PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 6th Meeting of the 2019 Interim

August 26, 2019

Call to Order and Roll Call

The 6th meeting of the Public Pension Oversight Board was held on Monday, August 26, 2019, at 1:00 PM, in Room 154 of the Capitol Annex. Senator Jimmy Higdon, 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 Christian McDaniel, Dennis Parrett, and Wil Schroder; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Other Legislators Attending: Representative Derrick Graham and Representative James Tipton.

Guests: Donna Early, Executive Director, and Stephen LeLaurin, Board Trustee, Kentucky Judicial Form Retirement System; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Richard Robben, Executive Director, Office of Investments, and Rebecca Adkins, Interim Executive Director, Operations, Kentucky Retirement Systems.

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

Approval of Minutes

Senator Parrett moved that the minutes of the June 24, 2019 meeting be approved. Senator McDaniel seconded the motion, and the minutes were approved without objection.

Biennial Budget Request/FY Ended Investment Returns and Cash Flows – JFRS

Donna Early, Judicial Form Retirement System (JFRS), and Stephen LeLaurin, Trustee, JFRS, began their presentation by reviewing the portfolio allocation for the judicial and legislators defined benefit and hybrid cash balance plans. Ms. Early discussed recent performance and noted that each of the plans had outperformed their benchmark for all trailing periods. Mr. LeLaurin added that the board meets with their investment manager, Hilliard Lyons, quarterly for a review to ensure the portfolios are being managed appropriately.

In response to questions from Mr. Fyffe regarding the cash balance fund's significant outperformance from fixed income, Mr. LeLaurin explained that the underlying outperformance was largely due to an exchange traded fund (ETF) authorized by the board to gain the fixed income exposure for the plans. He pointed out that the cash balance plans, when created, could not buy individual bonds like the defined benefit plans, so the board decided to authorize Hilliard Lyons to buy units of ETFs that had strategies comparable to the plans' benchmark, the Barclays Capital U.S. Intermediate Government/Credit Bond Index. Over time this index has become more and more allocated to corporate bonds, which have significantly outperformed governments, which is why the cash balance plans have experienced such positive outperformance. Mr. Fyffe pointed out that while performance had been positive, the plan was taking considerable risk as compared to the benchmark. Mr. LeLaurin stated that Hilliard Lyons had brought similar concerns to the board's attention and they were in process of considering options.

Ms. Early provided and reviewed a cash flow summary for the judicial and legislators plans. While preliminary, she stated that the judicial plan ended the year with an 8.45 percent increase in their market asset, while the legislators plan saw assets grow by 7.82 percent.

In response to question from Representative DuPlessis regarding employer contributions for the legislators plan, Ms. Early explained that only an appropriation for administrative expenses was made during the 2019 fiscal year. No funds were provided for contributions, which is reflected in the $2.3 million difference from FY 2018 to FY 2019.

Lastly, Ms. Early reviewed the funding data and stated that most of the actuarial assumptions will be the same as the 2018/2020 biennium, with the exception of incorporating the Getzen Model and the 2013 Society of Actuaries Yamamoto Health Care Costs Study to the health care trend rates. She also noted that in 2017 the interest rate assumption was lowered for the current biennium from 7 percent to 6.5 percent. Ms. Early discussed the annual required contributions for both the judicial and legislators plans for the 2018/2020 biennium and the 2020/2022 biennium. She discussed the figures for the requested, appropriated, percentage of payroll, and the preliminary projections. Ms. Early noted that the health care side of the judicial plan is 100 percent funded for both the defined benefit plan and the hybrid cash plan. The health care fund of the legislators plan is 100 percent funded in the defined benefit plan, but not the hybrid cash plan.

In response to questions from Senator Higdon regarding health care trend rate assumptions, Ms. Early stated the assumptions are used to project future retiree health benefits paid and the rates would be graded down over time from 8 percent to 5 percent.

In response to a question from Representative DuPlessis, Ms. Early stated that the administrative expenses are not included in her report. Representative DuPlessis pointed out that recent legislation had created an August 15 deadline for providing projected budget requests.

Biennial Budget Request/FY Ended Investment Returns and Cash Flows – TRS

Beau Barnes, Teachers' Retirement System, (TRS) began his presentation with a review of the investment performance for FY ending June 30, 2019, and discussing the 1-, 3-, 5-, 10-, 20-, and 30-year gross/net-of-fees returns.

Mr. Barnes next reviewed preliminary cash flow for the pension and health funds for the fiscal year ending June 30, 2019, as compared to FY 2018. He pointed out cash inflows, outflows, and the total net plan assets across both periods.

In response to a question from Senator Higdon regarding a recent distribution of surplus funds, Mr. Barnes stated that TRS received an appropriation of $70 million for the retiree insurance fund, which was reflected in the FY 2019 amounts reported.

In response to a question from Representative Miller regarding what recovery income represented, Mr. Barnes stated those amounts were primarily pharmaceutical rebates received.

Mr. Barnes continued by discussing TRS' preliminary budget request for the 2020-22 biennium. He reviewed the categories of funding requested, including pension leave of absence, the state's portion of shared responsibility medical funding, annual expenditures, amortized payments, additional employer contributions required, TRS budget actual/requested, statutory contributions funded through SEEK, and state expenditures for debt service. The total preliminary request from TRS was $1,166,508,800 for FY 2021 and $1,189,953,800 for FY 2022.

Senator McDaniel commented on the system's interpretation of KRS 161.550 and expressed belief that the initial intent of the language was to give TRS a "catch-up" clause for any contributions not received that were related to the fixed statutory rate. He noted that TRS is interpreting it a bit differently as a means of asking for additional dollars required above and beyond the statutory rate, which are largely the result of actual experience, missed assumptions, or changed assumptions.

Senator Higdon commented and pointed out the shared responsibility bill included full repayment of all funds redirected from the pension fund for insurance purposes. Mr. Barnes confirmed and noted that bonds the Commonwealth issued after the shared responsibility bill passed also included transitional funding and now represent the debt service reflected in the budget.

In response to questions from Representative Graviss regarding an increase in contributions funded through SEEK, Mr. Barnes stated the increase was combination of both payroll increases and additional teachers. Representative Graviss inquired if TRS staff could provide a breakdown between the two components and Mr. Barnes stated he would see if TRS staff could provide the data.

Senator McDaniel, referencing an earlier discussion on bonds that had been issued, clarified that those bonds were not to cover money that had been borrowed from the teachers' pension trust, but instead funds that had been paid to TRS, but reallocated or redirected to help cover insurance benefits. Senator McDaniel emphasized that the Commonwealth has never borrowed, swept, or otherwise taken money already received from TRS. Mr. Barnes agreed with both statements.

In response to questions from Representative Graviss regarding cash flow, Mr. Barnes stated that TRS has been in a negative cash flow situation since about 2008, but noted the recent additional funding received had made the negative cash flow much more manageable. In response to a follow up question, Mr. Barnes indicated that he did not anticipate a positive cash flow anytime soon. In response to another follow up question regarding their payroll growth assumption, Mr. Barnes stated that TRS assumed 3.5 percent annual growth.

In response to a question from Mr. Chilton regarding the TRS actuarially determined employer contribution (ADEC), Mr. Barnes noted that the statutory funding mechanism for TRS is different from the Kentucky Retirement System (KRS) plans. While those plans are funded relative to a calculated ARC or ADEC, the TRS plan was initially established as a fixed statutory plan. More recently, additional funding has been required, so TRS has requested those contributions in addition to the fixed statutory rate. However, Mr. Barnes stated that when combined, the total dollars requested to TRS in his presentation did reflect the ADEC as calculated by their actuary. The total dollars shown represented the required contribution, but the request is made differently than the KRS plans.

Representative Miller commented that cash flow and requested contributions are also impacted by underlying assumptions used. He noted actual payroll growth for TRS over the past decade had been well below the assumed 3.5 percent. If a lower assumption had been used, the required contributions would have been higher and helped offset the negative cash flow. Mr. Barnes stated that TRS strives for accurate assumptions and the board of trustees reviews those assumptions regularly.

In response to a question from Representative DuPlessis regarding cash flow, Mr. Barnes agreed that without the Commonwealth's payment of the additional contributions above the 13.105 percent fixed statutory rate, TRS would have an approximate negative cash flow of $1 billion. Representative DuPlessis emphasized the additional funding that had been provided, which was considerably more than the fixed amount. In response to a follow up, Mr. Barnes indicated that in 25 years, after the funding plan had been fully implemented, the Commonwealth's required contribution or ADEC, would be much lower than the current 13.105 percent. Lastly, in response to a follow up question regarding health insurance contributions, Mr. Barnes indicated that the Commonwealth provided a fixed amount of dollars, which equaled the total cost of the Kentucky Employee Health Plan premium less an amount paid by the member for new retirees who retired on or after July 1, 2010.

In response to a question from Senator Higdon regarding any delinquent employer accounts, Mr. Barnes stated that TRS does not have any delinquent accounts. In response to a follow up question regarding the system's assumptions, Mr. Barnes stated that the 7.5 percent assumed rate of return, as well as the payroll growth rate, will be considered during the system's Experience Study going forward. Mr. Barnes noted that if the assumed rate is lowered, it will increase the budget request.

In response to a question from Representative Graviss, Mr. Barnes stated that the health fund is funded at 36.3 percent and pension is at 57.7 percent as of June 30, 2018.

In response to a question from Representative Tipton regarding TRS' budget request, Mr. Barnes stated that the budget request for medical funding accounted for individual only and no dependent subsidy.

Biennial Budget Request/FY Ended Investment Returns and Cash Flows – KRS

Richard Robben and Rebecca Adkins, KRS, presented. Mr. Robben began with a review of key economic assumptions for Kentucky Employees Retirement (KERS) System, State Police Retirement System (SPRS), and County Employees Retirement System for the pension and insurance plans.

Next, Mr. Robben reviewed estimated annual required contributions for FY 2020 and 2021 as compared to FY 2019. He noted that estimated employer contributions to the KERS non-hazardous (NH) plan were expected to increase from $1.14 billion in FY 20 to $1.35 billion in FY 21, which is about an 18.2 percent increase.

Mr. Robben reviewed the pension investments as of June 30, 2019. He stated that depending on the time period reviewed, performance had been in line with benchmarks. He reviewed the 1-, 3-, 5-, 10-, 20-, and 30-year returns for each of the plans as compared to their stated performance benchmark.

Mr. Robben reviewed historical and projected funding levels for each plan and pointed out that several of the more poorly funded plans were beginning to see some positive movement. Using the KERS NH plan as an example, he noted that beginning in

FY 2019, the plan is projected to see funding levels grow and a total unfunded liability decrease for the first time in several years.

In response to a question from Senator Higdon regarding how assumption changes impacted funding levels, Mr. Robben agreed that some of the decline in funding had been a result of significant assumption changes made by the board of trustees.

Mr. Robben provided cash flow summaries for each of the pension funds as of June 30, 2019, compared to the prior fiscal year. He pointed out that the KERS NH fund experienced positive cash flow and growth in total assets for the first time in many years, driven primarily by the increase in contributions provided by the General Assembly. Mr. Robben stated that the insurance plans had performed similarly and all had flat or positive cash flow.

Senator McDaniel emphasized the importance of seeing the KERS NH post positive cash flow and commented that a long term disciplined approach was needed to continue that trend.

In response to a question from Representative Graviss regarding the portfolio's ability to weather a recession, Mr. Robben responded that he believed KRS was positioned fairly conservatively, especially in the KERS and SPRS plans, and should perform better than other plans if a recession were to occur. In a follow up question regarding the recent mortality assumption changes, Mr. Robben stated he did not expect those changes to have a significant effect on the information he had presented. While the changes will likely add some amount of liability, the plan has some positive experience that should minimize that impact. In response to a follow up question regarding since-inception performance, Mr. Robben stated that KRS' return, since inception, was around 9 percent and dated back to 1986. He stated having the historical return was interesting, but said in his experience the average pension plan should earn roughly 300 to 350 basis points above the 30-year treasury rate. With rates currently around 2 percent, expecting a 9 percent return over the next 30 years would be tough.

In response to a question from Representative DuPlessis with regards to how recent assumption changes impact other aspects of retirement, such as service purchases, Ms. Adkins responded that those same assumptions are used to price the cost of future service purchases and to calculate payments to survivors if a member selects a survivorship payment option. So, the recent changes in investment return assumptions and mortality have generally resulted in higher costs for buying service prior to retirement. For survivorship payment options, the assumptions have resulted in lower payments for the surviving beneficiaries of members when those options are selected. Ms. Adkins explained that these changes do not take effect until January 1, 2020, so members have some time to analyze and compare the impacts on their retirement.

In response to a question from Representative Wheatley regarding changing beneficiaries after retirement, Ms. Adkins stated that opportunity does not currently exist under state law. She noted that actuarial factors are based on age, which is determined at time of retirement. In response to a follow up question regarding the impact of allowing for a one-time change of the beneficiary, Ms. Adkins stated she would have to discuss the issue with the actuary and other organizations, but assumed it would require a recalculation and adjustment to benefits.

In response to a question from Senator Higdon regarding why the KERS NH retiree health fund had a funded ratio of 36 percent, Mr. Robben stated he would have to discuss it with Mr. Eager and report back.

In response to a question from Representative Graviss, Mr. Robben stated that KRS runs a stress test on the portfolio for risk of any failure or faltering in case of a recession. Mr. Robben added that the stress tests are reported to the investment committee. In a follow up question regarding whether the revenue schedule includes revenues that have not been collected or expenses that have not been paid, Mr. Robben stated that there should not be any unpaid expenses at this time.

Lastly, Ms. Adkins reviewed the outstanding invoices owed to KRS. She stated that as of June 30, 2019, the total unpaid invoices is $12,923,168.

In response to a question from Representative Graham, Ms. Adkins stated that there is a process KRS follows to collect unpaid invoices, which includes continuous contact throughout the collection process.

With no further business, the meeting was adjourned.