that was visited has not had any employees for a number of years.

MR. BOUCHER asked if there were written reports on those auditor visits. MR. PUCKETT said he would check, because he was not sure if it reached the point of final audit reports on it. MR. BOUCHER said he was interested in a summary report of the available documentation to help him understand.

MS. ERCHINGER wondered, if an employer is not collecting contributions from their employees and not making employer contributions either, if there is an obligation to notify those employees about that. She raised this in light of talk at another committee meeting about making sure to provide good opportunities for plan participants to invest wisely so they have money available for retirement. Is there some obligation, as the plan, to at least inform those employees that their employer is legally a participant in a retirement plan and is not collecting contributions or paying contributions on their behalf?

MR. PUCKETT said he understood her concern – the employers on the delinquent list that the auditor visited had not reported for a good number of years. The only way DRB would know who the employees were is if the employer had submitted a payroll, and these employers had not submitted anything. The challenge would be finding those employees.

COMMISSONER FISHER suggested that the department come back with a better description of what is known, and perhaps even a legal view of what the responsibility is with respect to this subset of employers.

MS. ERCHINGER clarified that she was looking at the issue from the angle of the plan and not the State and DRB dealing with the employers – therefore, the knowledge that the ARMB trustees have that those people are not being represented. She appreciated the commissioner's offer to check up on it, and she supposed that the legal question would be not only what responsibility the State has, if any, but also the responsibility of ARMB trustees, in terms of their obligations to the plan participants.

MR. WORLEY reported that the City of Nenana was an employer on the delinquent list at the last meeting. An assembly member asked that a letter be sent to the assembly, which he did, indicating how many payrolls they were behind and how much money was owed. The assembly members had been told that everything was fine and were not aware of how far behind they were. It was a shock to them to learn that Nenana was basically two years behind in payroll submissions, employee money was not contributed, and employer money was not contributed. He said a member also contacted him, who was concerned that he wanted to retire in about a year, and now two years of payroll contributions have not been submitted. That member is working with the city.

CHAIR PIHL commented that at least an audit program exists in Alaska. He understands that many states do not have one. He said next on the agenda was an update on GASB 68.

MR. BOUCHER reported that, at the encouragement of the Alaska Municipal League, a subcommittee of financial officers was formed as an education effort to understand how the existing unfunded pension liability allocation works. The subcommittee also wishes to talk about a process for the next allocation. They have already discussed what could potentially "whipsaw" municipal books in the next cycle because of the large state contribution to PERS. They want to look at an alternate way to allocate, and there are really only two options: looking retrospectively or looking forward. The education will be on the merits of both those options. Hopefully, once the group understands what the alternatives are, they can provide feedback on what would be the best path forward for the next allocation. He advised that a consistent methodology will have to be settled upon. The conversations have been productive, and the next meeting of this group is the week of February 29.

COMMISSIONER FISHER stated that the department was not coming to this discussion with an agenda or a result that it is trying to drive the process towards. The department wants to learn and understand and receive input from this group of finance officers.

CHAIR PIHL said the committee's questions come from the members' role as ARMB trustees, and the trustees are responsible for the funding of the retirement systems. He asked how this tracks with the State's position to disclaim liability for state assistance, and what the State's position is going forward with respect to state assistance.

COMMISSIONER FISHER said he guessed the State's position with respect to state assistance is that as a legal matter it has been described in the footnote to the CAFR (comprehensive annual financial report), when the net pension liability was added onto the balance sheet, that the State as a constitutional matter believes that past legislators cannot bind future legislators, so this is always subject to appropriation. He said the governor has been quite clear that he thinks it is critical to have healthy communities that have healthy municipalities, that it is a joint responsibility between the State and municipalities to provide for the needs of Alaskans. His impression is that this administration is more committed than perhaps an administration has been for some time to ensuring that we have healthy communities and healthy municipalities. So there is not a desire or effort on the part of the administration to diminish the funding of those liabilities, to the point that the administration put forward the idea to fulfill it through a pension obligation bond, which would result in a fairly material infusion of cash into the fund in an ongoing payment responsibility on the part of the State. He feels like the administration is committed to this. He viewed that as one is a policy matter and one is a legal matter, and he viewed them slightly differently.

In answer to the question about the way the liability is calculated and the State's position on it, COMMISSIONER FISHER said he did not really see a connection. He viewed them as independent discussions. He agreed that the Chair and Ms. Erchinger raised these issues in the Fairbanks meetings, and the department does not want to make a decision independent from what the finance officers of the municipalities want to see happen. So the department is trying to engage and educate them, get some feedback from them, and be responsive to the needs of the municipalities.

CHAIR PIHL remarked that he personally believes we are headed down a road that is going to be extremely rocky and difficult, and he is afraid where it is going to lead, in terms of the security of benefits for employees that the ARMB is charged with making sure funding is there. He added that he has been trying to help people understand how the allocations have worked. It started with $176 million of state assistance contributions to PERS pensions, which is an allocation of something in excess of $300 million. He finds no relationship of that allocation to the unfunded liability balance or the normal cost accruing or the accrued liability that exists. It seems to be arbitrary. However, that is the allocation that occurred, and that is the number for state assistance used in the allocation. The number used for employer contributions is $204 million, and he has yet to find anybody that understands how that number was developed off their payroll. The allocations made of all the contributions coming into the system over time have resulted in an unfunded liability balance that was 60% pension and 40% healthcare to in 2014 being 83%/17% and used in the allocation. If that ratio in 2014 were something nearer to relative unfunded liability balance or relative normal cost accruing or relative accrued liability, in the allocation that was made there would be at least $1.5 billion, and maybe $2 billion, less in pension liability that GASB 68 requires be allocated to employers. So the pension liability was $5.2 billion and, unfortunately, 62% of that liability goes to the State itself, with the rest being allocated to all the municipalities.

COMMISSIONER FISHER stated that he wanted to walk through each step that Chair Pihl just described so he understood it all.

CHAIR PIHL said he would give the commissioner a work sheet of the numbers.

MS. ERCHINGER mentioned that the topic was probably something for the Actuarial Committee to look at because it has to do with the methodology used for allocating the state assistance between pension and healthcare. Regarding GASB 68, she asked Mr. Worley where they were in terms of the 9/30 fiscal year-end preparation, as well as for the 12/31 fiscal year-end employers.

MR. WORLEY replied that they have been meeting with KPMG and Buck Consultants by telephone about every two to three weeks. Buck has been working on the valuation reports as well, so that delayed things about a week or two. He anticipated seeing some reports on Friday this week. At that meeting, they will also be talking about a timeline for the 9/30 and the 12/31 employers.

MIKE HAYHURST of KPMG stated that all the discussions have been around the question of how to neutralize the whipsawing for municipalities' contributions, determine how the proportion changed because of the State's additional large contributions this year, and figure out a way for that to make sense relative to GASB. The GASB did not provide a lot of leeway for ways to look at the allocation relative to contributions.

MR. BOUCHER said he had not had an appreciation of the different quarterly obligations that DRB has to produce the pension liability schedules for employers. There has been talk of going to an alternate method, but doing that without input could potentially harm folks. Meanwhile, there are deadlines, but there are some large employers that do not use the 6/30 fiscal year-end schedule. He said he was struggling with how to productively engage with employers and not end up implementing something at the last minute. The clear direction the department wants to go is to do no harm, or do as little harm as possible. Addressing Ms. Erchinger, he said he would appreciate her perspective as a municipal finance officer, because he is trying to guide Mr. Worley and the team on where to focus their priorities.

MS. ERCHINGER stated that, hindsight being 20/20, the employers that operate on 6/30 had delayed audits and were delayed getting their financials out. That reflects on the chief financial officers at the local level. To address just that issue, it would be nice for DRB to send out a letter to those communities in advance. The letter could state there were delayed results for the 6/30 employers, and the division anticipates that that is likely or possible for the 9/30 and 12/31 employers. They should be prepared that the financial statements may be late because they rely on data that the State is still trying to figure how to produce. That courtesy goes a long way, because it goes to the elected officials that the State has a lot of complicated decisions to make and is trying to make decisions that are going to do the least amount of harm. She said municipalities would rather get it right than "get it done" quickly to meet an arbitrary deadline they each have. She also thanked the Department of Administration for including finance officers in the discussions about how to implement the next pension liability allocation.

MR. HAYHURST stated that the 6/30's were late, and this year the Septembers and the Decembers will probably be late or at risk of being very close to the deadline. He thought that once this year's cycle was through, and the unusual items of trying to figure out the excess payment, and the impact that has on the proportion changes and other items, then going forward, once the process for the GASB 68 schedules is worked into the same timeline as the process for the pension audits, the GASB 68 schedules each year can then be issued pretty much on a December or January timeline, and that will set up the Septembers and the Decembers for that year. And the June 30's will have already received their information for the next year a month ahead of time for them to be able to work it into their process. He said he recognized that it has been a very rough year, but he anticipated that it would get smoother. It is only one set of schedules that gets issued, irrespective of what quarter deadlines people are dealing with.

C. Compliance Report and Update

JAMES MCKNIGHT, senior compliance officer in the Treasury Division, gave an update on investment compliance in 2015 *(a copy of the slide presentation is on file at the ARMB office)*. There are three different monitoring systems for investment compliance: Bloomberg, State Street Bank, and internal testing. They test 66 funds with Bloomberg, 35 funds with State Street, and currently 54 funds with internal testing. They test fixed income, equity, buy/write, TIPS, REITs, MLPs, and infrastructure investments. The funds are in the defined benefit plans, defined contribution plans, deferred compensation plans, and the Supplemental Benefit System. That encompasses 17,000 securities tested against 500 compliance rules per day, and much of the testing is automatic.

MR. MCKNIGHT went through a list of the other compliance checks that are done for ARMB funds on a monthly, weekly, or daily basis *(see slide 3 for the complete list)*. He said there were no instances of leverage in the funds in 2015, but they test for it daily. There were 29 instances of funds exceeding their cash allocations in 2015. There were quite a few overdraft fees in 2015, many related to a new fund (Alliance DCR fund), so the statistic is skewed from what could be expected normally.

MR. MCKNIGHT said he started analyzing every repo transaction this past year because it uses AY70, the cash fund that is shared by the ARMB funds and the State of Alaska. They found 11 errors from State Street, and there were 16 other errors in the LMCS repos from State Street. He intends to keep testing repos from now on.

Responding to MS. ERCHINGER, MR. MCKNIGHT explained that the errors were instances where State Street did not enter the transaction on the accounting side. Custody was not affected.

MR. MCKNIGHT said they check internal trades every day: there were only five minor errors from State Street on those trades. They also check the plan asset allocations daily, and there were only three instances of a plan drifting outside its asset allocation in the year. Monthly holdings are a State Street check, and in 2015 there were 13 instances where Bloomberg and State Street disagreed with each other. These were usually because State Street did not post a cash flow. Another check is for Iran compliance, and there were no instances of a manager purchasing a security on the Iran list.

MR. MCKNIGHT next gave a report on the 2015 Commission Recapture Program. The commissions rebated were $345,958, which was up about $15,000 from the prior year. The reason appears to be a slightly higher volume of trades for the year.

Regarding proxy votes, every investment manager provided written assurance that they voted all proxies in accordance with ARMB policy.

MR. MCKNIGHT explained the investment compliance goals for 2016: (1) continue to add more to the third manual check as an independent way to check Bloomberg and State Street Bank; (2) start daily checks on the new Securities Lending Program; and (3) institute several compliance checks on new strategies if they are approved (portable alpha and cash equitization program).

CHAIR PIHL stated that the committee appreciates receiving the monthly report from Compliance. There have been small items noted but no significant items to report.

MS. ERCHINGER remarked that Compliance does not report checking investments like timber and farmland. She asked if compliance testing was not done because any trades were so infrequent or if there was another reason.

MR. MCKNIGHT replied that there is not a whole lot that he can check financially: those investments are checked mostly by due diligence trips.

D. Future Audit Committee Topics

No additional topics were requested.

E. Further Meeting Schedule

The Audit Committee schedule was included in the packet.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC/COMMITTEE MEMBER COMMENTS

MS. ERCHINGER thanked Ms. Helmick and Mr. Denis in the Audit Unit, saying it is amazing the amount of work that Ms. Helmick has taken on right at the start. She met her in Seward when she was working with Ms. Gouyton on the audit there, and she found her very thorough and knowledgeable. She gave kudos to the division management for hiring Ms. Helmick, and it sounded like Ms. Helmick did a good job in hiring the second person in the Audit Unit.

CHAIR PIHL stated that his term on the Board is up March 1, and he has appreciated working with everyone over the years. He has found Mr. Worley very responsive to his questions, which he really appreciated.

MR. WORLEY remarked that Mr. Pihl has definitely nudged his mind in good directions with his questions, and he appreciated that.

ADJOURNMENT

The meeting adjourned at 12:10 p.m., on a motion made by Ms. Erchinger and seconded by Ms. Harbo.

Note: An outside contractor prepared the summary minutes from staff's recording of the meeting. For in-depth discussion and presentation details, please refer to the recording and staff reports and written presentation materials on file at the ARMB office.

Confidential Office Services
Karen Pearce Brown