PUBLIC PENSION OVERSIGHT BOARD

Minutes

April 22, 2019

Call to Order and Roll Call

The 3rd meeting of the Public Pension Oversight Board was held on Monday, April 22, 2019, at 1:00 PM, in Room 154 of the Capitol Annex. Representative Jim DuPlessis, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Dennis Parrett and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Mike Harmon, and James M. "Mac" Jefferson.

Other Legislators Attending: Representative Derrick Graham.

Guests: David Eager, Executive Director, Kentucky Retirement Systems; Danny White, GRS Retirement Consulting.

LRC Staff: Brad Gross, Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Senator Higdon moved that the minutes of the March 25, 2019 meeting be approved. Senator Parrett seconded the motion, and the minutes were approved without objection.

2019 KRS Actuarial Experience Study Results

David Eager, Kentucky Retirement Systems (KRS) and Danny White, GRS Retirement Consulting (GRS) presented. Mr. Eager opened his comments by noting the recently completed experience study by GRS, which is a statutorily required review of assumptions and covered the period of June 30, 2018 back to June 30, 2013. He reminded the oversight board that KRS had reviewed economic assumptions during 2017, which resulted in a much higher contribution rate. This recent study focused more on demographic assumptions. Mr. Eager stated the KRS board was considering more frequent studies of both economic and demographic assumptions in the future.

Mr. Eager reviewed the actuarial valuation process, the data and assumptions used, and the ultimate output calculated. Results are dependent on a mix of known data points, such as the member’s age, current salary, gender, and service to date, as well as some assumptions that must be made about the future, such as investment returns, future salary increases, retirement dates, and death, disability, or termination rates. He provided an example member scenario for the Kentucky Employee Retirement System (KERS), County Employee Retirement System (CERS), and State Police Retirement System (SPRS).

Danny White, GRS, summarized the recent actions by the KRS board with regards to the 2018 experience study. The board had adopted the recommendation by GRS from the investigation. The new assumptions will be used in the upcoming 2019 valuation, which will determine the required contribution rates of KERS and SPRS for the 2021 and 2022 fiscal years. Regarding CERS, the 2019 valuation would determine only the 2021 contribution rate.

Mr. White discussed the importance of the experience study and magnitude of underlying assumptions used in the process. Assumptions are not static and should change periodically to reflect new information, such as mortality expectancies, changes in retirement patterns, terminations, as well as evolving best practices. As to demographic assumptions, recent experience provides strong guidance. He discussed the importance of actuarial assumptions in determining contribution rates but said that the assumptions themselves do not change the ultimate cost, but actual experience will. The assumptions represent an educated expectation or estimate, but the actual cost is determined by actual retirement ages, investment returns, and life expectancy.

Mr. White reviewed the principle assumptions reviewed during the recent experience study, which fell under two primary categories: economic assumptions and demographic assumptions. Economic assumptions had been more thoroughly reviewed in 2017, so they were revisited and revalidated. Regarding the demographic assumptions, this study was the first review since 2013, so a much deeper dive was conducted. He reviewed several of the demographic assumptions reviewed, which included mortality, plan turnover, and likelihood of disability.

Mr. White provided a summary of the material recommendations from the experience study. For all systems, life expectancy was increased and the mortality assumption used was revised to include an explicit assumption for improvement of life expectancy for future retirees. With regards to the CERS hazardous plan, the rate of turnover before retirement was reduced to reflect actual results. The expected salary increases for individuals and rate of disability incidence were adjusted slightly for a few plans.

In response to a question from Representative DuPlessis with regards to recent reports in the popular press about decreasing life expectancy, Mr. White indicated that much of that decrease is actually being seen in the mid-life range of the population, which is the result of increased opioid use, obesity, and other factors. However, when looking at later stages of life and retired individuals, given the advancement of pharmaceutical benefits, life expectancy has been increasing.

Mr. White gave an update on the assumed rate of return for the KRS charts and referenced a recent survey conducted by the National Association of State Retirement Administrators in February of 2019, which showed the median investment return assumption across plans had decreased from 7.46 percent to 7.25 percent. As to the current experience study, GRS is not recommending changes.

In response to a question from Senator Higdon regarding how often mortality is reviewed and recent changes, Mr. White stated that the mortality tables for KRS had not changed since 2013.

Mr. White moved into a discussion of mortality rates and recommendations for the KRS plans. He shared a slide from the National Vital Statistics System that reported mortality rates by each state. Even within states, mortality rates can differ fairly dramatically by geographical region and factors such as education, race, and professional occupation.

Mr. White outlined two primary considerations an actuary makes when setting mortality rates: (1) identifying current life expectancy and (2) anticipating improvement of life expectancy. Identifying current life expectancy is data dependent, and a plan the size of KERS has a statistically significant number of retirees to determine such data with good confidence. The anticipated improvement in life expectancy requires national data and involves the actuary trying to anticipate the rate of improvement or expected trend. With regards to setting KRS assumptions, GRS used actual data to develop a base mortality, or current life expectancy, while a national mortality table would be used to build in activated improvement. Mr. White reviewed several charts that compared KRS' prior assumptions versus actual experience and the new recommended assumption for current life expectancy for males and females.

In response to a question from Senator Higdon with regards to how assumptions are set and the impact they can have on contribution rates, Mr. White noted that some assumptions can have a larger impact than others and referenced the payroll growth assumption's impact on the KERS plan's contribution rates. In response to a follow-up question regarding if KRS mortality rates had been set artificially low, Mr. White was hesitant to give an opinion without being able to look more closely at the data from 2013, but noted that even GRS had set assumptions in the past that looked very conservative years later. He said it is difficult to assume or estimate what is going to happen.

In response to a question from Representative DuPlessis regarding the use of a graduated scale with an anticipated improvement in other states, Mr. White stated that it was becoming more common practice. A reason was the timing of experience studies and a desire to see smaller incremental changes in the future. Using a flat rate has led to bigger jumps, similar to what KRS is adopting, while using the graduated scale should result in only minor changes in the future.

Mr. White summarized the mortality recommendations GRS made as a result of the study. A new base table, which was based on actual KRS experience, would be combined with a national improvement scale to project future improvements. In addition, GRS recommended updated mortality assumptions for pre-retirement and disabled retirees using published mortality tables.

In response to a question from Representative Graviss regarding GRS' recommendation for females falling above most peer states, Mr. White stated the recommendation was data dependent and based on actual results. In both males and females, there is enough data to be statistically relevant and reliable. What the data shows, specifically for females, is that life expectancy for KRS retirees is different than the data for state as a whole and when compared to peer states.

In response to a question from Representative Miller regarding the financial impact of the mortality changes, Mr. White noted that GRS' full report included fiscal impacts for each plan. For the KERS nonhazardous system specifically, the accrued liability grew from \$15.6 million to \$16.3 million due to the mortality assumption changes.

In response to questions from Representative Wheatley regarding the importance and impact of various assumptions, Mr. White stated the magnitude and importance often is dependent on the underlying plan. With regards to a plan like KERS nonhazardous, which has a large unfunded liability, the payroll growth assumption can have much larger magnitude than the investment return assumption, given the lack of assets. In response to a follow-up question regarding the importance of the life expectancy assumption, Mr. White agreed that for the KERS plan, where over 70 percent of the liability is driven by retirees, changing the life expectancy for that group will have material impact.

Mr. White discussed the turnover assumption, or the likelihood of a member reaching retirement. This assumption was studied for all plans, but recommended changes were only made for the CERS hazardous plan. He reviewed charts which showed actual rates of turnover per years of service from 2013 to 2018 compared to the plans current and recommended assumption. As a member's years of service increase, the probability of them leaving the system drops. For example, for members with roughly 6 years of service, approximately 5 percent of that population would turnover and become inactive members.

Mr. White reviewed the overall payroll growth assumption and noted that GRS reviews both changes in total payroll and membership, given membership is the underlying driver for any increase or decrease in total payroll. GRS is not recommending a change to current assumptions, but suggested a move away from having a payroll-based contribution model and instead utilizing a fixed allocation of amortization cost. Mr. Eager added that this is the most critical funding issue that KRS faces.

In response to a question from Representative DuPlessis with regards to what that change in funding would look like specifically if KRS moved to level dollar funding, Mr. White stated that the total contributions calculated during the valuation process would not change. If the funding period remained the same, invoicing a dollar amount to employers, instead of tying the contribution rate to a percent of pay, would result in KRS receiving exactly what is expected. Currently, GRS converts the dollar amount into payroll rates, but with payroll declining at approximately two percent per year, this results in two percent less contributions than expected.

In response to a question from Representative Graviss with regards to payroll growth decline, Mr. White stated that KRS does not receive any employee data on contracted employees, so it is difficult to quantify. Mr. Eager added that the active membership had decreased from 44,000 to 34,000 over the past 10 years. Representative Graviss commented that he believed it was worth looking into this to determine how many jobs had been consolidated versus how many had been outsourced or contracted. He requested that a total number of contract laborers be supplied for review.

In response to questions from Mr. Chilton regarding the differences between the payroll growth and individual salary increase assumptions, Mr. White noted the payroll growth assumption is used to determine how the unfunded liability is amortized, or financed. Comparatively, the individual salary increase is used to project active member final compensation for the purpose of calculating a total liability. He confirmed that if KRS moved to a level dollar method of financing the unfunded liability, the payroll growth assumption would not be needed, while a salary increase assumption would still be used for the benefit side. In response to a follow-up question regarding comparison of investment return assumptions to the nongovernment private sector, Mr. White stated that, generally, the private sector assumptions are a little lower.

In response to a question from Representative Miller as to the impact of the turnover assumption changes, Mr. White referenced the fiscal impact analysis included in the full report and indicated there would be a cost increase. Given the assumption is related to active members and not retirees, the impact on the accrued liability is not material, while most of the cost increase is reflected in an increase to the normal cost for both the pension and insurance plans.

In response to a question from Representative DuPlessis regarding how the amortization cost would be allocated in a fixed dollar funding model mentioned earlier, Mr. White stated there were two primary steps. First, GRS determines the amortization cost for that given fiscal year, which is the same process as they follow today. Secondly, the General Assembly would have to adopt legislation that outlined how that annual cost was allocated out to each of the employers. He mentioned two methods that had been considered, one based on recent payroll and one based on actual liability. Senate Bill 151 included language which allocated the amortization cost based on an employer's average payroll over the past 60 months. An alternative method could be to allocate the amortization cost based on each employer's percent of total liability as calculated during the valuation process. There are challenges to either method. Using an average payroll method may require employers who entered the plan later and do not have a base of retirees to pay more of the unfunded liability than they actually accrued. However, a benefit to this method is that payroll data is very transparent, while using the liability based allocation process is not quite as transparent. The actuary would calculate the liability, and employers who not have the level of detail or transparency they need could overwhelm KRS with requests to validate. Inherent to any cost sharing mechanism, no matter what method is chosen, is that there will be winners and losers.

Mr. White reviewed the fiscal impact and projected employer contribution rates of the recommendations. A slide reported each plan's unfunded liability, funding ratio, and employer rate before and after the assumption changes. The actual cost of a retirement system is based on the plan provisions and actual experience, not the actuarial assumptions. The big changes taking place now hopefully will result in smaller, less material changes when the next experience study is conducted.

Senator Higdon noted recent legislation that exempted employers from making contributions on certain reemployed retirees. He felt like some level of contribution needed to be paid by those employers, such as normal cost. Senator Higdon asked if KRS could report back to the board the impact of exempted contributions for retirees returning to work.

In response to a question from Representative Wheatley regarding if Tier 3 member activity was incorporated in the turnover research, Mr. White confirmed that Tier 3 experience was included. Representative Wheatley asked for some clarification on the actual turnover results and noted how low turnover can be for firefighters. Mr. White stated that firefighters across the country have low turnover, but in the case of CERS and KERS, the pool is a mix of public safety and other hazardous positions, including firefighters.

In response to a question from Representative Graviss regarding the KERS nonhazardous plan assumed rate of return, Mr. White said the board had a stated goal of setting a rate that they believe could be met 60 percent of the time. Based on current asset allocation, at a 5.25 percent assumption, there is approximately a 59 percent chance of meeting or exceeding that assumption rate.

Representative Miller commented that given CERS employers' liability was projected to increase about 10 percent as a result of these changes, the employer rate phase-in would likely be extended another year or so. He asked for some clarification regarding why the CERS nonhazardous insurance plan saw an approximate 22 percent increase. Mr. White indicated GRS would take a harder look and respond at a later date.

In response to question from Representative Graviss regarding if a assumed rate of return closer to the average expectation of 5.72 percent would have an impact on the quasi-governmental employer issue, Mr. White stated it would not have material difference. The increase in contribution rates from 2017 was largely driven by the change in the payroll growth assumption and that, with such few assets, the discount rate does not materially impact the employer contribution rate.

In response to a question from Representative Graviss regarding cash flow, Mr. White stated that future benefit payouts should not change significantly due to the assumption changes. Longer term, as members live longer, benefit payments may change more, but the higher contribution rates received now should help manage that cash flow.

With no further business, the meeting was adjourned.