

State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

Alaska State Museum, Lecture Hall
395 Whittier Street
Juneau, Alaska

March 28, 2018

ATTENDANCE

Committee Present: Rob Johnson (*chair*)
Kris Erchinger
Gayle Harbo

Committee Absent: None

Department of Revenue Staff Present:

Pamela Leary (director, Treasury Division)
Bob Mitchell (chief investment officer)
James McKnight (senior compliance officer)
Kayla Wisner (asset accounting)
Stephanie Alexander (board liaison)

Department of Administration Staff Present:

Ajay Desai (director, Division of Retirement & Benefits)
Kevin Worley (chief financial officer, Division of Retirement & Benefits)
Nimeri Denis (audit and review analyst, Division of Retirement & Benefits)

Others Present:

Leslie Thompson (GRS Retirement Consulting, review actuary)
Paul Wood (GRS Retirement Consulting, review actuary)
Norm West (ARMB trustee)
Sam Trivette

CALL TO ORDER

CHAIR ROB JOHNSON called the meeting to order at 9:13 a.m.

ROLL CALL

All three committee members were present at roll call.

PUBLIC MEETING NOTICE

MS. ALEXANDER confirmed that public meeting notice requirements had been met.

APPROVAL OF AGENDA

MS. HARBO moved to approve the agenda. MS. ERCHINGER seconded. The agenda was approved without objection.

APPROVAL OF MINUTES

MS. HARBO moved to approve the minutes of the November 10, 2017 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

It was moved and seconded to approve the minutes of the December 6, 2017 meeting. Those minutes were approved without objection.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES

There was no public comment by telephone or by anyone in attendance at the meeting site.

The Chair recognized former ARMB trustee Sam Trivette, who was present in the audience.

REPORTS

A. Employer Audits

KEVIN WORLEY, Chief Financial Officer in the Division of Retirement & Benefits, introduced Nimeri Denis in the audience, who is an audit and review analyst in the Division. He also announced that another auditor, Melanie Helmick, would be leaving the division in June due to family matters. He hoped to be able to hire her replacement in time so she could train the person on the Social Security administrator functions. He praised Ms. Helmick for helping strengthen the employer audits and increase the credibility of the Audit Unit.

MR. WORLEY referred to the Audit Unit report for the third quarter of the fiscal year, included in the meeting packet [*on file at the ARMB office*]. As of March 9, 18 employer audits have been completed. An additional seven audit reports are in the preliminary phase and should become final in about 45 days. He pointed out the chart of employers under assessment (page 2), which are smaller employers where it is cost prohibitive for an auditor to travel to their locations. An auditor conducts a desk audit on these employers and works with them via teleconference and email as needed.

The third-quarter report also contained a list of common employer audit issues discovered to date, in order of prevalence. The number one issue relates to temporary employees being misclassified for reporting to PERS. Other issues are PERS-eligible employees not enrolled in PERS, rehired retirees in PERS- and TRS-eligible positions, retirees with pre-existing arrangements for continued employment, and true termination of employment when retiring. MR. WORLEY stated that the regulations for bona fide separation in service were issued January 1, 2018; however, the years being audited can be 2016 or 2017, before the regulations became effective, and the auditors may be discovering these issues after the fact.

MR. WORLEY reviewed additional work performed by the Audit Unit in this fiscal year: (1) work with the chief pension officer on SBS; (2) collaborative work with all the sections in the Division of Retirement & Benefits to solve system issues and create consistency; (3) PERS and TRS employer manual revisions; (4) a new version of the employer reporting system to start this year; and (5) hosting the bi-annual Employer Conference in October. DRB has started soliciting questions from employers on topics they would like to see covered at the conference.

MR. WORLEY also reviewed the State Social Security Administrator's duties this fiscal year [*see page 3 of the Audit Unit report for details*].

MS. HARBO asked if the Employer Conference would speak to the employers about educating members in the defined contribution plan (DCR) about their benefits. She has heard from teachers who are unable to get time off to attend education about their DCR benefits because their employers do not give them time.

MR. WORLEY replied that a segment will deal with the DCR plan, and the Division does notify the employers attending the conference that they should be allowing DCR members to attend any educational opportunities that the Division provides. Education is also available on the web site. The Division continues to add information through video, primarily due to budget cuts for counselor travel.

B. GASB 68 / 75 Update for PERS/TRS Defined Benefit Pension and OPEB

MR. WORLEY stated that GASB 68 and 75 are the employer reporting of the allocated net pension liability and the allocated portion of the net OPEB (other post-employment benefits) liability. In the June 30, 2017 financial statement audits, the Division, as part of its required supplementary information, provides through Conduent Human Resource Services, the Division's consulting actuary, what the net pension liability is for the PERS plan and the TRS plan. The same goes for the post-employment healthcare.

For the employers, the Division takes the numbers in that report and allocates it to the employers so they can report it on their financial reports for June 30. The Audit Committee will see that report at the June meeting.

MR. WORLEY said the Division is currently on task for GASB 68 (pension). The information has been provided to KPMG in the financial statements, which is in the process of auditing them. This is the first year for GASB 75, reporting the net OPEB liability to employers for the June 30, 2018 audits. That report is scheduled to go out in June this year. That puts the Division on track per the calendar they provided last September.

CHAIR JOHNSON asked if it was correct that the dollar amount of the liability that is allocated to employers, as calculated under GASB 68/75, has no regard whatsoever to what their liability is when the Alaska Retirement Management Board (ARMB) sets the employer contribution rates. He wondered if the difference was because of the timing between the two calculations.

MR. WORLEY confirmed that there is a disconnect between the two numbers and a timing difference. The accounting number that the Division has in its audit is going to be a little different than what Conduent computes during the actuarial valuation process. While the audit reports must be done quickly after a fiscal year end (by October), the valuation process for June 30, 2017 is still ongoing. And the valuation reports will not be adopted until June of this year. There will be some differences, because the actuary goes through a process using the last *adopted* valuation report to develop an accounting number.

MS. ERCHINGER asked if the Division had an estimated timeline for getting the reports to the calendar year-end employers.

MR. WORLEY replied that he hoped they would have the GASB 68 reports by the end of next month. He has the draft valuation reports that he will make available on the GASB website within the week so that employers will have at least an idea of what their allocated number is.

C. GASB 67 Timing Difference from Actuarial Valuation Reports

MR. WORLEY stated that the committee brought this question up again at the December meeting to understand the difference between the GASB 67 net pension liability, which is reported in the audited financial statements, and the actuarial valuation reports. Initially when GASB 67 and 68 were issued, one of the points brought up was that these disclosure statements provide some kind of disconnect between what is an accounting number and what is a valuation number. Much of it is related to the timing of the audits and when financial statements must be issued, and the actuarial valuation process that culminates a good six months after the State has to issue its CAFRs (comprehensive annual financial reports).

MR. WORLEY explained in detail a table that summarized the differences between the GASB 67 disclosure report and the annual actuarial valuation reports [*part of a two-page handout, on file at the ARMB office*]. At the conclusion, he stressed that the State does not use the GASB 67 calculations for setting employer contribution rates. GASB 67 accounting is for consistency in reporting among government retirement plans across the United States.

MR. WEST was invited to join the table and provide his perspective. He echoed Mr. Worley's statement that the entire purpose of GASB is to make financial statements of government units comparable by attempting to place a fair market value on a liability under a set of rules. It is very possible for a retirement plan to be overfunded according to third-party actuaries and under GASB standards still have an unfunded liability because the rules determine the time periods and the comparability. It is not unusual to have fairly substantial differences.

MR. WORLEY stated that the ARMB puts more reliance on the valuation reports because those are what drive the funding.

D. FY2018 Audit Calendar Changes Coming

MR. WORLEY reported that the State of Alaska is required by statute to issue the State CAFRs, of which the retirement systems are part, by December 15. The Division has just received the management letter of the State of Alaska's audit. One of the comments related to the Division

providing its audited financial statements to the State Accounting Office – or the Division of Finance – by the end of October. In order to do that, the Division really has to move up its schedule. They are working with KPMG on the audit calendar and will provide that to the committee in June. He has already talked with the actuary about the GASB reports that the Division needs and about the timelines. The revised audit calendar will have a final audit issue of October 31. In order to meet that timeframe, if the Audit Committee wants to continue to look over the financial statements, the date for that meeting would have to be pushed up by about a month.

E. Investment Compliance Report and Update

JAMES McKNIGHT, Senior Compliance Officer in the Treasury Division, presented an update on investment compliance for 2017. He had a short slide presentation, which is on file at the ARMB office. He explained that the compliance section automatically downloads all the ARMB funds from the custodian, State Street Bank, every day. They then upload that data directly into the Bloomberg servers and run rules to test everything in the ARMB funds. They also do independent testing directly from State Street reports to check if everything matches. The ARMB has many types of different funds now and over 17,000 securities on which to test the rules every day.

MR. McKNIGHT stated that, in addition to the daily testing, the compliance section uses a variety of other tests to check the ARMB funds for compliance on a daily, weekly or monthly basis. He went into more detail about the types of testing and what errors or non-compliance were found in 2017 [*see slide 3 for the details*]. He mentioned that repos are checked daily, and usually State Street has made the rare mistakes, such as making duplicate trades or forgetting to post something in accounting. Sometimes repo transactions are under-collateralized: two years ago, there were six of those transactions, and this year there were only two. He pointed out that there are more internal trades as in-house investment staff is moving more funds internally. Compliance staff checks those transactions daily, and typically there are no errors on those. He noted that there were no instances of anything being outside its asset allocation in 2017.

CHAIR JOHNSON asked if the occurrence of overdrafts, which appeared to be small potatoes in terms of \$4,500 total fees in 2017, had any kind of a negative reaction by any third parties towards the ARMB. MR. McKNIGHT said not at all.

MR. McKNIGHT went on to show a 2012-2017 graph of the occurrence of ARMB investment compliance alerts. He said everything is generally going down over time.

MR. McKNIGHT provided an update on the 2017 commission recapture program, which rebates a portion of certain broker commissions back to the ARMB. He said there was a drop in rebated commissions last year. It is a situation where either broker commission rates are very low or there is something to recapture. The ARMB is tending towards having a low broker commission rate over time.

Regarding proxy votes in 2017, MR. McKNIGHT stated that all the investment managers gave statements indicating that they voted in accordance with ARMB policy on proxies for the whole year. The ARMB received two Freedom of Information Act requests for the proxy voting records, which was similar to the year before.

MR. McKNIGHT outlined the investment compliance challenges in fiscal year 2018:

- A proposal will be made at this week's board meeting to start buying and selling futures directly through JP Morgan. The compliance team normally checks the futures activity monthly between SSgA and JP Morgan. With the proposed change, they will have to set up to reconcile the internal records with JP Morgan.
- Potential new mandates for internal management of international equity and a currency overlay program.
- The securities lending program, which currently accepts only cash collateral, may change the type of collateral that will be held. The compliance team would need to develop new reports to track this collateral.
- As more and more funds are managed internally, they require a little more daily scrutiny, especially in regard to Bloomberg. There are always quirks with the Bloomberg trading system, which changes often, and compliance staff must keep on top of that.

MS. HARBO asked if Mr. McKnight saw a need to increase the compliance staff (currently two), given that almost \$2 billion dollars of ARMB assets were under internal management. It appeared to her that compliance staff conducted checks on the activity of internal investment management daily.

MR. McKNIGHT replied that much of the monitoring they do is automated, which minimizes the time they spend entering data.

MS. HARBO said it was an interesting report, plus Mr. McKnight sends the committee monthly compliance updates as well.

F. Future Audit Committee Topics

CHAIR JOHNSON indicated he would like the committee to hear more about the securities lending program, to better understand how much of ARMB's securities are subject to the lending program and how exposed the portfolio is.

Chief Investment Officer BOB MITCHELL said he would characterize it now as all public securities are available, unless an investment manager has indicated to staff that they would prefer not to have the securities in their portfolio loaned out. There is manager discretion and there is a layer of staff discretion as well. The program is structured so that only securities that are in high demand are loaned out, and there is a threshold. The previous securities lending program resulted in broad swaths of the public securities being on loan. The current implementation of the program is structured so that only a portion of those securities are loaned out and that those that are loaned out have a high return. He estimated that now only about 20% of the securities are loaned out, but the program is realizing about 80% of the previous revenue. Operationally, it is less of a headache for the managers that are affected by those securities lending transactions.

MR. MITCHELL said the program is structured to invest the cash collateral in high-quality money market instruments. Investment staff is currently evaluating that component because he thought it

was prudent to do so periodically. There are other options available, including receiving non-cash collateral for securities that are being loaned.

CHAIR JOHNSON asked if the securities lending process was subject to human control or an automatic system, and if an automatic system was a good idea. He was worried about systems going crazy or huge defaults being declared.

MR. MITCHELL explained that the ARMB has engaged State Street as the third-party securities lending manager. He imagined that State Street has largely automated the securities lending process to gain efficiencies in the program. There is potential for mistakes to occur there. He assured the chair that staff would address that issue when they reported back to the committee.

CHAIR JOHNSON asked that staff give the presentation on securities lending to the whole Board.

MS. HARBO stated that she wished to hear a better explanation about the Cadillac Tax and how it will affect the unfunded liability of the retirement systems.

MR. WORLEY said it was an item in the actuarial valuations, and he could talk to Conduent's Scott Young about explaining that further.

G. Further Meeting Schedule

The 2018 committee meeting schedule was included in the packet, along with a draft 2019 meeting schedule. MS. ALEXANDER encouraged committee members to make any changes they wanted to the draft 2019 schedule.

MS. ERCHINGER observed that 2019 was consistent with what the committee has done in the past, and she favored staying the course, unless there was a need to change something.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC / COMMITTEE MEMBER COMMENTS

MS. HARBO thanked Melanie Helmick in the Division of Retirement & Benefits for all the work she did on the employer audits in the past few years. It seems to be a smooth-running operation at this point. She hated to see Ms. Helmick leave right now but wished her well.

ADJOURNMENT

Ms. Harbo moved to adjourn. Ms. Erchinger seconded. The meeting adjourned at 10:05 a.m.

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.

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Karen Pearce Brown