PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 6th Meeting of the 2021 Interim

August 30, 2021

Call to Order and Roll Call

The 6th meeting of the Public Pension Oversight Board was held on Monday, August 30, 2021, at 10:00 AM, 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; Senators Christian McDaniel, Robby Mills, Gerald A. Neal, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, Jason Petrie, James Tipton, Russell Webber, and Buddy Wheatley; Mike Harmon, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System. David Eager, Executive Director, and Rebecca Adkins, Executive Director, Office of Operations, Kentucky Public Pensions Authority.

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

Approval of Minutes

Senator Wilson moved that the minutes of the July 20, 2021, meeting be approved. Representative Webber seconded the motion, and the minutes were approved without objection.

Discussion of PPOB Request to LRC Regarding Actuarial Audit per KRS 7A.250(8)

Senator Higdon discussed actuarial audits for each of the system actuaries to be conducted once every five years as required under KRS 7A.250(8). He offered an explanation of an actuarial audit and the request-for-proposals (RFP) process necessary for the Public Pension Oversight Board to hire an actuarial firm. Under 7A.240, the funding for the actuarial audit shall be paid by the state-administered retirement systems. For this meeting, the PPOB members were asked to vote to request that the Legislative Research Commission (LRC) expend funds to hire an actuary upon authorization from the Senate President and Speaker of the House.

In response to questions from Senator Wilson, Senator Higdon stated the specific differences in cost between a Level 1 or Level 2 or Level 3 actuarial audit is not known,

but generally, a Level 1 is the most expensive and a Level 2 is less expensive. In a follow up question, Senator Higdon stated that the RFP process will assure the bidding actuaries are qualified.

In response to a question from Representative Miller, Senator Higdon noted LRC staff's response that most actuarial firms that conduct valuations of public retirement systems also conduct actuarial audits depending on the scope of the RFP.

In response to a question from Representative Tipton, Senator Higdon stated that this is the first actuarial audit conducted under KRS 7A.250(8), which was added to the PPOB's duties in 2016 and required to be conducted every five years. He added that the reason for a Level 2 audit is to look at the accuracies of the previous actuarial valuations by using a sampling of data from the systems.

In response to a question from Senator Wilson, Senator Higdon stated staff would look into whether the RFP can seek bids for a Level 1 as well as Level 2 audit.

Representative Miller asked that the PPOB exclude the three actuaries that are already involved with system consulting and audits.

Representative Tipton moved that, per its authority under KRS 7A.250, the PPOB request that LRC expend funds to hire an actuary for an actuarial audit of the state-administered retirement systems. Senator Wilson seconded the motion, and the motion was approved without objection. Auditor Harmon abstained.

TRS Sick Leave/Payment Information Follow-up

Beau Barnes, Teachers' Retirement System (TRS), began his presentation by announcing the fiscal year end return of 29.59 percent net of fees.

In response to a question from Senator Higdon, Mr. Barnes stated that the 29.59 percent will be subject to a five-year smoothing and will show all periods above 7.5 percent now.

Mr. Barnes advised that he was appearing to explain the so-called "Green Box" dollars funded by the state budget, and what is included in those expenditures. Generally speaking, the "Green Box" dollars describe payments coming out of the General Fund for prior benefit adjustments. First, he discussed sick leave payments. Starting in the 1990s, the state moved from paying for sick leave benefits by lump sum to paying for them on an amortized basis. Mr. Barnes presented the payments for the beginning amortization year (2003 through 2022), the balance as of June 30, 2021, the annual payment for fiscal year 2022, and the year of last payment.

In response to a question from Senator Higdon, Mr. Barnes explained the accumulation of the amortized costs and stated that the total outstanding sick leave balance is $433,180,254 with an annual payment of $63,493,200.

In response to a question from Senator McDaniel, Mr. Barnes stated that the balance for each amortization year is what is incurred by the retirees who retire in the respective amortization year, not a cumulative amount from previous years. In response to a follow up, Mr. Barnes agreed that the annual payment is calculated at the same assumed rate of return internal to the system.

In response to a question from Representative Miller, Mr. Barnes agreed that the 20-year amortization period was in the budget bill starting in the late 90s.

In response to a question from Senator Higdon, Mr. Barnes stated that the total annual amortization payment is $63,493,200.

In response to a question from Representative Tipton, Mr. Barnes agreed that there is a 7.5 percent interest payment on the $433,180,254. In response to a follow up, Mr. Barnes stated that the annual payment, without debt, would be around $44 million, but he would provide the accurate amount at a later time.

Mr. Barnes discussed other payments included in the "Green Box" dollars, including supplemental cost-of-living adjustments (COLAs) over the statutory 1.5 percent, which were paid on an amortized basis starting in 2003 through 2008, and non-single subsidies for health insurance, which were amortized beginning in 2012. For each category, Mr. Barnes provided the beginning amortization payment amount, balance as of June 30, 2021, annual payment for fiscal year 2022, and year of last payment. He noted that the COLAs last payment will be in 2027 and the non-single subsidies' last annual payment is for the current fiscal year 2022.

In response to a question from Senator Mills, Mr. Barnes stated that the budget request will be adjusted down from the $63 million.

In response to a question from Senator Higdon, Mr. Barnes stated that there is nothing preventing the balances for sick leave, supplemental COLAs, and non-single subsidies to be paid off in a lump sum earlier than the schedule amortized date. If those debts were paid off with a lump sum total of $570,266,111 as of June 30, 2021, it would result in a reduction of approximately one percent of the actuarially required contribution (ARC) or about $37 million less per year.

In response to a question from Representative Miller, Mr. Barnes stated that the "Green Box" dollar payments for fiscal year 2022 do not reflect the actuarial changes

adopted by the TRS board this summer. However, any increase in the payment resulting from those changes could be offset by the extraordinary return for year-end 2021.

Next, Mr. Barnes discussed the impact of sick leave credit on the annual retirement pension benefits for retired teachers and their survivors. Statistics were presented, which included a range of annual pension payments between $10,000 and $250,000 or more, with nearly half of beneficiaries falling in the $50,000 to $75,000 range, number of annuitants/beneficiaries, total share of pension payments, final average salary of group, average service credit, average annual benefit, and average sick days paid.

In response to a question from Senator Higdon, Mr. Barnes agreed that the higher pay range was attributed to high amounts of sick days and a higher salary.

In response to a question from Representative Wheatley, Mr. Barnes stated that about 90 percent of retirees stay within Kentucky, but he did not have percentages for other states. In response to a follow up question, Mr. Barnes stated that he will provide data regarding retiree dollar amounts being spent in Kentucky.

Mr. Barnes discussed the formula for how retirement allowances are calculated. The final average salary is one element of the annuity calculation formula, which creates an average using the high five or three salaries, and is defined in KRS 161.220(9). Total service credit times the statutory multiplier times final average salary equals the annual benefit.

Mr. Barnes discussed how sick leave impacts final average salary and, therefore, the retirement allowance. For school district teachers, sick leave can be converted into salary credit for the last year of employment. For teachers hired on or after July 1, 2008, there is a 300 day cap for sick leave, and for new tier teachers hired on or after January 1, 2022, sick leave shall not be used for defined benefit calculation purposes. He explained the sick day calculation, which is a three step process: (1) the contract salary divided by contract days equals the daily rate; (2) the daily rate times the local policy (school board option to compensate from 0 to max 30 percent) equals the sick day value; and (3) the sick day value times the number of unused sick days equals the final payment. The final payment is then incorporated into the member’s last annual salary for the retirement allowance calculation.

In response to a question from Representative Wheatley, Mr. Barnes stated that, based on the three high salaries, the formula would give you the final average salary.

In response to a question from Senator Higdon, Mr. Barnes stated that he believes that some districts roll in unused personal days into sick days.

Mr. Barnes discussed how sick leave impacts retirement. He provided example scenarios with 27 years of service on high 5 and high 3 salaries.

In response to a question from Representative Miller, Mr. Barnes stated that the leave payment in the example is based on the last annual salary not the final average salary. In response to a follow up question, Mr. Barnes stated that the school district is responsible for the lump sum sick leave costs for school districts at 30 percent of the daily rate, and the Commonwealth pays the actuarial cost of having the sick leave cost included in their retirement allowance.

In response to a question from Senator Higdon, Mr. Barnes stated that with the new assumptions, including reducing the discount rate, there will be some differences to the amortized sick leave payments. However, with the exceptional annual return in 2021, it is difficult to predict the final result.

In response to a question from Senator Mills, Mr. Barnes agreed that, if sick days were paid by the school district when the teacher retired and were not rolled into the teacher's last year of calculated salary, the Commonwealth's cost of sick days would be alleviated. In response to a follow up question, Mr. Barnes stated that the Commonwealth will see some relief from sick leave costs associated with the changes made for members hired after July 1, 2008, who have their sick leave capped at 300 days, and through HB 258 and the new tier for teachers hired on or after January 1, 2022, which eliminates sick leave being used for defined benefit calculation purposes.

In response to a question from Representative Miller, Mr. Barnes stated that the school district is responsible for the lump sum financial sick leave payment at retirement and the Commonwealth, by statute, is responsible for the actuarial costs of having that payment applied to their last year's salary for retirement calculation purposes.

Mr. Barnes concluded his presentation on how sick leave impacts retirement with various factor ranges, such as, salary, unused sick days, final average salary years, leave payment, and final average salary.

KPPA Update on HB 8 Implementation

David Eager, Kentucky Public Pensions Authority (KPPA), began his presentation by introducing Ed Owens, the CEO of County Employees Retirement System. Mr. Owens introduced himself and stated that he is excited to use his skills in this new role.

Mr. Eager began the overview of HB 8 with the calculation of the employer contribution rate. He discussed the four points of importance that HB 8 addresses: (1) decreasing payroll and declining membership as a result of downsizing, outsourcing, and contract employment; (2) a continuation of the same initial calculation of the unfunded accrued liability (UAL) each year; (3) a shift from using projected payroll in order to eliminate the impact of decreasing payroll; and (4) the adoption of the UAL level-dollar

percentage requirement, establishing an employer's percentage share of the UAL based on the 2019 valuation. Mr. Eager then gave an example for an employer in the Kentucky Employees Retirement System non-hazardous plan using the fiscal year 2019 total unfunded liability of $19.2 billion. Lastly, Mr. Eager went over the appeal process, subsidies, and what entities are not eligible to appeal.

Ms. Adkins discussed the entities who are eligible to appeal. She stated that 47 employers have appealed, which represents 26,060 members with a total 2019 liability of $2.4 billion. There were a total of 5,189 members whose employment was appealed by the agencies with a total 2019 liability of $366,308 million. She stated that the majority of the appeals were based on three reasons: (1) the agency is not last employer, (2) the employee was under contract with executive branch, and (3) the employee worked previously at a state mental health facility.

Ms. Adkins gave a summary of appeal concerns, such as calculation validation; federal funding, which requires a percent-of-pay calculation; a misunderstanding of liability calculations; and a lack of understanding of how HB 8 did not assign a specific liability dollar amount to each employer, but rather a percentage. KPPA has also received protest letters, rather than appeals, from approximately 12 agencies, who have paid but reserve the right to mount a legal challenge. There have also been some late payments in July. She noted that at this time no concerns have been identified that will require legislation.

Ms. Adkins concluded with contribution comparisons for July 2020 compared to July 2021 for payroll, employee count, employer contribution, contribution rate, UAL payment, and total employer contribution. Despite a declining payroll and decrease to the employee count, the total employer contribution did go up. So, HB 8 is working as intended.

In response to a question from Senator Higdon, Mr. Eager stated quasi-governmental agencies will need to have at least 60 percent of payroll by fiscal year 2023 and 2024, or the agencies loses their subsidies.

With no further business, the meeting was adjourned.