PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 7th Meeting
of the 2020 Interim

December 14, 2020

Call to Order and Roll Call

The 7th meeting of the Public Pension Oversight Board was held on Monday, December 14, 2020, at 1:00 PM, in Room 149 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, Gerald A. Neal, Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Steven Rudy, Russell Webber, and Buddy Wheatley; John Chilton, Joseph Fawns, Mike Harmon, John Hicks, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Representative C. Ed Massey; David Eager, Executive Director, Kentucky Retirement Systems; and Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System.

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

Approval of Minutes

Representative DuPlessis moved that the minutes of the November 17, 2020 meeting be approved. Representative Miller seconded the motion, and the minutes were approved without objection.

Senator Higdon announced that this is Representative Graviss' last meeting and thanked him for his work and for being a true asset to his community. Representative DuPlessis also stated that Representative Graviss has been an active, factual, and nonpartisan member and is appreciated for all the work he has done.

Proposed Legislation (Discussion Only)

Representative Massey discussed proposed legislation for a new hire plan for the Teachers' Retirement System (TRS) effective January 2022. He explained that the new hybrid plan would include features to: take some of the responsibility or risk away from the state and transfer it to new hires; provide that new hires could retire at age 55 with 30 years of employment with incentives to encourage additional years of service; limit the state's cost for new hires to 10 percent of pay (8 percent foundational and 2 percent supplemental); and create a stabilization fund that, if the plan were to ever fall below 90 percent funding, could be used by the TRS board, along with other levers, to bring the fund where it needed to be. Also, the plan would allow a person to retire, draw unreduced benefits, including retiree health benefits, at age 55 with 30 years' experience, at age 60 with 10 years' experience, and at age 65 with 5 years' experience.

Representative Massey stated that at this time there has been good responses from the universities and stakeholder associations involved.

Representative Massey stated that this proposed legislation will not resolve the retirement funding issue and that an unfunded legacy deficit will still exist, but that this would be a fully-funded tier for new hires and would at least stop the bleeding.

In response to a question from Representative Graviss regarding whether there was any research done on how the proposed plan would affect the recruitment of new teachers, Representative Massey stated there has been more discussion than research due to unknown trends and patterns. However, the adjustments that have been made are intended to improve the ability to recruit when employment is compared regionally. He stated that one of the adjustments would load more benefits on the front end of employment and taper off some incentives on the back end.

In response to questions from Representative Wheatley, Representative Massey stated that bill information was not previously provided to the Public Pension Oversight Board (PPOB) for no other reason than it was unknown if stakeholder negotiations would proceed. In response to a follow-up question regarding the risk being removed from the state and placed with the new hire employees, Representative Massey stated that Kentucky does not have the money to sustain the current program, much less continue sustainability into the future. He added that benefit portability is also valued and welcomed by new employees.

In response to a question from Senator Higdon, Representative Massey confirmed that the plan includes a supplemental fund account, which also belongs to the members and should be substantial at the time of retirement if properly prepared. He also stated that the health component for all members should be fully funded in a few years.

In response to a question from Representative Miller, Representative Massey stated that this bill does have a trigger/lever under which the TRS board can take action if the fund drops to a certain percentage and creates the stabilization fund to ensure that it will remain funded.

In response to a question from Senator Wilson, Senator Higdon stated it takes five years to be vested into the system. Senator Wilson commented that with the legacy system the General Assembly is only statutorily required to contribute 13 percent of payroll, but it has funded TRS with $500 million above the 13 percent each year for the last 5 years.

Representative DuPlessis commented that he feels like Kentucky is losing educators to bordering states such as Indiana, Ohio, and Tennessee. Indiana offers a defined benefit plan, much like Kentucky's, and a defined contribution plan, although Indiana's retirement multiplier is only 1.1 percent with Social Security benefits, whereas Kentucky offers a 2.5 percent multiplier with no Social Security benefits. One of the things in the bill that Representative DuPlessis favored, is teachers will get a Social Security replacement defined benefit plan along with a defined contribution plan merged together. Representative DuPlessis believes that new graduating educators are more interested in the higher pay in the beginning of their career, rather than what retirement benefits are offered. He believes that this bill moves Kentucky toward being able to offer higher salaries to new teachers.

In response to a question from Representative Pratt, Representative Massey stated he believes that Ohio's defined benefit plan currently requires 30 years' service with benefits being paid at age 65.

Representative Graviss commented that TRS has had representatives and actuaries testify that TRS is performing well and only needs the ARC funded. Representative Graviss stated that KEA's position is to not opine on a bill until it is filed and that he has checked the LRC website and does not see BR 278 as a prefiled bill. He stated he has spoken with the top folks of KEA and that their position is they have no position because the bill has not been filed and their board of directors has not issued a statement. Representative Massey clarified that it was his testimony that KEA stated that, if the draft is what it purports to be, then KEA would tell its membership not to oppose it. Representative Massey responded that the draft was given to the KEA with authorization to send to their membership, which it did. With no further questions, Representative Massey concluded his remarks.

Representative Webber discussed BR 277, which would create separate statutory benefit structures while maintaining co-administration of the County Employees Retirement System (CERS) and the Kentucky Retirement Systems (KRS) as required by House Bill 484.

Actuarial Update – Kentucky Retirement Systems

David Eager, KRS, began his presentation by stating that as of June 30, 2020, nine of the 10 retirement insurance plans improved their funded status. He also noted that the Kentucky Employees Retirement System (KERS) nonhazardous plan's payroll continues to decline. He stated that it declined 5.9 percent in fiscal year 2020 and has an average decline of about 3.5 percent over 10 years, which continues to be a serious problem.

In response to a question from Senator Higdon regarding how many payroll employees have been lost from the quasi-employer and state government groups, Mr. Eager stated he did not have those specific numbers, but that in fiscal year 2020, Eastern Kentucky University's payroll went down more than 40 percent and the payroll for Morehead State University and Murray State University went down 22 and 23 percent, respectively. In response to a follow-up question, Mr. Eager stated that KRS is not notified of any outsourcing of positions.

Mr. Eager explained the cycle of declining payroll and increasing employer contributions under a percent of pay amortization method. Employers are incentivized to outsource so as not to pay the 85 percent of payroll contribution rate, which then increases as a result of declining payroll. He stated that if House Bill 171, which passed the House during the 2020 Regular Session, or a similar fixed allocation bill were to pass in 2021, it would freeze the liability for all agencies to a fixed dollar amount to be paid over a period of 30 years. Therefore, employers would be incentivized to hire, as they will be paying a fixed rate on the UAL and only the normal cost for employees, making it advantageous to hire and retain and not outsource. Mr. Eager noted that one particular employer at one time had 300 employees participating in a retirement plan, now there are only 3 employees participating even though they still have 300 working, just as employees of a nonparticipating subsidiary.

In response to a question from Senator Higdon, Mr. Eager stated that there were about 400 juvenile justice officers that switched over from nonhazardous to hazardous duty retirement in 2020, which also caused a negative impact on payroll.

Mr. Eager discussed the unfunded actuarial accrued liability (UAAL). He provided a chart showing the pension and insurance 2019 and 2020 valuations for each of the pension plans along with the change in the UAAL. He stated that the combined total equaled $660 million less UAAL.

Mr. Eager discussed funded ratio with comparison of the 2019 and 2020 valuation for pension and insurance for each of the pension plans along with the change in funded ratio.

In response to a comment from Senator Higdon, Mr. Eager agreed that the CERS hazardous is the only plan with a negative change in the funding, which decreased by 0.2 percent. He attributed the change to lower investment returns and possibly payroll issues as well.

Mr. Eager discussed employer contribution rates. He provided a chart comparing the actuarially determined rates for 2019 valuation (FY 2021) and 2020 valuation (FY 2022) along with the board certified rates for FYE 2021 and 2022 for all plans.

Mr. Eager also discussed the calculated contributions for all plans for the 2019 valuation (FY 2021) and 2020 valuation (FY 2022) with the change in dollar amounts. He noted that with the higher rate and smaller payroll, KERS is going to lose $34 million in cash flow.

Mr. Eager discussed the projection information for KERS nonhazardous and CERS nonhazardous for pension and health combined. He provided a chart that showed valuation years 2020, 2021, 2025, 2030, 2040, and 20 year totals.

In response to a question from Representative Wheatley, Mr. Eager explained that the difference in the actuarially determined employer rates and board certified rates for the CERS plans reflect the statutory phase-in that the board is required to follow.

Mr. Eager presented an illustration of the stochastic projection model for KERS nonhazardous. He stated that KERS can be fully funded by 2049, if the ARC is fulfilled every year and if KERS nonhazardous earns 5.25 percent. The model reflects the degree of probability of attaining a 100 percent funded ratio by that date.

In response to a question from Representative Graviss, Mr. Eager stated that the KRS board of trustees has not formally discussed BR 424, the new bill draft which proposes a fixed allocation payment for the employer cost of the UAAL.

In response to Senator Higdon's request for the opinion of Mr. Eager on the PPOB's recommendations, Mr. Eager stated that GRS Consulting is satisfied with the standardized actuarial analysis bill. In regards to the housekeeping bill, he stated that pension spiking is the major issue and KRS's approach will be to waive anyone whose spike is not greater than 10 percent or does not improve their benefit by greater than 25 dollars per month. Mr. Eager stated that KRS is comfortable with BR 411 regarding beneficiary changes after retirement.

Representative Wheatley commented that he has met with KRS staff regarding adjustments to BR 411.

Representative Miller moved that the 2020 Recommendations be approved. Representative Wheatley seconded the motion, and the recommendations were approved without objection.

Representative Graviss commented that he would like the PPOB to determine whether stakeholder groups were adequately involved in the collaboration and drafting of BR 278.

Representative DuPlessis moved that the draft 2020 Annual Report be approved subject to the addition of the recommendations just approved and any technical edits needed. Representative Pratt seconded the motion, and the draft PPOB 2020 Annual Report was approved without objection.

Actuarial Update – Teachers' Retirement Systems

Beau Barnes, TRS, began his presentation with an update on investment performance for the quarter ended September 30, 2020, which was 6.51 percent net, above the benchmark of 5.79 percent, and placed TRS in the top 5 percent of public pension plans in the nation. He then reviewed returns for the 1-, 3-, 5-, 10-, and 20-year periods with a 30-year compounded gross return of 8.32 percent.

Mr. Barnes discussed how carried interest works for TRS. Carried interest occurs when there is a group of partners who join together to invest in a business or profit-sharing enterprise. Most of these investments are complex, dealing with the business of business (e.g. corporate restructuring). Within this model, there is a general, managing partner and multiple limited partners. All limited partners pay a management fee of typically 2 percent to the general partner, and then all the partners share in the profits of the investment. Carried interest is the general managing partner's share of the profit from the enterprise.

He explained that TRS generally receives back its initial capital investment, a preferred rate of return on the capital investment (e.g., between 7 and 9 percent), and the management fee before the general partner receives any profits. The profit sharing typically is 20 percent for the general partner and 80 percent for the limited partners such as TRS.

In response to a question from Representative DuPlessis regarding the high 2 percent management fee, Mr. Barnes stated that the 2 percent management fee is typical in the industry, but limited partners do continue to negotiate for better terms or lower fees. However, Mr. Barnes added that TRS not only earns a 7 to 9 percent return on its investment, but also recoups its initial investment plus often the 2 percent management fee before the general partner receives $1, plus 80 percent of the profits as a limited partner.

Mr. Barnes continued that, with these types of multi-year investments, the limited partners never know what the final general partner's profits or carried interest will be until the fund closes. He added that because carried interest is a share of the general partner's profits, this is not a fee or expense to TRS, as there is no legal right to the money. If TRS were to record the general partner's profits as an expense on its financial statements, TRS would also have to record those profits as income, which it does not do, since it has no legal right to those unrealized profits.

Mr. Barnes discussed the system's private equity gross returns for fiscal years 2012 through 2020. He stated the five-year return for quarter ending September 30, 2020, was 10.2 percent gross and 8.4 percent net.

Mr. Barnes discussed TRS' experience with private equity profit sharing or carried interest. He provided examples of investments in which TRS was a limited liability partner. Some of these enterprises included a U.S. –headquartered global leader in insurance brokerage space, toll roads, fuel storage, and a furniture/home décor store chain. Finally, he presented the total profit allocation or carried interest paid to the general partners' for FY 2020, which was $(1,537,736) for the retirement annuity fund and $(1,099,434) for the health insurance fund. He noted that the carried interest was negative as a result of the pandemic, but because these are multi-year investments, the partnerships will wait to sell until the investments recover and reap profits.

In response to a question from Senator Higdon, Mr. Barnes stated that TRS is reporting the carried interest in the aggregate, which includes private equity, private real estate, and private credit.

In response to a question from Representative Pratt, Mr. Barnes stated that TRS's comprehensive annual financial report details business partners along with investment managers, attorneys, investment consultants, and management fees.

In response to a question from Representative Wheatley, Mr. Barnes stated that the management fees are reflected within the 0.33 percent net returns. In response to a follow-up question regarding the 20-, 10-, and 5-year returns continually rising, Mr. Barnes stated this reflects changes made to diversify the portfolio with expanding into different equities/assets. Mr. Barnes added that TRS continues to increase its allocations.

Mr. Barnes summarized the actuarial valuation for the retirement annuity and the health insurance trust funds for the FYE June 30, 2020. He included total values of assets, liabilities, UAAL, and the funded ratios.

In response to a question from Senator Higdon regarding the increase in the UAAL despite a good year, Mr. Barnes stated that TRS has had two back to back years of about 5 percent returns and is still in the early stages of the 30 year amortization.

Mr. Barnes discussed the actuarial findings from the annual valuation for FYE June 30, 2020. He stated that TRS received 100 percent of the actuarially determined employer contribution (ADEC), the retirement annuity trust fund increased by $345 million, and TRS's negative cash flow for 2020 as a percentage of assets was (3.68) percent, which was consistent with the two prior years. Senator Higdon commented that it is concerning that TRS has a negative cash flow.

Mr. Barnes discussed TRS's actuarial experience gain/(loss) analysis by source. He stated that, this year, TRS has had a loss in investment returns, turnover and retirement, mortality, and new entrants. However, over a 10 year period, TRS has had more gains than losses.

Mr. Barnes discussed the 2022 budget request based on the 2019 valuation for FY 2021, actual, and FY 2022. He itemized the budget request including pension leave of absence matching, the state's portion of shared responsibility health insurance funding, amortized payments, and additional employer contributions for ADEC, for a total TRS actual and requested. He also added the statutory contribution to TRS funded through the SEEK Formula in the budget for the Kentucky Department of Education for a complete total to TRS.

In response to a question from Mr. Hicks, Mr. Barnes stated that he believes that most retirement systems have the ADEC language in their statutes as opposed to having a fixed statutory rate. In response to a follow-up question, Mr. Barnes stated that there have been bills introduced that would have provided specific ADEC language as opposed to or in addition to the existing fixed statutory language.

Mr. Jefferson commented that, in his experience, the industry has seen a standardization of private equity as an asset class, and the costs associated with such investments are typically a 2 percent stated annual fee and carried interest. He agreed that the carried interest is not an annual cost and is more complicated. However, the investment world classifies carried interest as a cost or fee, albeit an inconsistent one that is paid only when profits occur within the partnership. He also commented that his position on the PPOB has been to assist legislators in understanding and providing a level playing field in comparing pension plans that legislators are responsible for funding. As such, it is very important for legislative staff to have the information on a timely basis and the opportunity to have reports created so they can analyze these different plans. To date, Mr. Jefferson stated, to the best of his knowledge, TRS has created a deficit in getting the information requested by staff regarding its payment of carried interest and fees. From the legislative perspective, he believes that it is important that TRS get the information requested to staff and the PPOB on a timely basis in order that the legislators may make funding judgments to the best of their ability.

In response to a question from Senator Higdon, Mr. Barnes stated that the $26,753,600 increase for the additional employer contributions required for ADEC in FY 2022 is a normal increase that is unaffected by the ongoing experience study.

Mr. Barnes continued with actuarial projections for the 2020 valuations for the retirement annuity and health insurance trust funds with projections through FY 2042.

In response to a question from Representative DuPlessis, Mr. Barnes stated that the 2 percent fees are for management fees paid to an external general partner.

In closing, Mr. Barnes discussed the actuarial experience study for the five-year period ended June 30, 2020. He stated that the actuary uses demographic assumptions such as rates of withdrawal, pre-retirement mortality, disability retirement, service retirement, post-retirement mortality, and salary increases. The actuary also uses economic assumptions, such as price inflation, investment return, and wage inflation. The study will be completed in 2021.

In response to a question from Senator Higdon, Mr. Barnes stated that the increases in the TRS budget request for the ADEC from one year to the next relates to the amortization method, which tracks the payroll growth.

In response to a question from Representative Pratt, Mr. Barnes stated that the 2 percent management fees paid to the general partner includes salaries of staff for the general partner, marketing strategies, and expenses. In response to a follow-up question, Mr. Barnes stated that TRS has in-house investment experts that are paid a salary only.

In response to a question from Representative Graviss, Mr. Barnes stated that the actuaries project that if TRS continues receiving the funding it has received for the past 5 years the system will reach 100 percent funding.

In response to a question from Mr. Harmon, Mr. Barnes stated, in agreement, that the ADEC has been fully paid within the last five or six years, but that in some years prior to that, TRS had not always received full funding.

With no further business, the meeting was adjourned.