

STATE EMPLOYEES' RETIREMENT SYSTEM OF ILLINOIS

MINUTES OF THE REGULAR MEETING

OF THE BOARD OF TRUSTEES

October 30, 2012

The annual meeting of the Board of Trustees of the State Employees' Retirement System of Illinois convened on Tuesday, October 30, 2012, at 10:00 a.m. in the System's Springfield office located at 2101 South Veterans Parkway with a videoconference location at the Bilandic Building, Room N-703, 160 North LaSalle Street, Chicago, IL.

The following trustees were in attendance:

Judy Baar Topinka, Chairperson
Lori Laidlaw, Vice Chairperson
Thomas Allison, Trustee
Shirley Byrd, Trustee
Renee Friedman, Trustee
David Morris, Trustee
Patricia Ousley, Trustee
Patricia Rensing, Trustee
Danny Silverthorn, Trustee
Harold Sullivan, Jr., Trustee
Virginia Yates, Trustee

Absent:

Michael Noser, Trustee

Others in attendance were:

Timothy Blair, Executive Secretary
Steve Bochenek, Attorney
William Atwood, Director, Illinois State Board of Investment
Nicholas Merrill, Manager, Accounting Division
Staci Crane, Chief Internal Auditor
Alex Rivera, Gabriel Roeder Smith & Company
Paul Wood, Gabriel Roeder Smith & Company
Loren Iglarsh, Office of the Comptroller
Alexis Sturm, Office of the Comptroller
Barbara Baird, SERS Chicago Office
Dawn Blakeman, Recording Secretary
Dan Hankiewicz, CoGFA
John Fitzgerald, Illinois Nurses Association
John Adams, Illinois Nurses Association

Chairman Topinka presided from the Chicago location, and called the meeting to order at 10:00 a.m. with a quorum present.

REPORT OF THE ILLINOIS STATE BOARD OF INVESTMENT

William Atwood, Director of the Illinois State Board of Investment (ISBI) distributed copies of the Executive Summary of the ISBI report for the period ending September 30, 2012, and addressed the Board. He called attention to the portion of the report reflecting a 15.6% return for the entire portfolio for the year ending September 30, 2012, which compares favorably to the total portfolio benchmark of 14.9%. For the same time period, the fixed income portfolio returned 7.8%, while the benchmark returned 6.4%.

Director Atwood continued by noting the U.S. Equity portfolio, excluding the Hedge Fund of Funds allocation, returned 28.2% for the year ended September 30, 2012, while the benchmark returned 30.2%. He then directed the Board to Page 3 of the report and the Hedge Fund of Funds and Non-U.S. Equity asset classes, which returned 8.1% and 17.8%, respectively, during the previous year. These returns compared favorably to the respective benchmark returns of 2.5% and 14.9%.

Director Atwood then reminded the Trustees that these return numbers represent a return at a specific point and that there is a lot of volatility in the various asset classes that make up the portfolio. As an example, he pointed out that for the 1 year period ended June 30, 2012 the portfolio returned 0.5%, compared to a 1 year return of 15.6% for the year ended September 30, 2012. Director Atwood then offered to address any questions the Board may have.

Trustee Friedman asked if the volatility wouldn't be in any group of asset classes, as opposed to the whole portfolio. Director Atwood responded that volatility and the correlation of returns has historically been predictable between various asset classes; when stocks went up, bonds went down and when bonds went up, stocks went down. But, now bonds move with stocks, stocks move with bonds. It seems as if the returns on most of the asset classes are generally moving together, possibly with the exception of emerging markets.

Trustee Sullivan followed up by asking Director Atwood if the ISBI directly owned futures or swaps in separately managed accounts. Director Atwood responded there are two primary areas where derivative instruments are used in the portfolio; 1) currency futures, and 2) cash put into an equitization program through State Street, the ISBI custodian.

Chairperson Topinka told Director Atwood she noticed Calpers had invested over \$1 billion in Woodfield Mall and asked if that was something that ISBI should be doing – investing in sizable real estate assets. Director Atwood responded the real estate portfolio has been a big focus of attention for the ISBI staff and Board for the last 2 years and he feels they are moving in the right direction. He said there are separate accounts in the real estate portfolio and noted the ISBI portfolio is much smaller than Calpers. So even though ISBI is not able to purchase something the size of the Woodfield Mall, the real estate portfolio is invested in retail properties.

He further explained that real estate market generally consists of investible bonds and they are centered in major metropolitan areas. The barriers to entry in most of those markets are very significant considering the size of investment ISBI is making. But, the ISBI

is able to invest in certain real estate assets and they also utilize opportunities under limited partnerships.

Trustee Allison told Director Atwood he had reviewed the memorandum about the management fees paid to hedge fund of fund managers and found it interesting that only the worst performer had not agreed to lower ISBI's management fees. Director Atwood informed the Board that ISBI had since reallocated those assets to other managers who had agreed to lower the fees charged to ISBI and the resulting savings amounted to something in the neighborhood of \$5 million annually.

Trustee Sullivan complimented Director Atwood on the new format of the ISBI report and commended him for the ISBI work in maintain a very low fee structure for ISBI as a whole.

Trustee Ousley moved to accept the ISBI Report for the period ending September 30, 2012 and Trustee Sullivan seconded the motion, which passed unanimously. A copy of the report is maintained in the ISBI office and made a part of these minutes as Exhibit A. Chairperson Topinka and the Trustees thanked Director Atwood for his informative report and excused him from the remainder of the meeting.

REPORT OF THE ACTUARY

June 30, 2012 Actuarial Valuation and FY 14 Employer Contribution Rate. Alex Rivera and Paul Wood of Gabriel, Roeder, Smith & Company presented the FY 12 actuarial valuation, including the calculated FY 14 certified employer contribution.

Mr. Rivera referred the trustees to a handout summarizing the results of the FY 12 actuarial valuation. He pointed out two items in the FY 12 valuation: based on the actuarial value of assets, the funded ratio decreased from 35.5% in FY 11 to 34.7% in FY 12 while the required employer contribution increased from \$1.6 billion, or 36.116% of payroll in FY 13, to \$1.7 billion, or 38.435% of payroll in FY 14. The main reason was a decline in the active population and an increase in the retiree population. Mr. Rivera continued by pointing out that GRS believes the 7.75% investment return assumption is reasonable, but the Board should remain diligent about monitoring the investment return assumption.

Trustee Sullivan asked about the investment return assumption of other Illinois public retirement systems, including JRS and GARS. Mr. Rivera noted the investment return assumption for TRS was recently lowered to 8% and that JRS and GARS have adopted an assumption of 7%. SURS adopted 7.75% shortly after SERS made the change in 2010.

Mr. Wood referred the trustees to page 3 of the handout and pointed out the unfunded liability increased from \$20.4 billion at June 30, 2011 to \$22.1 billion at June 30, 2012. He continued by referring to the portion of the presentation that showed the decrease in the funded ratio from 35.0% in FY 11 to approximately 33.1% in FY 12, based on the market value of assets.

Mr. Wood continued the presentation by outlining the reasons for the decrease in the funded ratio. The employer contribution shortfall, when compared to a contribution equal

to the employer's normal cost plus interest on the unfunded liability, was the largest factor that caused a decrease in the funded ratio, followed by investment returns being less than assumed in FY 12. Trustee Allison asked Mr. Wood if the contribution shortfall is a function of the statutory funding plan and Mr. Wood answered in the affirmative. The other factor accounting for the decrease in the funded ratio was an unexpected 40% increase in the number of retirements during FY 12, when compared to the retirement rate assumption.

Mr. Wood continued by comparing the actual FY 12 cashflow to the projected FY 13 cashflow. For FY 12, benefit payments and expenses were \$17 million higher than the combined employee and employer contributions. In FY 13, the employer and employee contributions are expected to be \$70 million higher than benefit payments and expenses. He further pointed out that the FY 13 statutory employer contribution is \$218 million less than the normal cost plus a 30 amortization payment (the ARC), and the FY 14 statutory employer contribution is \$254 million less than the ARC.

Mr. Wood then briefly reviewed several charts showing projected contributions, funded ratios and cash flow for the remainder of the funding plan and entertained questions from the Trustees. Trustee Allison confirmed with Mr. Wood that the effect on the funded ratio of changing the investment return assumption occurred in FY 11 rather than FY 12 and asked if changing the funded ratio would be addressed in the presentation. Mr. Rivera answered that it would be discussed after Mr. Wood's prepared review of the valuation.

Upon the completion of a brief review of current demographics of actives and retirees, Trustee Sullivan asked Mr. Rivera if he still considered the 7.75% investment return assumption reasonable. Mr. Rivera explained that he does but he thinks the Board and actuaries should continue to monitor the assumption closely, if not every year then at least every other year. Trustee Sullivan followed up by asking Mr. Rivera what he considered the range of reasonableness for the assumption. Mr. Rivera explained that there is pressure at many funds to lower the assumption, but he feels that the Board should be cautious about lowering the rate every other year, as these assumptions are supposed to be long term in nature.

Trustee Sullivan continued by asking Mr. Rivera if the range of reasonableness for the investment return assumption could be 5% to 8%. Mr. Rivera said the range depends on the asset allocation of the plan, specific liquidity requirements and the reliability of employer contributions. He also pointed out that GASB Statements 67 and 68 will move the System's liability onto the balance sheet, but that these statements will not change the way SERS is funded, but will require an additional liability calculation based on different interest rates.

Trustee Allison then offered that based on this discussion, the 7.75% investment return assumption may be too high in the long run and Mr. Rivera concurred. He noted that a lower assumption is better for SERS even though the financial condition appears worse with the lower assumption. He then asked if there was any adverse impact of lowering the assumption from 8.5% to 7.75% in FY 10 and if there was any reason the assumption shouldn't be lowered again as was discussed in FY 10. Mr. Rivera noted a 7.5% assumption could certainly be supported by the data and is as valid as 7.75%.

Trustee Sullivan asked how much adopting a 7.5% investment return assumption would impact the FY 14 required contribution. Mr. Wood answered the FY 14 contribution would increase by about \$41 million. Trustee Allison followed up by asking if there is anything that should prevent us from reviewing the assumption now. Executive Secretary Blair responded by pointing out there is a State Actuary for the first time that will be reviewing all assumptions and actuarial work done by the State-funded retirement systems. He suggested asking the actuaries to review the assumption for the January Board meeting. The Board agreed and made the request of Mr. Rivera.

Chairperson Topinka asked Executive Secretary Blair to invite the State Actuary to the January Board meeting to address the Board, which he agreed to do. Trustee Friedman then requested a sensitivity analysis be prepared by the actuaries, for the January meeting, that shows the effect of unexpected retirements like those that occurred in FY 12. Trustee Byrd made a motion to have the actuaries return to the January Board meeting with the requested information. Trustee Rensing seconded the motion and all were in favor.

Trustee Sullivan then moved to adopt the FY 12 actuarial valuation and certify the FY 14 employer contribution rate as presented by GRS. Trustee Friedman seconded the motion and all were in favor. In accordance with Public Act 88-593, as amended, the Board-certified State contribution rate for FY 14 is 40.312% of payroll, or \$1,743,865,000.

MINUTES OF THE JULY 17, 2012 BOARD MEETING

The minutes of the meeting of the Board of Trustees held July 17, 2012 were presented to the members by Chairperson Topinka for approval. Copies of these minutes were previously provided to each trustee for preliminary review. Trustee Friedman moved to approve the minutes as submitted. Trustee Allison seconded the motion, and all were in favor.

REPORT OF CHIEF INFORMATION SYSTEMS OFFICER (CISO)

Systems Modernization. Mr. Mitchell informed the Board that the Active Member System has been implemented. This new system allows much quicker access to member information and therefore better service to SERS members. Mr. Mitchell reviewed several positive comments from the Claims Division regarding the new system. The re-engineering of the systems related to the Active Member System continues.

Mr. Mitchell continued by discussing the division of the development team into web systems development while the re-engineering of the internal systems continues. Inactive statement re-design continues in anticipation of the re-design of all statements. The migration of the legacy systems to new equipment is completed and a system to request IT service has been implemented in SharePoint.

Imaging. Mr. Mitchell reported the imaging backfile conversion continues, with 17 of 21 Lektrievers emptied. He expects all paper files to be imaged by the end of December.

SB 1313 Implementation. Mr. Mitchell reported the IT systems changes required to implement SB 1313, which makes significant changes to retiree health care premiums,

have been completed and testing is being completed. He pointed out that negotiations with the Union are ongoing, so we don't know when the program will be implemented or what changes will have to be made to the system based on the outcome of negotiations.

Web Presence. In the effort to move the website in-house, Mr. Mitchell informed the Board that infrastructure testing has been completed and the required network upgrades are ongoing.

Disaster Recovery. Mr. Mitchell reported that Business Continuity planning is ongoing and that as part of the process, he had been working with CMS regarding the usage of their Northern Data Center. He then offered to answer any questions from the Board. Chairperson Topinka thanked him for his hard work and complimented him on the timely completion of the imaging project.

Chairperson Topinka asked Mr. Mitchell about transparency and our ability to comply with all relevant laws and still maintain security for our members' personal information. He responded by noting that most of our member data is considered public information under the Freedom of Information Act. SERS will be able to provide transparency as required by statute and still maintain the security of all personal information.

Trustee Rensing followed up by referring to the financial compliance audit and noting that a comprehensive risk assessment has not been performed which would identify confidential and personal information. She asked Mr. Mitchell if this is contradictory to what he had just said. Mr. Mitchell responded that these were two different subjects. The Chairperson had asked about sharing information with the proposed open data portal and whether we can protect our private information. He stated the answer to that question is yes. He noted the risk assessment referred to in the audit finding points out that SERS has never completed a comprehensive risk assessment to identify where our risks are. It refers to more than just IT. He pointed out that he does think it is important to complete a comprehensive risk assessment.

Chairperson Topinka asked Mr. Mitchell how long he thought it would take to complete a comprehensive risk assessment. Staci Crane, new Chief Internal Auditor of SERS, offered to address the Board in response to the Chairperson's question. She briefly addressed the Board by providing her background and experience. She then answered that a comprehensive risk assessment usually takes a year to 2 years, depending on the type of data you are looking at and how much of it there is.

Chairperson Topinka then asked if this would then be another audit finding due to the length of time it would take to complete. Ms. Crane responded the finding was immaterial so the Legislative Audit Commission would not even be notified of the finding. And she noted this is done intentionally by the Auditor General so that "hackers" don't know that a risk assessment hasn't been performed.

Chairperson Topinka then asked Secretary Blair how long he had known about the lack of a comprehensive risk assessment. He responded by noting that risk is an ongoing discussion among management and that he had informal discussions with the former internal auditor regarding perceived areas of risk, but that no formal assessment had ever been done by any of the former auditors. He then said one of the reasons Ms. Crane was hired

was to help with the risk assessment. He pointed out the current calculation system is 30 years old and he is not entirely confident in it.

Mr. Mitchell then added that the trustees' security concerns were appreciated, but that IT had had CMS come in to try to access data and had a network security risk assessment. Only a few "holes" in security were found and they were fixed.

Trustee Rensing then moved to have a comprehensive risk assessment policy drafted and a comprehensive risk assessment completed within 2 years. Trustee Friedman requested that Mr. Mitchell include progress reports on the risk assessment in his quarterly report to the Board, which he agreed to do. Trustee Sullivan clarified the assessment should also include controls, processes and functions. These requirements were added to the motion, which Trustee Sullivan seconded. All were in favor.

REPORT OF CHAIRPERSON

Election of 2013 Vice-Chairperson. Chairperson Topinka informed the Board members the election of Vice-Chairperson for 2013 was in order and opened the floor for nominations. Trustee Allison nominated Vice-Chairperson Lori Laidlaw for re-election to the position. The motion was seconded by Trustee Friedman. There being no further nominations, Chairperson Topinka closed the nominations. The vote which followed resulted in the unanimous re-election of Vice-Chairperson Lori Laidlaw for calendar year 2013.

Appointment of Executive Committee. Chairperson Topinka announced the annual appointments to the Executive Committee were in order. Thereupon, she moved to reappoint Loren Iglarsh as the Committee's Chairman, with Vice-Chairperson Laidlaw and Executive Secretary Blair as Committee members. The motion was seconded by Trustee Sullivan and all trustees in attendance voted in the affirmative. The Chairman expressed her appreciation to the appointees for their time and effort serving on the Committee.

REPORT OF CHIEF INTERNAL AUDITOR

The System's Chief Internal Auditor, Staci Crane, addressed the Board. She began by referring to the documents that she had distributed to the Board electronically and that were brought to the meeting in hardcopy form. Ms. Crane briefly reviewed the internal audit charter and functions and asked the Board if there were any questions. She then referred the Board to the 2-year audit plan and explained this is a more comprehensive document than they have seen in the past. She explained that this a function of the poor results of the 2011 peer review of the prior Chief Internal Auditor and that she had implemented several of the issues during the peer review.

Chairperson Topinka asked if Ms. Crane had yet identified any problems. She pointed out she had discussed risk areas with Secretary Blair and that he had mentioned the benefit processing area, which is a very manual process. Trustees Allison and Rensing then stated they were not happy with these revelations and again questioned Secretary Blair on his assessment of areas of potential risk. Secretary Blair responded that his main concern is the antiquated systems relied upon to process claims and generate benefit checks totaling

over \$150 million per month. In addition, member information was previously kept in paper files which contained personal and medical information that could be viewed by all employees, rather than just employees of the Disability Section.

Chairperson Topinka asked that Ms. Crane and Secretary Blair report back to the Board at the next meeting regarding the assessment of risk. Trustee Allison then asked Secretary Blair to compile a list of areas of concern and provide to Ms. Crane for review. Secretary Blair agreed to compile the list and to work with the Chief Internal Auditor and trustees.

Chairperson Topinka asked who Ms. Crane reports to. Ms. Crane responded that according to the Internal Auditor Act she reports directly to Secretary Blair.

REPORT OF THE EXECUTIVE SECRETARY

Calendar Year 2013 Meeting Dates. In order to abide by the Open Meetings Act, it is necessary to post a schedule of meetings for the ensuing year in the System's offices and on the web site, as well as publish the schedule in a State newspaper. Trustee Rensing made a motion, seconded by Trustee Byrd, to approve the 2013 meeting dates. All Trustees voted in the affirmative for the following meeting dates for 2013:

Thursday, January 8
Tuesday, April 16
Tuesday, July 16
Tuesday, October 29

All 2013 meetings will be held at 10 a.m. in the System's Springfield office with the videoconference option in Chicago.

FY 2013 Funding Update. Secretary Blair informed the Trustees that SERS has received money from the State representing FY 13 employer contributions through mid-September. Comptroller Topinka added that her office is trying to provide some predictability to all of the State-funded systems by making at least partial employer contributions to all of the Systems. Secretary Blair added that the scheduled November withdrawal from the ISBI was cancelled due to the more timely employer contributions.

Fraud Policy. Secretary Blair referred the Board to a proposed fraud policy for their consideration. He explained the policy is not in response to anything, but rather just to provide a framework for reporting suspected attempts to defraud the System. He informed the Board that Steve Bochenek, the Board's attorney, had reviewed the proposed policy and was available to answer any questions the Board may have. Secretary Blair added that staff would be trained in the requirements of the new policy. Trustee Rensing made the motion to adopt the proposed fraud policy. Trustee Friedman seconded the motion and all were in favor.

Death Match. Secretary Blair explained to the Board that the prior Chief Internal Auditor completed the death match, but that responsibility had been temporarily assumed by Dawn Blakeman, Recording Secretary, until a permanent home for it could be found. He

reported that Dawn had identified the \$37,288.74 in payments that were scheduled to be paid to decedents whose deaths were not reported to SERS.

Chairperson Topinka asked Secretary Blair how the decedents are identified. He explained that SERS provides a list of all annuitants to the Berwyn Group. The Berwyn Group then matches it up against other databases that include reported deaths and then let us know if they find “matches” or probable matches that we should investigate.

Chairperson Topinka questioned if we sometimes pay benefits to decedents before they are identified during the death match process. Recording Secretary Blakeman offered that it does sometimes happen. Chairperson Topinka then asked if we try to recover the overpayments. Secretary Blair explained the System works with the Attorney General and Comptroller’s Office in recovering any overpayments and that most overpayments are the result of the Disability Program. Chairperson Topinka asked Secretary Blair to contact her Chief of Staff about utilizing the Comptroller’s Office to further recoup overpayments.

FOURTH QUARTER FINANCIAL STATEMENTS

Nicholas Merrill, Manager of the Accounting Division, presented the financial statements for the fourth quarter of Fiscal Year 2012.

Mr. Merrill very briefly reviewed the financial statements and explained the significant difference from the 4th quarter of 2011 was an increase of \$275.7 million in employer contributions. This increase in the employer contribution amount allowed SERS to decrease the 4th quarter withdrawal from ISBI by \$221.0 million.

On motion by Trustee Ousley, seconded by Vice-Chairperson Laidlaw, and by unanimous vote, the Board approved the financial statements as presented for the period April 1, 2012 through June 30, 2012. Copies of the financial reports are attached to these minutes as Exhibit B.

APPROVAL OF EXECUTIVE COMMITTEE MINUTES

The trustees had previously been furnished with copies of the July, August and September, 2012, Executive Committee minutes for review.

There being no changes to these minutes, Trustee Sullivan moved for their adoption. Vice-Chairperson Laidlaw seconded the motion, which prevailed by the affirmative vote of all trustees.

CLOSED SESSION

Vice-Chairperson Laidlaw made a motion to go into Closed Session to discuss pending litigation. Trustee Friedman seconded the motion. A roll call vote by Recording Secretary Blakeman was taken with all trustees present voting in the affirmative.

The Board returned to Open Session.

OLD BUSINESS

There was no old business to be brought before the Board.

NEW BUSINESS

There was no new business to be brought before the Board.

ADJOURNMENT

There being no further business to be brought before the Board, Trustee Morris moved for adjournment at 12:45 P.M. The adjournment motion was seconded by Trustee Yates and all were in favor.

Judy Baar Topinka, Chairperson

Date: _____

ATTEST:

Timothy Blair, Executive Secretary

Date: _____