PUBLIC PENSION OVERSIGHT BOARD

Minutes

June 24, 2019

Call to Order and Roll Call

The 5th meeting of the Public Pension Oversight Board was held on Monday, June 24, 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: Representative Jim DuPlessis, Co-Chair; Senators Christian McDaniel, Dennis Parrett, and Wil Schroder; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; John Chilton, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

Guests: David Eager, Executive Director, and David Harris, Chairman, Investment Committee, Kentucky Retirement Systems Board of Trustees, Danny White, GRS Retirement Consulting; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Donna Early, Executive Director, Kentucky Judicial Form Retirement System and AC Donahue, Trustee for Judicial Form Retirement System; Bryan Sunderland, Deputy Chief of Staff and Legislative Director, Office of the Governor and John Chilton, State Budget Director.

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

Approval of Minutes

Senator Parrett moved that the minutes of the May 20, 2019 meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Investment and Cash Flow Quarterly Update – Kentucky Retirement Systems

David Eager, Kentucky Retirement Systems (KRS) providing a summary of investment performance, as of March 31, 2019, for each of the pension and insurance plans across the fiscal year to date, 3-, 5-, 10-, and 20-year time frames. Mr. Eager pointed out that most of the plans had performed near their respective benchmarks and that staff expected the fiscal year returns to be approximately 5.5 percent depending on the specific plan. He cautioned that KRS may experience a more difficult period going forward, as the Federal Reserve (Fed) is expected to ease rates, which benefit equity markets and hurt fixed income assets. Given KRS has less equity and more fixed income than most peers, it could prove to be difficult period for plans.

Mr. Eager discussed cash flow for the first nine months of FY19 as compared to the same time period in FY18. He began with the Kentucky Employees Retirement System (KERS) nonhazardous pension plan. He pointed out that a lower total of member contributions was due to a continued decline in payroll, while the significant increase in employer contributions was the result of the new and higher rates. Overall, he noted that KERS was experiencing a positive net cash flow for the first time in 15-16 years. For the County Employees Retirement System (CERS) nonhazardous plan, cash flow was very similar to the prior year and assets were effectively flat. He noted payroll had declined slightly and stated employer contributions were increasing as the higher rates are being phased-in over the next couple of years. Moving to insurance, Mr. Eager stated that net cash flow had improved, however, lower investment gains had impacted the change in assets for a few plans.

In response to questions from Representative Miller regarding what the plans expected funding ratio might be for the upcoming June 30, 2019 actuarial valuations, Mr. White responded that he expected the KERS nonhazardous fund to remain near its current 13 percent funded status. He noted that recent assumption changes would likely increase the unfunded liability from the prior year, but the increased contributions and asset gain would serve to offset. For the CERS nonhazardous plan, Mr. White estimated the funding ratio would likely dip a bit as a result of the assumption changes and the fact that employers are phasing into the higher contribution rates. Overall, across the board, a slight decline should be expected due to the new assumptions.

In response to a question from Representative Wheatley regarding the CERS nonhazardous pension fund's cash flow, Mr. Eager confirmed that the change in net position for CERS nonhazardous went from $350.8 million in FY18 to $1.2 million in FY19.

In response to a question from Representative Graviss regarding any incentives for employers to decrease payroll, both Mr. Eager and Mr. White both stated they were not aware of incentives, but given that pension costs are tied to total payroll, one way an employer can manage that cost is to manage payroll. In a follow up question from Representative Graviss regarding an alternative plan of allocating the liability proposed by KRS, Mr. Eager stated that staff believed allocating the liability cost separate from a percent of payroll method would serve as disincentive for employers from shedding payroll.

Representative DuPlessis stated that follow-up information had been provided to each member in their packets regarding the alternate plan outlined in May, which provided a comparison of estimated contributions for each individual quasi-employer under the two approaches.

In response to questions from Senator McDaniel with regards to adjusting the assumed rate of return in light of recent increased contributions and future expectations in the equity markets, Mr. Harris responded that there is a temptation to use the current scenario and market expectations to revise return assumptions, but this would be a challenge given the funding ratios of KERS and a need for more risky assets to reach a higher assumption. He noted that the increase in employer contributions was making a significant impact, but indicated that trend would have to continue for a few more years before the board would feel comfortable adjusting assumptions. In a follow up question from Senator McDaniel regarding the recent changes to the mortality assumptions, Mr. White responded that GRS had recommended an updated mortality assumption that was based specifically on actual KRS retiree experience, which also included an improvement scale into the future.

In response to a question from Representative Miller regarding how to determine and pay the unfunded liability portion of the plan, Mr. Eager stated there are two different calculations. First, the unfunded liability payment due must be calculated and in this step a plan has to decide whether to use a level percent of pay or level dollar method. Second, once you have the payment amount determined, a plan must determine if the employers want to make that payment based on their percent of the plans total payroll or by their share of the total unfunded liability.

In response to questions from Representative Graviss regarding if the portfolio might look to add more of the safer equity assets given the Fed’s expected policy decision and outlook for those assets, Mr. Eager responded that ultimately that would be a decision of the investment committee, but that the target allocations do include a range where staff and the committee can have some flexibility. Representative Graviss expressed some concern that assets were not allocated conservative enough to protect the fund. In response to a follow-up question regarding how long the actuary’s project out liabilities, Mr. White responded that cash flows are generally projected out over a 90-year period, while the liability projection covers approximately 30-35 years.

In response to a question from Senator Schroder with regards to when mortality assumptions have changed, Mr. White stated the assumptions were last changed during the 2013 Experience Study, and he noted that a member’s assumed life expectancy was 2 years longer than in the past.

In response to a question from Representative Wheatley regarding the changes in mortality assumptions, Mr. White stated that contribution rates were estimated to increase about 4 percent due to the changes. In response to a follow-up question regarding how KRS retirees were living longer than the average citizen, Mr. White stated that demographics and characteristics of KRS members likely drove that experience, pointing out education, lifestyle, and life choices as examples.

Representative DuPlessis commented that looking at average life expectancy is a bit misleading due to the fact that national averages include younger populations as compared to a KRS population of retirees. He noted that actuaries have found that if someone lives past the age of 45 or so, the life expectancy is going to be higher than the overall 79-81 average. Mr. White stated that GRS looks at the retiree population starting at age 65.

In response to a question from Representative DuPlessis regarding how actual experience might impact next year's contribution rates, Mr. Eager stated that KRS expects returns to be very close to assumptions, maybe slightly less for the plans with a 6.25 percent assumption, but that contribution rates should not be impacted significantly due to investment performance. He did note that the new mortality assumptions will be incorporated in this valuation, so there will be an increase in rates due to those changes.

Investment and Cash Flow Quarterly Update – Teachers' Retirement System

Beau Barnes, Teachers' Retirement Systems (TRS), began his presentation discussing the pension investment performance as of March 31, 2019. He discussed the benchmarks and gross and net returns for the quarter, fiscal-year-to-date, 1-, 3-, 5-, 10-, and 20-year trailing time periods. He stated that the 30-year compounded gross return is 8.27 percent.

Mr. Barnes next reviewed cash flow for the pension fund through the first three quarters of FY19 and FY18. He pointed out cash inflows, outflows, and the total net plan assets across both time periods.

In response to a question from Representative DuPlessis regarding member and employer contributions, Mr. Barnes confirmed that members contribute 9.105 percent from their pay towards the pension fund, while the state's (employer) total contributions of $799,599,000 was the 13.1 percent statutory rate plus an additional amount needed to pay the full unfunded liability, which totals approximately 29 percent.

In response to a question from Representative DuPlessis regarding net cash flow, Mr. Barnes agreed that the pension fund experienced a negative cash flow of approximately $250 million before investment gains or losses. Mr. Barnes noted the additional contributions appropriated along with recent portfolio rebalancing tactics make the negative cash flow manageable.

In response to a question from Senator McDaniel with regards to the impact of fully funding the contribution rate, Mr. Barnes stated that the additional funds received from the General Assembly and Governor has not only allowed TRS to fully implement their funding plan, but has also served as a game changer for investments.

Mr. Barnes continued with an update on cash flow for the medical fund cash as of March 31 of FY19 and FY18. He discussed cash inflows, outflows, and the total net plan assets across both time periods.

Lastly, Mr. Barnes discussed the recently completed spring trustee elections and stated that 13,637 members voted, which was an increase of approximately 1,000 members from the previous year. The cost per ballot was 56 cents. Mr. Barnes stated that with the helpful guidance of Representative Miller, TRS initiated for the first time electronic voting through the TRS member portal so members could vote in an encrypted manner.

In response to questions from Representative Wheatley regarding funding levels, Mr. Barnes stated that the pension fund as of June 30, 2019, was 57.7 percent funded, and the medical fund was 36.3 percent funded. In response to a follow up question, Mr. Barnes stated that the TRS health care fund is better funded when compared to other states, of which many are pay-as-you-go plans.

Representative Graviss inquired whether KRS could provide a 30-year return for KERS. Representative DuPlessis requested Mr. Eager email the 30-year return information to the members.

Representative Graviss commented that it is noticeable that TRS is earning higher yields, has more money invested in safe equities, and less money in private equities and alternatives than KRS. He expressed his concern as to why KRS' investment committee was not investing more like TRS. Representative DuPlessis responded that Mr. Eager had testified during previous meetings that KRS would take more risk if their unfunded liability was closer to that of TRS or if the plan had more assets.

In response to a question from Senator Schroder with regards to TRS mortality rates, Mr. Barnes stated the assumptions were changed during their Experience Study four years ago. The next study will begin next year.

In response to a question from Representative Miller with regards to payroll growth, Mr. Barnes stated that the board currently utilizes an assumption of 3.5 percent.

In response to a question from Representative DuPlessis regarding how actual experience might impact next year's contribution rates, Mr. Barnes stated he doubted TRS would have 3.5 percent for FY19, although TRS is experiencing positive payroll growth. He indicated there could be some increase due to experience and stated that the budget request that TRS makes will reflect a payroll growth that is less than anticipated.

Investment and Cash Flow Quarterly Update - Judicial Form Retirement System

Donna Early, Judicial Form Retirement System (JFRS), joined by A.C. Donohue, Trustee, began her presentation with the performance overview for the defined benefit and hybrid cash balance plans for both the Judicial (JRP) and Legislators' (LRP) Retirement Plans. She presented charts for each plan with information on the total portfolio, total portfolio net of fees, total equity, total fixed income, and cash and equivalents.

Next, Ms. Early presented the statement of changes in net position for both JRP and LRP. She discussed the cash inflows, cash outflows, and net plan assets for FY19 and FY18.

In response to a question from Representative DuPlessis, Ms. Early stated that the $1.6 million reduction in the cash inflow employer contributions for the LRP for FY 2018-2019 was due to the appropriations being taken out in the current budget. Ms. Early noted that the lack of appropriations will have an impact in the future.

In response to a question from Senator Parrett, Ms. Early provided the approximate number of members in each of the four plans administered by JFRS: the LRP defined benefit plan, the LRP hybrid plan, the JRP defined benefit plan, and the JRP hybrid plan. She explained that for the LRP, the plans total membership does not total 138, since some legislators participate in other systems (i.e. KERS, TRS). She said that she would provide exact membership numbers as a follow up after the meeting.

Representative Miller commented that he was a strong proponent of not funding the legislative plan because he thought it looked horrible that the Legislators' Retirement Plan is funded so well compared to the KERS plan. Ms. Early commented that in defense of the funded status, it has been a result of the remarkable investments. She also noted that legislators have never contributed more than what the statutory formula provided. Mr. Donahue added he believes it is important to continue funding what is required to keep the funds fluid.

Discussion of BR 9/BR 19 (Draft Proposal)

Bryan Sunderland, Office of the Governor, started his presentation with a few opening remarks and reviewed a timeline of how the plan was developed. Mr. Sunderland stated that BR 9 was made available to the public on May 1, 2019, which was two full months prior to the end of the fiscal year. He stated that multiple briefings and meetings had been held with both stakeholders and legislators. He noted that a copy of the bill, summaries, side-by-sides, the actuarial analysis, and other explanatory material was provided to these interested parties, along with multiple endorsement letters from quasi-governmental employers and KRS. Mr. Sunderland stated that his office worked with KRS and had taken input from a number of legislators throughout the process.

Mr. Sunderland outlined the difficult challenge of trying to balance the needs of quasi-governmental employers, their employees, as well as the retirement system. He noted that each quasi-governmental entity faces different needs, financial conditions, and underlying employee demographics. He stated that some wish to stay in the system, while some wish to exit the system. Some are willing to pay by installments, while others wish to pay by lump sum. Others wish to allow current employees to stay in the system. In short, Mr. Sunderland commented that one size does not fit all.

Next, Mr. Sunderland reviewed past legislation relating to cessation of participation from the retirement system. He referenced HB 62, which was passed in 2015 and signed by then Governor Beshear, as the proposal that set the framework and allowed participating employers to exit the plan. In 2017, the General Assembly returned to pass HB 351, which made some changes relating to the process for payment of the actuarial cost to exit the system (lump sum only), but maintained an employer's ability to exit the system. Mr. Sunderland then explained the conflict between the General Assembly's support for and Governor Bevin's strong objection to HB 362, which would have allowed universities, community colleges, health departments, and other entities to cease participating in the retirement systems during a defined window, provided the ceasing employers paid the actuarial costs of cessation through equal installments with zero interest over a 30 year period.

Moving to the current proposal, Mr. Sunderland outlined that BR 9, which is now BR 19, provides for a one year cost relief to allow quasi-governmental employers to determine which solution is best for their individual situation. If the employers decide to remain in the system, they have one year to financially prepare. If the employers decide to opt-out, they can with a lump-sum option, installments that are phased-in for affordability, and they can decide to move all employees to a new plan or leave Tier 1 and Tier 2 employees in the current system. Mr. Sunderland stated that no employer would be forced out of the pension system. All remain in KERS nonhazardous unless the employer takes action to exit. Each employer will have one year to plan and budget and will receive all financial information prior to having to make a decision. He noted that no employer could elect to opt-out prior to April 1, 2020, which falls after the General Assembly's next budget session where additional decisions regarding financing may be made.

As a result of discussions between the Governor's staff and legislators, Mr. Sunderland explained that a few changes to the original BR 9 proposal had been made and referenced a letter from the Governor that had been sent on June 5th outlining four primary changes: (1) replacing Section 7 with a non-severability clause; (2) adding language that would require the pledge of assets in case of default; (3) adding language that would stop any additional accrual of future benefits/service credit for employees still participating in KERS, if an employer failed to pay; and (4) adding specific language to ensure the 2020 General Assembly had the opportunity to revisit the issue addressed by the Act and correcting of the indemnification clause. The resulting draft is BR 19.

Mr. Sunderland discussed the process employers who make the decision to exit would follow and noted they could do so either by paying their full actuarially accrued cost by lump sum or installment payments. If the employer chose to completely exit and all employees moved to a new plan, described as a hard freeze, and the employer decided to pay by lump sum payment, the actuarially accrued cost payment would be based on a 4.5 percent rate of return. If the employer choose a soft freeze, by leaving Tier 1 and Tier 2 employees in KERS, the cost payment would be based on a 3.5 percent rate of return to account for the additional risk to KERS. All employers choosing the lump sum option would have until June 30, 2021, to make full payment and would incur an annual 5.25 percent interest on pension costs and 6.25 percent interest on health costs until the sum was fully paid.

For employers choosing to exit and pay in installments, Mr. Sunderland reviewed the options. First, employers choosing to pay their full actuarially accrued liability in installments over 30 years or less and opting for a complete exit of all employees would use a 3.5 percent rate of return, while a soft freeze option where legacy employees remained in the system would result in a 3.0 percent rate. Employer installments would be calculated as the higher of the employer's FY19 contribution or its 60 month average payroll multiplied by 49.47 percent, plus a 1.5 percent annual increase for 30 years or until fully paid. Second, for those ceasing entities who would not fully pay off their liability in 30 years, Mr. Sunderland stated the cost would assume the same rates of return, but that employers who chose the hard freeze would fully exit the plan after 30 years of installments regardless if they left behind a liability or not. However, if employers choose the soft freeze option, their full liability would have to be paid and their initial starting rate would be increased to ensure payment was fulfilled over the 30-year period.

Mr. Sunderland discussed the desire to provide a proposal with multiple options that could be tailored to meet each employer's specific needs. He pointed out the various options, which included employers staying in the plan, choosing to exit with one of two lump sum options, or utilizing one of the installment options.

Mr. Sunderland reviewed three financial projections provided by GRS Consulting. First, he reviewed a distribution of each quasi-employer and the percent of the actuarial cost they would finance under the hard freeze option. He noted that 54 out of the 113 employers would fully pay their liability over the 30 year period, while the remaining employers would leave behind a portion of their full cost. Secondly, he reviewed a distribution of the initial installment rate that would be required for employers choosing the soft freeze installment option. Under this option, each employer would have to fully pay the cost over 30 years and he noted that only 28 out of the 113 employers would do so with a starting rate of 49.47 percent. He pointed out that 12 of the remaining 85 employers would see their starting rate increase to 70-75 percent in order to fully meet their obligation over 30 years. Third and last, Mr. Sunderland discussed a summary of the financial impact of the two lump sum and two installment options. He noted that the hard freeze option resulted in more relief as employers were being priced at a higher discount rate relative to the soft freeze option.

Mr. Sunderland closed his presentation by pointing out what the plan does and does not do. The plan does not force any employer out of the pension system, and it does not take away any earned benefits or change any benefit structure. He emphasized it does not affect other plans, and it does not prevent the 2020 General Assembly from making changes or making supplemental appropriations to any quasi-governmental entity. Instead, he stated the plan does provide immediate relief and time for employers to prepare and decide a course of action. The plan does provide future options and allows employers to do what is best for their employees. The plan balances the need for services and the need to pay for the benefits promised, and it provides time for the 2020 General Assembly to make adjustments or make appropriations.

Mr. Chilton commented that the financial situation quasi-governmental entities are facing is severe and was recognized when the General Assembly gave a one-year reprieve on the increased rate, which resulted in $132 million not going into the system. Mr. Chilton noted that the proposal provides another year of reprieve and gives time for all stakeholders to process the financial information and get a clear understanding of the true financial situation for each employer. Mr. Chilton stated that this plan adds some additional options for affordability and also pointed out that there are subsidies that may be provided in the future. He stated that in the current budget there is almost $50 million of subsidies going to these organizations to enhance their ability to make these payments. Lastly, Mr. Chilton stated that all the groups that represent the organizations that will be benefited have supported this measure.

Representative Graviss commented that he and the minority caucus had been working on two alternative options that he had requested to have added to the agenda and presented. Representative DuPlessis responded that given the Governor was the only individual who could call a special session, the chair had decided to focus the current meeting on allowing members to hear the Governor's proposal. Representative DuPlessis noted that he and Rep. Graviss had been working offline and had shared some ideas and commented that the Governor's proposal would still give legislators three months to pass their own legislation.

In response to questions from Representative Graviss regarding the addition of a non-severability clause, Mr. Sunderland stated the proposal was a comprehensive solution, and Section 7 of the bill draft ensures that all the provisions remain together. In response to a follow-up question regarding the need for only 51 votes to pass, Mr. Sunderland stated that as a result of the emergency clause included in the bill, a total of 51 votes are required. He expressed a belief that the proposal was not an appropriations bill, but stated that prior appropriations bills had been passed with less than 60 votes.

In response to a question from Representative Wheatley in regards to whether the CERS would be impacted, Mr. Sunderland expressed a belief that the bill was narrowly crafted for the quasi-governmental groups and regional universities. In response to a follow-up question regarding specific language included in the draft, Mr. Sunderland suggested that the provisions had been included in previous legislation in 2015, but agreed that staff would look into this language again. In addition to a follow-up question regarding what type of plan employers who had exited were using, Mr. Sunderland stated he was not aware of any employers who were utilizing a defined benefit plan.

In response to questions from Senator McDaniel regarding the differences between BR 9 and BR 19, Mr. Sunderland stated that the only changes were the ones he had identified during the presentation. In response to a follow-up question regarding employee-based lawsuits and the pending Seven Counties withdrawal from KRS, Mr. Sunderland stated that he is not aware of any lawsuits regarding a breach of the inviolable contract, but added that the Seven Counties situation is exactly what the Governor's office is trying to prevent. Senator McDaniel further commented that the pension plan is a multiemployer plan, and each of these quasi-governmental employers opted in KERS via an executive order. He stated that if an entity offers a benefit, it needs to be able to pay for that benefit and, if not, the liability cannot be thrown back on to the Commonwealth, which also has obligations to its employees.

In response to a question from Representative Miller regarding how many counties had maxed out their local tax rates, Mr. Chilton stated that he is unsure but said he would provide a list of those who could raise their local tax.

In response to a question from Representative Graviss regarding the inviolable contract, Mr. Chilton stated the proposal does not impact any current or accrued benefits, but only affects benefits on a go-forward basis. Mr. Sunderland added that he would refer to the May 8, 2019 legal memorandum that was forwarded to all members of the General Assembly.

In response to a question from Representative Wheatley regarding the inviolable contract, Mr. Sunderland stated that, while he was not an attorney, it was his understanding the contract was between the Commonwealth and the individual employee. He added that the question is whether or not the contract guarantees benefits not yet earned or guarantees that an employee has the ability to earn benefits in the future. In a follow-up question regarding whether any liability with regards to inviolable contract challenges would transfer to the employer exiting, Mr. Sunderland stated that was how he understands the bill, but noted again he was not an attorney.

In response to a question from Representative Graviss as to whether an actuarial analysis had been conducted, Mr. Sunderland and Mr. White stated that an analysis had been provided on BR 9, and the changes discussed during the presentation would not have a material impact on the analysis. In response to follow-up questions regarding the requirement for collateral, Mr. Sunderland noted that in a bill that tries to make the best out of a tough situation that language is difficult and not necessarily great. He stated that some quasi-governmental entities have expressed some concern about that provision of the bill draft, but that some legislators believe that this particular provision was necessary to protect the pension system. Lastly, in response to Representative Graviss regarding the contribution rate for quasi-governmental employers who remain in KERS, Mr. Sunderland stated their ARC would increase to the full 84 percent with an expected increase of 4 to 5 percent as a result of recent mortality assumption changes.

With no further business, the meeting was adjourned.