MINUTES
BOARD OF TRUSTEES OF THE
INDIANA PUBLIC RETIREMENT SYSTEM

Meeting held at:
One North Capitol
Conference Room 315
Indianapolis, Indiana 46204

February 22, 2013

Board Members Present
Ken Cochran, Chairman
Chris Adkins
Tim Berry
Jodi Golden
Michael Pinkham
Bret Swanson

Others Present
John Dowell, Nyhart
Rich Dabrowski, Strategic Investment Solutions (SIS)
Ray Jones, IRTA
Nancy Tolson, IRTA

Staff Present
Steve Russo, Executive Director
David Cooper, Chief Investment Officer
Mike Hineline, Chief Information and Technology Officer
Jeff Hutson, Chief Communication Officer
Julia Pogue, Chief Financial Officer
Teresa Snedigar, Director of Internal Audit
Tom Davidson, General Counsel
Scott Davis, Investments, Director of Public Equity
Allen Huang, Investments, Director of Fixed Income
Blair Webb, Investments, Investment Analyst
Erin Hankins, Executive Assistant
Katie Williams, Legal Analyst

Meeting called to order at 10:02 a.m. by Chairman Cochran.

I. Approval of Minutes from December 14, 2012 Board of Trustees Meeting

MOTION duly made and carried to approve the minutes from the December 14, 2012 board meeting.

Proposed by: *Bret Swanson*
Seconded by: *Chris Adkins*
Votes: *6 in favor, 0 opposed, 0 abstentions*

II. Required Business

No required business was discussed.

III. Unfinished Business

In accordance with normal practice, written materials for the following matters were provided to the board members by mail in advance of the meeting.

A. Annuity Rates and Funding Options

Steve Russo gave background on the topic and provided history of methods used for calculating INPRS annuity rates. Mr. Russo summarized the discussion that began with the board in the fall of 2012. He identified the key issues: how the rates are calculated and whether the employee or employer would bear the risk.

David Cooper, joined by Rich Dabrowski of Strategic Investment Solutions (SIS), presented the ASA annuity funding considerations to the board. Mr. Cooper began by stating that INPRS decided not to do an RFI from insurance providers as they were able to gather information from other sources, such as actuaries and plans similar to INPRS.

Mr. Cooper reviewed the objectives of the ASA annuity review and gave an overview of the PERF and TRF plans and the function of the annuity portion of the benefit.

Board member asked if a member can transfer funds into their ASA at retirement and if the employer is responsible for that risk. Mr. Cooper replied that members can transfer funds from other qualified plans into their ASA to be annuitized at retirement and that the employer does take on the risk for those additional funds.

Mr. Cooper then provided the board information on the current status of the ASA annuity. The INPRS annuity rate in effect is 7.5% and the INPRS Defined Benefit ("DB") long-term rate of return expectation is 6.75%; the rates are mismatched. Mr. Cooper gave examples showing that the current annuity rate implies an estimated payout that is higher than the expected earnings on a present value basis. Duration of liabilities is different for different annuities: 10.4 years for DB and 7.6 years for existing INPRS annuity. Mr. Cooper provided the sources of information used to compile the current status data. He stated that staff concluded that the information obtained from these sources was robust and adequate for an interactive discussion with the board and decided against a public RFI.

Mr. Cooper provided information about the Federal Thrift Savings Plan ("TSP") that was used as a case study. TSP is a defined contribution plan for Federal employees and members of the uniformed services. Similar to the INPRS ASA/RSA, TSP members have the option to convert their account balance to a life annuity at retirement. The key difference is that TSP purchases their annuity from a third party provider on behalf of its members. The financial risk of funding the annuity program resides with the third party. TSP's annuity rate in effect is 1.75%, which is on trend with the overall market interest rate. The rate of utilization of the annuity option is 2% with TSP members and close to 50% for PERF and TRF members.

Mr. Cooper presented a consideration for management of existing INPRS Annuity liabilities. The existing INPRS annuity is accounted for in the overall DB funded status. The implied impact on the funded status is both unfavorable to TRF (by 0.1%) and to PERF (by 0.2%). The duration of existing INPRS Annuity liabilities is 7.5 years. The implied impact of this on the percent of employer contributions (calculated over the duration of existing INPRS Annuity liabilities) is 0.7% for TRF and 1.1% for PERF.

Mr. Cooper offered two options for the management of existing INPRS Annuity liabilities. Option one is to strip out the existing INPRS Annuity liabilities. This would allow INPRS to invest annuity assets with a different allocation than the DB, which would better match expected earnings with annuity payout and better match the duration of annuity assets and liabilities. The considerations for these options are: the potential impact on the DB funded status; it may require a higher allocation to more volatile asset classes (taking on more risk) or the use of leverage in order to meet the annuity payout rate; and that the financial risk of the funding shortfall between earnings and payout continues to reside with the DB. Option two is to maintain the status quo. INPRS would prudently invest annuity assets alongside the DB allocation and work to smooth the earnings/payout mismatch over time. The consideration for this option is that the INPRS DB may incur a theoretical loss of $107MM given the mismatch between earnings and payout.

Mr. Cooper then presented points to consider for the management of future INPRS Annuity liabilities: internal verses external management going forward, method of determining the annuity rate, frequency of rate review, who should bear the financial risk of funding the future annuity benefit, and how to account for future INPRS Annuity liabilities relative to the DB.

Board member asked for clarification about external management and how a third party provider is utilized. Mr. Cooper replied that the third party provider would make payments directly to members. Members as a group would get a better rate than if they invested individually with the provider.

Mr. Cooper discussed the impact of interest rates on annuity payout amounts: Every 1% reduction in annuity rate equals an 8% reduction in monthly annuity payout.

Mr. Cooper then presented four options for the management of future INPRS Annuity liabilities and offered pros and cons for each. Option one is to maintain the status quo. The pros and cons are similar to Option two for the existing liabilities. Option two is to make the INPRS annuity rate the same as the DB long-term rate of return expectation. This would allow for a better match of the earnings and payout expectations. Cons for Option two include: the financial risk of the funding shortfall between earnings and payout continues to reside with the DB; the duration of the DB liabilities and INPRS Annuity liabilities is different; and implementation risk (e.g. communication to members and timing). Option three is similar to the Guaranteed Fund as it would keep the funds separate; the INPRS annuity rate would be the same as the variable market rate. INPRS would conservatively invest annuity assets in predictable, high quality fixed income securities with like duration as annuity liabilities. This option would give the INPRS Board the ability to customize the INPRS annuity: dictate frequency of annuity rate setting; provide an explicit benefit to members if appropriate; and utilize more conservative mortality and COLA assumptions when calculating the annuity payout. Financial and implementation risks, similar to that of Option two, would exist with Option three as well. Option four is to utilize a third party annuity provider, similar to what TSP has done. This would eliminate the financial risk of a funding shortfall between earnings and payout to the DB. INPRS could do a periodic RFP to ensure that a competitive annuity is maintained (every 5 years). The cons of Option four: INPRS would not have the ability to customize a third party annuity; it could potentially reduce or eliminate an explicit benefit to members; and implementation risk.

Board member asked about the difference in cost, beyond potential liability, between internal and external annuity management. Mr. Cooper responded that the third party provider would have overhead risks, would be more conservative on spread risk, and have the need to make profit, which INPRS does not have. Therefore, it may be possible to increase the rate of return.

Mr. Cooper opened the topic for board discussion and consideration. Mr. Russo stated that the staff expectation was not that the board would feel the need to make a decision, but to offer information for discussion. Chairman Cochran stated that he would like to have a full board present before making a decision. Board member asked about possibility of doing an RFP in order to compare costs of various third party annuity providers with managing the annuity internally. Mr. Dabrowski stated that was possible. A discussion was had among board members about their experiences with third party products and variance in rate of returns. Board member expressed support for the consideration of removing burden of risk from employers. Mr. Cooper stated that his team could research different options within the market.

Chairman Cochran asked to see options at the April board meeting. Mr. Russo asked the board members to contact him with any additional questions before then.

IV. New Business

A. Internal Audit Update

Mr. Russo invited Teresa Snedigar to present the INPRS internal audit update to the board. Mr. Russo stated that this would be internal audit's midyear report to the board.

Ms. Snedigar reported that four audits had been completed since the last board meeting in the areas of: Investment Policy Statement Risk Ranking, member statements, non-standard payments, and data transfer to actuaries. The department consulted on major system implementations (ERM and INPAS), on one-time issues, and IT department procedures. Ms. Snedigar reviewed the eight audits in progress, four of which should be completed by the end of the month. She stated that there are nine audits remaining that have not yet been started. Internal Audit will continue to participate in the new system implementation project for INPAS. They will also continue to enhance the Fraud quarterly analytics for new systems as they go live. As required by the Institute of Internal Auditors standards, a quality assurance program is being implemented over the Internal Audit function. Ms. Snedigar stated that her team will continue to work with IT in developing department and agency guidelines in the areas of privacy, data security, and IT general controls. Future plans include providing computer based training on fraud for the entire INPRS organization. Risk assessment for Fiscal Year 2014 will begin in May 2013.

B. FY13 Actuarial Assumptions & Methods

Mr. Russo introduced the topic and stated that the purpose of bringing the information to the board at this time was to give the board members an opportunity to ask questions or raise any concerns before the actuaries begin working on the valuation.

Julia Pogue was joined by John Dowell from Nyhart for the presentation. Ms. Pogue reviewed the major actuarial assumptions: interest rate and investment return; cost of living increases; future salary increases and inflation; and mortality. Areas of actuarial methods considered are: actuarial cost method; actuarial value of assets method, and amortization method and period. The staff recommendation is to make no changes to the actuarial assumptions and methods for FY2013.

Ms. Pogue provided background on the interest rate and investment return, which are the most volatile and can have the greatest effect on the actuarial costs of a Defined Benefit plan. She reviewed the board decision of 2012 to lower the long-term interest assumption from 7.0% to 6.75%. The assumption matches expected returns from the INPRS current asset allocation. The final impact of the rate assumption change increased unfunded liability for INPRS to $1.0B and increased the contribution rate for PERF and TRF by 0.8%. Ms. Pogue shared information on the INPRS return expectations. She stated that the overall investment policy and strategy should determine how funds are invested. Staff recommends that the interest rate and investment return assumption match the expected return from targeted investment asset allocations. INPRS management, in conjunction with INPRS' consultants, recommends an investment return assumption of 6.75% be maintained.

Ms. Pogue then summarized the current Cost of Living ("COLA") actuarial assumptions for the funds: 1.0% for PERF, TRF, EG&C, and LEDB; 2.25% for 1977 Fund; and 4.0% for Judges. She stated that the assumptions are different for various funds because they are determined by statute. If 13th Checks continue, the 1.0% assumption for PERF & TRF will overstate costs over time. Legislators continue to consider annual COLAs and the average historical COLA increase has been between 1.5% and 2.0%. The staff recommendation is to make no changes to COLA assumptions and continue with a 1.0% COLA.

A board member asked about where the COLA fits in the State budget. Mr. Russo responded by providing a brief update of items currently in the legislative process regarding COLAs and 13th Checks.

Ms. Pogue noted the current assumptions for Future Salary Increases for each fund are based on past experience studies. She stated that changing the assumptions would only be considered if the long-term interest rate is reduced. The staff recommendation is to make no changes to Future Salary Increases and Inflation assumptions.

Ms. Pogue stated that the mortality table was changed last year to adopt the 2013 IRS Static Table projected forward five (5) years. The current mortality table is used for all defined benefit funds. Compared to mortality tables used by the Social Security Administration, INPRS' current assumption is conservative. Ms. Pogue provided an example of this to the board. Staff recommends no change to the mortality table.

Ms. Pogue reviewed the current Actuarial Cost Methods: all plans except the LEDB used "Entry Age Normal – Level Percent of Payroll"; the LEDB uses the Traditional Unit Credit. The Entry Age Normal method is the most common and is approved by the GASB's newest pension accounting rules. Staff recommends no change to the Actuarial Cost Method.

Ms. Pogue explained the Actuarial Asset Valuation Method and reviewed the current method of valuing actuarial assets: 4-year smoothing of investment gains or losses subject to a 20% corridor, thereby limiting the amount of variance from the Market Value of Assets. She stated that the smoothing of four years keeps INPRS closer to true market value verses the industry standard of five years. Staff recommends no change to the Asset Valuation Method. A brief discussion was had on GASB's methods.

Ms. Pogue reviewed the current Actuarial Amortization Method (level dollar) and Period (30 years, closed, which is statute driven). Ms. Pogue noted that the actuarial community is currently reviewing standards due to upcoming GASB 67 and 68 changes. Staff recommends no change to the Amortization Method or Period for the FY2013 valuation.

Overall, staff recommended no changes to the actuarial assumptions and methods to be used in the FY2013 actuarial valuations of INPRS administered plans. The board was advised that a board vote was only necessary to make changes to existing assumptions and methods. With no board motions made, existing assumptions and methods will be used in the FY2013 valuation.

C. <u>ASA & 401h Administrative Fees</u>

Mr. Russo introduced the topic by stating that it would be another issue that would require a discussion on whether the employer or employee should bear the cost.

Ms. Pogue began her presentation by mentioning that staff was not looking for decision, but for discussion among the board and guidance for next steps. She provided background on the ASA administrative costs and recordkeeping fee discussion and referenced applicable Indiana law.

Introducing a discussion of industry statistics, Ms. Pogue stated that several sources were used to learn how other plans pay for recordkeeping and administrative fees. The industry standard is for participants to pay these fees; some charge only recordkeeping fees and most plans charge fees through the NAV. Fees associated with plans vary on number of participants and average account balances. Ms. Pogue provided examples of what other plans charge and how they determine the rates. Mr. Russo pointed out that INPRS is unique in the industry because the ASA is bundled under the DB plan. Ms. Pogue provided examples of fee breakdown for the Indiana 529 plan, the Indiana 457 plan, and peer plan as provided by CEM benchmarking. She mentioned that these other plans have marketing and education fees that INPRS doesn't have.

Ms. Pogue spoke specifically about the Guaranteed Fund ("GF"), stating that interpretation of current law prohibits the charging of any fees to those members who have chosen the GF as their investment option. She mentioned that the annual recordkeeping costs for members in the GF are around $4M. More work is required to determine how to mitigate the costs associated with the GF. Some options include changing the Indiana Code, investigating if a rule in the Indiana Administrative Code will suffice, and factoring the fees into the interest crediting rate to absorb the costs.

Mr. Russo offered an explanation of methods for factoring in costs, determining rates, and how the board would be involved.

Ms. Pogue then discussed fee payment options for other ASA funds (excluding the GF). One alternative is to maintain the status quo: employers pay fees through contribution rates covered in DB assets. Another alternative is to charge the member accounts with the recordkeeping fees or the recordkeeping fees plus the administrative cost (which is not very large). Other alternatives are to embed the fee in the NAV or charge a flat fee. Ms. Pogue then provided pros and cons for each of the ASA and ASA-Only fee payment alternatives.

Ms. Pogue opened the floor for discussion and asked for guidance from the board. A board member asked about whether investment management fees have been considered when developing interest rates. Ms. Pogue responded in the affirmative. A discussion was had about asking PMOC to review the relevant statutes and suggesting changes. A board member noted that the statutes were created when the Guaranteed Fund was the only investment option. Mr. Russo stated that he would engage PMOC on the topic.

Ms. Pogue presented information on the 401(h) Accounts (Retiree Medical Benefits) to the board. She explained that Section 401(h) of the Internal Revenue Code permits a pension or annuity plan to provide for payments of benefits for sickness, accident, hospitalization and medical expenses for retired employees, their spouses and dependents. These medical benefits must be maintained in a separate account. Employers who pay through the Auditor of State will have the opportunity in 2013 to provide 401(h) accounts to their employees upon retirement. Funding for 401(h) accounts will come from the employee’s unused vacation balance at the time of retirement. 401(h) accounts will be administered outside of pension funds and are available on a pre-tax basis for retirees to use for medical expenses.

Ms. Pogue reviewed the fees associated with 401(h) accounts. She then stated that the fees and expenses cannot be paid for by INPRS pension assets because they are health care accounts. The 401(h) account fees and expenses can by paid for either by participating employers or through member account charges. Ms. Pogue stated that INPRS would consult with the State Personnel Department (SPD) to make a decision about who will pay the fees.

A board member asked if a plan document exists. Mr. Russo replied that the legally binding plan document is comprised of the applicable Indiana Code and

Indiana Administrative Code as submitted to the IRS. INPRS staff will continue to work with SPD on the appropriate summary documentation needed to inform participants of the plan details.

Ms. Pogue then presented the alternatives for paying the 401(h) fees. If the employer pays the fees, the vendor administering the plan could bill the employer directly for the fees. If the member pays fees through account charges, the method to administer this is yet to be determined. Ms. Pogue then asked the board how they would like to proceed if it decided that the member will pay the fees.

A discussion was had regarding the 401(h) plan, the criteria used at retirement, scenarios for fee payment, and how a decision will be made. Ms. Pogue informed the board that the plan goes into effect on July 1, 2013.

Chairman Cochran suggested that the decision regarding 401(h) fees could be delegated to staff. Mr. Russo responded that Indiana Code states that the INPRS board may adopt rules after consultation with SPD. INPRS staff would bring an update to the board at the April board meeting.

D. Financial Update

Julia Pogue presented the INPRS financial update to the board. She reviewed financial highlights as of December 2012 including details of items that affected the change in net position. She then summarized the Fiscal Year 2013 actual and forecasted expenses compared to the budget for four specific areas: administration, projects, investments, and capital. She described the main factors driving favorable variance in each area. Ms. Pogue noted that the favorable variance for investments is primarily due to management fees related to private equity managers. The budget assumed that all managers would report management fees and that all commitments would be fully funded, which is not occurring. Mr. Russo stated that INPRS is seeking to hire someone to work in the area of investment fee management to help in this area.

Ms. Pogue reviewed the FY2013 actual and forecasted change in net position due to net change in investments; contributions received; and benefit payouts and expenses. She provided a year-to-date analysis for the net change in investments and compared the annual current forecast with the original forecast for each area.

Board member asked where the reserve excess that the pension funds received shows on the charts. Ms. Pogue replied that those funds are included in the contributions received.

E. Investments Update

David Cooper began by sharing the three imperatives that drive the INPRS investment team and their 2012 accomplishments. He presented the team's 2013 objectives and explained the first four: internal investment management study and recommendation; Guaranteed Fund definition and construct clarification; ASA merger; and annuitization of ASA recommendation and implementation.

Mr. Cooper then provided an update on the Indiana Investment Fund II and Legacy Indiana Focused Funds. He reminded the board that representatives from Carlyle Group will present an update to the board on their progress on Indiana investments at the April board meeting. Mr. Cooper highlighted to events that on the IIF timeline that occurred since the last meeting: the IIF-II legal documentation was finalized and executed on 12/20/12 and a 60 day notice of termination of general partner was sent to CFIG or IIF-I, IIF-A, and Credit Suisse Indiana Venture Fund on 2/1/13. Mr. Cooper provided information on current actions and next steps for IIF-II logistics, IIF-I and Credit Suisse Indiana Venture Fund, and IFF and iNext. Mr. Russo praised Mr. Cooper and his team for their efforts to work with other co-investors to complete the transition to a new general partner.

Mr. Cooper gave highlights for the INPRS portfolio. He stated that INPRS asset values are at all time highs ($27.1 billion). A combination of unusually low volatility in markets and positive returns has led to high return/risk ratio for the plan. All asset classes are within target asset allocation ranges; every type of asset class has been a positive contributor to performance in 2012. Through January 2013, the fiscal year-to-date return exceeds 6.75% by 100 basis points. The DB performance in both the short and long term has outperformed the actuarial hurdle and the customized benchmark. Mr. Cooper expects the 10-year annualized performance to dip below the 6.75% hurdle by April, 2013. Mr. Russo emphasized how each year's performance affects the 10-year performance. Mr. Cooper stated that risk parity performance is on par or exceeding every benchmark inception to date and ASA performance is tracking its benchmarks as expected.

INPRS quarterly market values and DB market value performance (peak to trough to new peak) were provided to the board. Mr. Cooper noted that the current market value is significantly above the last peak in October of 2007. He then presented the economic update and discussed how concerns have changed from one year ago.

Mr. Cooper reviewed the asset allocations of 12/31/12 (all are in range and on target) and discussed the CY 2012 performance of asset types in different economic environments. He reviewed the fiscal year 2013 performance, stating that all asset classes have been a positive contributor overall, and provided quarterly performance data for calendar year 2012. He then reviewed the distribution of INPRS' monthly returns from January 2009 to December 2012.

Mr. Cooper reviewed the DB Performance chart, compared the rates of return for private equity and private real estate, and gave an update on risk parity performance (net returns since inception, March 14, 2012 to January 31, 2013). He reviewed the ASA performance (which is tracking well), target date funds performance (the new default for members), and the pension relief and special death funds performance (also doing well).

Mr. Cooper referenced the list of recent investments and terminations and briefly explained new commitments and investments; there were no terminations. Mr. Cooper concluded with an update on the Watch List and explained how each manager on the list has a 3-year return that is less than the benchmark. Graphs and detailed reports were provided to the board.

F. <u>Executive Director Report</u>

Steve Russo began his Executive Director Report by sharing recent INPRS recognitions. INPRS is a finalist in two awards: Large Public Pension Plan of the Year (through Institutional Investor Magazine) and TechPoint Mira Award (in the Corporate IT Excellence & Innovation Category).

Mr. Russo reported two line of duty deaths to the board: Jerry Baker, a Plainfield firefighter, died February 21, 2012, and Timothy A. Betts, Corrections Officer, died August 26, 2012.

In his legislative update, Mr. Russo provided updates on the 26 bills tracked by INPRS. Fourteen bills have yet to receive committee action (as of 2/15/13). Mr. Russo provided information on the 12 bills moving through committee.
As a side note, Mr. Russo informed the board that some states are talking about shutting down their defined benefit plans and initiating legislation to do so.

ASA-Only plan is on track to go-live on March 1, 2013. Mr. Russo discussed the criteria used to determine eligible employers, which is being clarified as of part of SB499. Mr. Russo described the information about the ASA-Only plan that State Personnel Department (SPD) will include in the on-boarding process for new hires. A board member suggested that details about the ASA-Only interest rate be included in the informational video. Jeff Hutson, Chief Communications Officer, stated that he would add that information to the video. A discussion was had on the importance of ensuring that new hires are well informed about their options. Mr. Russo reported on the efforts made to communicate with ASA-Only eligible governmental units that likely do not participate in SPD on-boarding.

Mr. Russo provided an update on ERM to the board. As of February 8, 2013, 96% of employers have submitted at least one report, 98% of active members have at least one contribution posted, and 68% of employers are fully compliant (i.e. ERM submissions are made within 7 days of payroll date). A discussion was had on efforts made to encourage on-time payments from employers. Since going live, $355M in total contributions has been received. Mr. Russo provided data for the separate call center that was created to provide customer service to employers. Of the 16,799 incoming employer inquiries, 98.5% were resolved upon initial contact. The IT team has responded to requests for data fixes (70% of requests), system fixes (20%), and clarifications to questions (10%). May 1, 2013 is the target date to begin imposing interest penalties for submissions that are eight or more days late. A board member asked about the timing of posting contributions. Mr. Russo provided an overview of the payment processing timeline; contributions appear in member accounts within 1-2 days of payroll once received by INPRS.

Mr. Russo stated that the metrics were on trend and details were provided for board review.

V. Other Business as Requested by the Board

No other business was requested by the Board.

VI. Preliminary Agenda for Next Board Meeting

The date of the next board meeting is set for April 26, 2013. A draft order of business was provided to the board.

VII. Adjournment

MOTION duly made and carried to adjourn the February 22, 2013 board meeting at 12:26 p.m.

Proposed by: ***Bret Swanson***
Seconded by: ***Chris Adkins***
Votes: ***6 in favor, 0 opposed, 0 abstentions***