PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 9th Meeting of the 2019 Interim

November 25, 2019

Call to Order and Roll Call

The 9th meeting of the Public Pension Oversight Board was held on Monday, November 25, 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:

<u>Members:</u> Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Christian McDaniel, Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Russell Webber, and Buddy Wheatley; J. Michael Brown, John Chilton, Timothy Fyffe, Mike Harmon, and James M. "Mac" Jefferson.

<u>Guests:</u> David Eager, Executive Director, Kentucky Retirement Systems and Danny White, GRS Retirement Consulting via Phone Conference; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Donna Early, Executive Director, Stephen LeLaurin, Investment Committee, and A.C. Donahue, Board Trustee, Kentucky Judicial Form Retirement System.

<u>LRC Staff:</u> Brad Gross, Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Representative Miller moved that the minutes of the October 28, 2019 meeting be approved. Representative Pratt seconded the motion, and the minutes were approved without objection.

Senator Higdon announced that during the December 16, 2019 Public Pension Oversight Board (PPOB) meeting, recommendations for legislation will be considered.

Actuarial/Financial Update – Kentucky Retirement Systems

David Eager, Executive Director, Kentucky Retirement Systems (KRS), began with opening remarks regarding the recently completed valuation. He noted that the economic and demographic assumption changes were the primary driver of the more than $2 billion increase in unfunded liability in the current valuation and the more than $7 billion increase in unfunded liability since 2017 for the KRS pension funds collectively. He stated that most of the plans' funding status had declined due to the changes. However, the increased funding received had placed each plan on a road to improvement.

In response to a question from Senator Higdon in regards to the frequency of experience studies and future assumption changes, Mr. Eager stated that assumptions were examined annually and, if a change was warranted, it would be done more frequently. He also stated that experience studies might occur every four years rather than five.

Next, Mr. Eager made several general comments about the valuation results. First, he emphasized the importance of maintaining or increasing the contribution efforts for the Kentucky Employees Retirement System (KERS) non-hazardous pension fund, which had liabilities of just over $16 billion and a funding status of 13.4 percent. Secondly, he noted the valuation included all new assumptions that had been adopted by the board in April of 2019. Third, he discussed investment experience, which ranged from 5.0 to 5.8 percent, and resulted in modest negative experience relative to assumptions. Fourth, he discussed changes in active membership and payroll, pointing out the KERS nonhazardous and State Police Retirement System plans continued to deal with a trend of decreased payroll. He stated the County Employees Retirement System (CERS) non-hazardous and hazardous payroll had grown by 2.2 and 4.8 percent, respectively.

In response to questions from Senator Higdon regarding a group of KERS non-hazardous members who were transferred to the hazardous plan, Mr. Eager stated that approximately 500 employees were transferred. In response to a follow-up question regarding how the existing liability would be paid down, Danny White, GRS Retirement Consulting (GRS), stated that the liability and assets remained in the KERS non-hazardous plan, thus the remaining employers will have to pay a higher rate to cover the unfunded liability left behind. Senator Higdon expressed concern with this practice, given the difference in contribution rates and the fact that an employer was moving employees' benefits at the expense of other employers.

Mr. Eager continued by providing a summary of liability experience during the year for the pension and insurance funds. On the pension side, the previously referenced changes in assumptions, most notably mortality rates, had resulted in an increase of $1.8 billion across all plans. In addition to the assumption changes, an additional $354 million was added due to performance relative to all assumptions. On the insurance side, Mr. Eager pointed out that a spike in Medicare premiums, which grew 13 percent, was an additional factor.

In response to a question from Senator Higdon, clarifying how much of the change in liability was due to actual losses versus actuarial changes, Mr. White stated the $1.8 billion was due to updated demographic assumptions, while the additional $354 million was due to actual liability being higher than what was expected, based on assumptions from the 2018 valuation. He referenced members retiring earlier than expected and individual salary increases as two items that impacted liability changes.

Mr. Eager presented a slide showing the employer contribution rates for the pension and insurance plans of each system as calculated in the 2018 and 2019 valuations, compared to the FY 2020 budgeted rate. In addition, he reviewed a similar slide comparing the unfunded liability for each system in 2019 compared to 2018. He pointed out the total unfunded liability across all plans was $28.93 billion, with KERS and CERS nonhazardous representing $16.0 and $8.3 billion respectively.

Mr. Eager provided the historical trends of each system as it related to active members, covered payroll, retired membership and total benefits paid. He pointed out the continued decline of both membership and payroll for the KERS nonhazardous plan, while noting the active to retiree ratio of both KERS and CERS continued to decline.

In response to a question from Representative Graviss regarding a projection of when the retired membership would peak in the future, Mr. Eager and Mr. White stated that was attainable, but not on hand. Representative Graviss requested the information be made available for the December 2019 PPOB meeting.

In response, Representative DuPlessis expressed some concern with having GRS spend the time and money to provide projections given, what he believed legislators were actively working together to make changes that would change future outcomes. Senator Higdon commented that the chairs would discuss the potential request at a later time.

Senator McDaniel requested that KRS provide the data underlying the historical trends on membership count and the benefit distribution that Mr. Eager had just reviewed.

In response to a question from Mr. Chilton regarding how the funding ratio of 13.4 percent for KERS non-hazardous was impacted by the budget surplus allocation, Mr. Eager stated that the funded ratio would have been approximately 13.0 or 13.1 percent without the budget surplus allocation.

Mr. Eager continued by providing several slides that provided 30-year projected liabilities, funding ratio, and contribution information for the pension and insurance funds of each system. He pointed out that each of the plans would require 24 additional years of higher contributions to pay off the unfunded liability, but in 2044, the total contributions would drop significantly to just the normal cost.

Senator Higdon commented on the projected unfunded liabilities of the CERS plans as compared to KERS, pointing out the CERS plans were projected to see a slight increase over the next couple of years while the KERS plans would decline. In response to the comment, Mr. Eager stated the difference was primarily due to CERS phasing into a full ARC payment while the KERS plans moved to the full rate in FY 2019.

Mr. Eager discussed a few comments from the actuary. First, it is imperative the State and participating employers in the systems contribute the actuarially determined contribution in each future year to improve the system's financial security. Secondly, GRS also recommended that KRS work with the General Assembly for an alternative method to collect the amortization cost from participating employers that is not payroll based.

Mr. Eager discussed a few legislative recommendations or proposals KRS has for the 2020 Regular Session. The first and strongest recommendation from KRS staff is to adopt a fixed allocation funding model, which would allocate contributions that are based on each employer's actual share of the total unfunded liability. A drawback to the proposal is that some employers will see rates go up, while others will drop, so there are definite losers that might require some additional financial assistance in the form of subsidies.

In response to a question from Senator Higdon regarding if the recommendation was being made for all agencies or just quasi-governmental employers, Mr. Eager stated that it would be for all agencies and that even state agencies had been reducing payroll and headcount. So, moving away from payroll would remove the incentive for decline. Mr. Eager noted that all state agencies would be grouped together and pay the same rate, while each quasi-governmental employer would have a separate contribution rate.

Representative DuPlessis commented that he is currently working on a bill regarding the fixed allocation funding for quasi-governmental agencies.

In response to a question from Representative DuPlessis regarding the significant drop in contribution rates projected at the end of the amortization period and if there was a way to smooth it out, Mr. White stated that at current funding levels the current contribution rate policy needed to be continued, but that as the plans get closer to the end of the window, there could be some restructuring to smooth out or minimize the cliff in contribution rates. He referenced moving to a layered amortization approach, which would spread the debt out across multiple maturities.

In response to a question from Representative Graviss regarding whether KRS was recommending a fixed allocation method for the other systems, Mr. Eager stated they were only recommending for KERS nonhazardous at this point.

Representative Miller expressed some concern with slowing down or adjusting assumptions that might impact the amortization policy. He referenced how recent payroll growth had not met historical assumptions for several plans and was the cause for the current need for additional contributions.

Senator McDaniel commented on the General Assembly's decision to reset the closed 30-year amortization period in 2013 and noted how many of the assumptions had changed since that decision was made. He pointed out that changes to payroll growth, investment return, and mortality assumptions had significantly impacted rates and requested that KRS look into how rates would be impacted if the 30-year amortization period was reset on July 1, 2020 or July 1, 2021.

Representative Miller commented that he would also like to discuss a stacked amortization period in regards to the assumption changes. Mr. White stated that amortization changes would require a statutory change.

In response to a question from Representative Wheatley regarding assumption changes and what steps could be taken to lessen the volatility on contribution rates, Mr. Eager stated the plan was to make more frequent reviews of assumptions so that any changes are smaller. He stated KRS had waited until the changes needed were significant, which resulted in such a sharp increase to the employer contribution levels

Mr. Chilton commented that moving to a fixed allocation method would remove the issue of payroll growth or decline from the equation. In addition, under this proposed method, the amount of liabilities assigned to each employer is the actual liability associated with their specific active, inactive, and retired employees. So, an agency that has high turnover or employees with shorter tenures will not be paying other agencies' unfunded liabilities. Mr. Chilton stated he believes these items should be pursued for the reason of eliminating the payroll estimate from the formula.

Senator Higdon referenced employers that had aggressively cut payroll, while also receiving subsidies to assist with the added contributions. He commented some had taken advantage of the situation and any changes should also prevent employers continuing to do so.

Mr. Eager continued with KRS staff's legislative recommendations. A second recommendation would revise reciprocity with regards to health insurance coverage for retired members that have time in both Teachers' Retirement System (TRS) and KRS. Their recommendation was to require members to choose coverage from the system in which they had the most service. Third, KRS recommended language be added to provide a penalty under KRS 61.685 for the commission of a fraud against KRS to obtain benefits or assist anyone to do the same. Fourth, staff was asking that SB 2 be amended to exempt the posting of all investment contracts that were signed prior to the enactment of SB 2. In closing, Mr. Eager outlined a few technical and conforming items that would be included in a KRS housekeeping request.

In response to a comment from Representative Graviss regarding if additional language was needed for the disclosure of carried interest, Mr. Eager stated that KRS does disclose their carried interest.

Senator Higdon commented that the Auditor's report pointed out three deficiencies between the systems: disclosure of investment contracts entered into before and after SB 2, KRS redactions, and the lack of transparency on carried interest by the TRS. Mr. Harmon confirmed these deficiencies.

In response to a question from Representative DuPlessis, Mr. Eager stated that the Kentucky Association of Counties, Kentucky League of Cities, and Kentucky School Boards Association are scheduled to present at the December 5, 2019 KRS Board meeting and then KRS will decide what their view is regarding the CERS separation.

Mr. Eager continued with cash flow and investments. He discussed the cash flow trends for the pension and insurance funds. He discussed contributions, which included, total cash inflows, total cash outflows, and net cash flow for KERS and CERS for pension and insurance. Mr. Eager discussed the investment performance by reviewing the 1-, 3-, and 5- year returns for all plans for the pension and insurance funds.

In response to a question from Senator Higdon, Mr. Eager stated the investment performance for the 30-year is 9.02 percent, the 20-year is 5.77 percent, and the 10-year is 7.78 percent.

Actuarial/Financial Update – Teachers' Retirement System

Beau Barnes, TRS, started his presentation with a discussion of recent investment performance. He discussed the most recent quarter, 1-, 3-, 5-, 10-, and 20-year retirement annuity trust returns ending September 30, 2019.

In response to a question from Senator Higdon, Mr. Barnes stated that their payroll growth for the past 1-year period was close to 3 percent and the assumption was at 3.5 percent.

Mr. Barnes continued his review of recent TRS investment performance, pointing out that above average performance from 2008 to 2019, when compared to the average pension plan, had resulted in an additional $3 billion in returns.

Mr. Barnes discussed the cash flow update for the pension and health funds for the first quarter of FY 2020 as compared to FY 2019. He pointed out cash inflows, cash outflows, and the total net plan assets across both periods.

In response to a question from Representative Miller regarding what recovery income represented in the retiree health fund, Mr. Barnes stated the income represented things like rebates from pharmaceutical companies and subsidies from the federal government that is collected to help pay the costs of medical insurance.

Mr. Barnes discussed the actuarial valuations for the pension and health funds for the FY 2018 compared to FY 2019. He pointed out the funding ratio of the pension fund had increased for the third consecutive year to 58.1 percent. On the insurance side, he noted the plan has grown from 3 percent in 2010 to 46 percent as of June 30, 2019.

In response to a question from Mr. Jefferson regarding the pension plan's negative cash flow, and what legislative proposals, if any, TRS had to address, Mr. Barnes stated negative cash flow is not necessarily a bad thing, especially for mature plans like TRS. However, Mr. Barnes stated that TRS was proposing $110 million of additional funding above the ARC, which he stated would lead TRS out of negative cash flow in about three years.

In response to a follow up question from Senator Higdon regarding an additional $110 million budget request, Mr. Barnes stated that TRS' budget request will be the standard ARC, which totals approximately $1.3 billion, but they have added an additional $110 million to address cash flow.

In response to a question from Mr. Chilton regarding how the plan can reach full funding while negatively cash flowing, Mr. Barnes stated that total appreciation of assets help offset any negative cash flow. He stated that as the state continues to pay the full employer contribution along with investment return will result in a fully funded plan.

In response to a follow up question from Representative DuPlessis regarding cash flow and what could be done to make it more manageable, Mr. Barnes stated that the important statistic for the PPOB to be thinking about in regard to negative cash flow is what percentage of assets is under management. Any level above five percent tends to be problematic. Outside of additional cash, Mr. Barnes stated only cutting benefits could help and that is limited due to the inviolable contract and those items exempted from the contract, like cutting sick time payment impacts on pensions, do not necessarily have large savings.

Representative Miller commented that while he did agree with Mr. Barnes that cutting sick time was not a game changer, he stated the TRS board could address some of their cash flow issues by just using more accurate assumptions. Using a more accurate payroll growth and investment return assumption would result in more cash through contributions, instead of the board making this separate request in addition to the ARC.

In response to a question from Representative Graviss regarding if TRS provided actuarial projections, Mr. Barnes stated that TRS does provide projections in their annual valuations. Representative Graviss stated that he felt like having TRS provide projections would help validate some of the information being shared.

In response to a question from Senator Wilson regarding TRS' statutory language, Mr. Barnes agreed that TRS did not have language statutorily with regards to an ARC. Senator Wilson noted that statutorily, TRS has a fixed rate that currently is below the amount calculated by actuaries and currently being paid by the General Assembly. He commented that he did not hear TRS requesting legislative changes with regards to that language.

Mr. Barnes continued his presentation with a few comments regarding their actuarial valuations. He noted that TRS had received 100 percent of actuarially determined employer contribution, that their annuity trust increased by $390 million, and that negative cash flow improved for 2019 as percentage of assets to (3.48) percent from (3.63) percent.

In response to a question from Senator Higdon regarding what percent of contributions the insurance fund received, Mr. Barnes stated the contribution the General Assembly made towards the insurance fund was premium costs for new retirees under the age of 65, on or after July 1, 2010. In FY 2019 the cost was approximately $60 million and the General Assembly appropriated the full amount. Mr. Barnes also stated that active teachers and school districts are also making contributions of 3 percent annually.

Mr. Barnes continued with a discussion of actuarial gains and losses during the most recent fiscal year, by source. During the year, the plan had slight actuarial losses from investment returns, while individual teacher salary increases were less than expected and resulted in an actuarial gain. He stated that since 2015, each year's gains or losses are separately amortized over 20-year periods.

In response to a question from Senator Higdon regarding an actuarial loss on new entrants, Mr. Barnes stated that is the result of the actuary's method of counting new members and represents a small group of new members who started mid-year during the prior fiscal year.

In response to questions from Senator McDaniel regarding payroll growth and average retirements, Mr. Barnes stated that payroll growth is mostly inflation and TRS' payroll growth is currently 3.5 percent. Mr. Barnes stated that there are approximately 3,000 teachers retiring per year. Senator McDaniel commented on how state mandated raises could potentially have measurable impact on long term liabilities, especially for teachers who reach 30 years and received a higher benefit factor

In response to a request from Representative Webber for the data underlying the actuarial gains and losses, Mr. Barnes stated that he could provide data.

In response to a question from Mr. Chilton with regards to asset smoothing, Mr. Barnes stated only the investment returns were smoothed. In a response to a follow up question, Mr. Barnes stated that their actuarial reports were placed on their website upon approval by the Board.

Mr. Barnes concluded his presentation by noting that TRS would be having an experience study performed in 2020 for the 5-year period ending June 30, 2020. Lastly, he stated that TRS will have their legislative recommendations to the PPOB by December 6th.

In response to questions from Senator Schroder regarding the amortization period, Mr. Barnes stated the period was initially set as 30 years. The legacy UAL is the majority of payment and currently sits at 25 years remaining. Annual gains and losses will be added and amortized over 20 years, but TRS expects them to be incremental.

In response to questions from Representative Graviss regarding disclosing carried interest, Mr. Barnes stated TRS has not disclosed because of its proprietary nature, and it could compromise their ability to invest. Mr. Barnes stated that TRS does believe it can be reported at asset class level and hopes that could be a resolution.

In response to a follow up question from Representative DuPlessis regarding how other pension systems, in and out of the Commonwealth, are reporting carried interest without investor problems, Mr. Barnes stated that TRS' general partners considered carried interest proprietary and did not want their competitors knowing how much profit is made in their investments. In response to a question regarding how TRS' investment peer rankings have dropped over the 1-year period, Mr. Barnes stated the drop is reflective of the current markets, which did not favor the value-oriented style of TRS external managers.

Senator Higdon made a follow up comment with regards to the earlier discussion on insurance contributions. He noted actuaries had determined the fund received approximately 239 percent of the calculated ARC.

Actuarial/Financial Update – Judicial Form Retirement System

Donna Early, Executive Director, Stephen LeLaurin, Investment Committee, and A.C. Donahue, Board Trustee, Kentucky Judicial Form Retirement System (JFRS), started their presentation with a review of investment performance for the quarter, and 1-, 3-, 5-, 10-, and 20-year periods for each of the plans. Ms. Early noted that JFRS outperformed their benchmark.

Ms. Early discussed the cash flow update for the Judicial Retirement Plan and Legislators' Retirement Plan for FY 2020 as compared to FY 2019. She pointed out cash inflows, cash outflows, and the total net plan assets across both periods.

Ms. Early discussed the funding data for the 2020-2022 biennium that is required under KRS 21.525 and KRS 21.540(1) for the judicial and legislator plans. She noted that the actuarial assumptions are extremely reasonable.

Ms. Early discussed JFRS' legislative agenda for the 2020 regular session. She stated that it is very important to continue to maintain a status of being actuarially sound. She stated their actuary had raised a concern with regards to how the plan's unfunded lability is amortized, which has led to a proposal to amend KRS 21.525 and the current process. Mr. LeLaurin added the change was important due to the fact that the current process will never lead to the unfunded principal being paid off.

Representative Miller commented that Representative Tipton is working on an amendment that would affect the JFRS plan and urged them to contact him.

Ms. Early concluded with the legislative agenda stating that it is imperative that the actuarial required contribution be met.

With no further business, the meeting was adjourned.