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February 8, 2010

The Audit Committee of the Board of Trustees
The Employees' Retirement System of the State of Hawaii
Honolulu, Hawaii

Ladies and Gentlemen:

We have audited the combined financial statements of the Employees' Retirement System of the State of Hawaii (the ERS), for the year ended June 30, 2008, and have issued our report thereon dated February 8, 2010. In planning and performing our audit of the combined financial statements of the ERS, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the ERS' internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the combined financial statements but not for the purpose of expressing an opinion on the effectiveness of the ERS' internal control. Accordingly, we do not express an opinion on the effectiveness of the ERS' internal control.

During our audit, we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are summarized as follows:

Alternative Investments

The ERS is responsible for making fair value measurements and related disclosures included in the combined financial statements. Alternative investments present challenges for management with respect to obtaining sufficient appropriate evidence in support of the existence and valuation of such investments, because of the lack of readily determinable fair values of these investments and the limited investment information generally provided by investment managers. At June 30, 2008 and 2007, management's estimates of the fair value of these alternative investments were $458 million and $393 million, respectively, and these values were generally based on unaudited financial information provided by the respective external investment managers.

We recommend that management should perform sufficient procedures to ensure that the fair values reported to the board of trustees and included in the ERS' combined financial statements are fairly presented in accordance with U.S. generally accepted accounting principles. In general, detailed internal control policies and procedures should be documented in writing and adhered to. These procedures should include, but not be limited to:

- Understanding the investment managers' controls, policies, and procedures employed to report fair values to the ERS, including those over recording investment transactions, allocating gains and losses, and assessing the qualifications of the independent auditors opining on the alternative investments. Given the current market disruptions, the ERS needs to continually monitor and update its understanding of the processes followed by the investment managers and be cognizant of changes to these policies that may affect the existence and valuation of the investments. The ERS may consider participating in monthly investment manager conference calls. The ERS may also consider utilizing its investment advisor to verify transactions (e.g., randomly select trade tickets and then gain permission to independently contact counterparties and custodians to verify existence).

- Performing periodic sensitivity analyses and recalculations, as applicable, of their alternative investment balances. Comparing these recalculations to the balances provided by the respective investment managers will indicate to the ERS of any significant fluctuations in the fair values of the alternative investments, which may lead to further analysis to support the existence and valuation assertions.

Management's ability to determine fair value measurements and disclosures can only be accomplished if the information provided by the investment managers contains sufficient detailed information and is received on a timely basis. This will become increasingly important as the value of the ERS' alternative investments grows.

The ERS has policies and procedures over alternative investments, obtains an understanding of the controls and policies of the respective investment managers, and performs periodic analyses of the fair values of the investments. We recommend that the ERS continues its efforts to enhance policies and procedures with respect to reporting fair values for alternative investments. This will improve the ERS' ability to determine the reasonableness of fair values provided by the investment managers.

Financial Reporting

The ERS' accounting department is responsible for the preparation of the ERS' combined financial statements and the comprehensive annual financial report (CAFR). The CAFR is due to the Government Finance Officers Association (GFOA) six months subsequent to year-end. For the year ended June 30, 2008, the ERS was not able to prepare its CAFR for submission to the GFOA by the December 31, 2008 deadline. The following items were identified as factors contributing to this delay:

- Several members of the ERS' accounting department were allocated to assist with the implementation of the ERS' new V3 pension benefit system. By dedicating a significant amount of their time to the system implementation, insufficient personnel resources were available to prepare the CAFR.

- The ERS changed custodians of its pension assets during the year ended June 30, 2008. This change resulted in an additional burden for the ERS' accounting department as the transfer of assets needed to be appropriately accounted for and reconciled, which impacted the timing of the preparation of the CAFR.

- During the past few years, the ERS' accounting department dealt with numerous vacancies, and more recently, employee furloughs. In August 2008, the Governor imposed a hiring freeze due to the State's weakened economy. At various points during the past two calendar years, there were up to three vacancies in the accounting department. During December 2009, while the ERS was able to hire two staff, one additional staff member retired, leaving two vacancies. Compounding the vacancies, mandatory furlough days were established for State employees in October 2009 and are scheduled to continue through June 2011.

We recommend that the ERS' management should continue to work towards filling the remaining vacancies with qualified individuals to ensure that the accounting department is able to operate in a timely and efficient manner. Further, as special projects arise, the ERS' management should consider hiring additional staff or contractors to ensure that the existing accounting processes are not negatively impacted due to a reallocation of the accounting staff's time away from their normal responsibilities.

Finalization of Benefit Payments to Retirees

The ERS is responsible for providing timely and accurate pension payments to qualified retirees. The ERS calculates and remits pension payments to retirees using a three-step process. Initially, calculations are performed and payments are remitted to retirees based on estimated pension data. Then, the unused sick leave credit is added to the estimated pension to increase the pension benefit amount with additional service credit. Lastly, a finalized pension payment amount is calculated based on verified pension data, and if necessary, retroactive adjustments are made.

We noted the following:

	Number of retirees	Awaiting finalization > 6 months
Retirees awaiting finalization – at June 30, 2006	2,900	
Calculations finalized	(500)	
Retirees added	1,800	
Retirees awaiting finalization – at June 30, 2007	4,200	3,200
Calculations finalized	(2,400)	
Retirees added	1,900	
Retirees awaiting finalization – at June 30, 2008	3,700	2,800
Calculations finalized	(2,300)	
Retirees added	1,800	
Retirees awaiting finalization – at June 30, 2009	3,200	2,200

The accumulation of the backlog over the past several years is due in part to the length of time it takes for the ERS to obtain certain participant information from the respective employers. This issue is compounded by the shortage of available personnel to address this backlog. On January 1, 2004, Act 134 (the Act) became effective, which provided the ERS the ability to charge employers a monthly fee for delays in receiving information required to finalize the persons' benefits in a timely manner. In addition, the Act also required the ERS to pay 4.5% interest per annum on any underpayment to qualified retirees, which was not finalized within a six-month period.

Beginning in the fiscal year ended June 30, 2008, the ERS utilized a third-party resource to assist in reducing the backlog. As a result of their involvement, a decrease in the retirees awaiting finalization, as well as those outstanding for more than six months, occurred during the fiscal years ended June 30, 2009 and 2008.

We recommend that the ERS continues its efforts to reduce the backlog of the finalization of the pension benefit calculations, which could include establishing reasonable deadlines for the respective employers to provide the participant information to the ERS. Further, the ERS should continue to utilize their third-party resource to bring the backlog down to a level that can be managed by the ERS' personnel. These would facilitate the ERS' responsibility to provide timely and accurate pension payments to qualified retirees and also reduce the amount of interest expense incurred.

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Our audit procedures are designed primarily to enable us to form an opinion on the combined financial statements and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the ERS' organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This communication is intended solely for the information and use of the audit committee, management, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP