PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 7th Meeting of the 2021 Interim

September 21, 2021

Call to Order and Roll Call

The 7th meeting of the Public Pension Oversight Board was held on Tuesday, September 21, 2021, at 3:00 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: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Christian McDaniel, Robby Mills, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, Jason Petrie, Russell Webber, and Buddy Wheatley; Joseph Fawns, Mike Harmon, John Hicks, and Sharon Mattingly.

Guests: Jim Carroll, President, Kentucky Government Retirees; David Eager, Executive Director, Kentucky Public Pensions Authority, Danny White and Janie Shaw GRS Consulting; Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; and Bo Cracraft, Executive Director, Stephen LeLaurin, Chair, and Ben Allison, Board Member, Judicial Retirement Investment Committee, Judicial Form Retirement System.

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

Approval of Minutes

Representative Webber moved that the minutes of the August 30, 2021, meeting be approved. Senator Mills seconded the motion, and the minutes were approved without objection.

Discussion on Retiree Cost of Living Adjustments (COLA)

Jim Carroll, President, Kentucky Government Retirees (KGR), began his presentation stating that KGR is an organization founded 10 years ago and now represents 15,000 retired and active members. While being more concerned for the efforts to strengthen the fiscal status of the Kentucky Public Pensions Authority (KPPA) funds, KGR has never advocated for COLAs even though there has not been any COLAs granted for about 10 years.

Mr. Carroll emphasized that over the past decade the inflation rate has been relatively low, while the cost of living has risen about 14 percent. He added that most other public pension plans around the country provide a COLA for their members as a hedge against inflation. He added that the pension reform bill, Senate Bill 2 (RS 2013), provides for a pre-funded COLA adjustment underwritten by a General Fund allocation.

Mr. Carroll reminded the board that KPPA experienced the highest investment returns in its history, realizing a gain for its combined funds of $3.15 billion over last fiscal year with a rate of return exceeding 20 percent across the board. KGR is proposing, as an alternative to a General Fund allocation, a time-limited COLA financed from a small portion of that gain. A 1.5 percent COLA would cost roughly $33 million annually to be paid for about five years. The cost would represent a fraction of a percent of the asset increase experienced by KPPA last year.

In closing, Mr. Carroll stated that KGR believes a COLA would be an investment in Kentucky's economy. According to the National Institute on Retirement Security, every dollar spent to support public pensions in Kentucky produces $1.35 in spending in state.

Senator Higdon commented that a COLA would be a huge benefit for those who have not received one for some time and the matter deserved consideration of the information presented.

In response to a question from Representative Graham, Mr. Carroll stated that he had met with Mr. Eager and has made a public comment to the KPPA board of trustees and deferred to Mr. Eager on comments from KPPA. In response to a follow-up question, Mr. Carroll stated that a 1.5 percent COLA would cost about $33 million. In response to a second follow-up, Mr. Carroll stated that the last COLA was July 1, 2011. Representative Graham commented that with a cost analysis he would support the proposal.

Representative DuPlessis commented that he agrees that the pension systems need to be solid and believes a COLA is important. He stated that the cost of $33 million a year with compounding interest needs to be understood in more detail. Further, he expressed concerns about retirees having to give up the COLA after five years.

Representative Miller commented that he believes something needs to be put in statute saying, if inflation reaches a certain benchmark, that a COLA be granted. Mr. Carroll responded that some states base a COLA contingent on the performance of their investments.

Representative Graham commented that he hopes that the General Assembly will take the step to show appreciation to the service provided by the retirees.

Representative DuPlessis commented that he agrees with Representative Graham and is open to ideas.

Biennial Budget Request – Kentucky Public Pensions Authority

David Eager, Executive Director, KPPA, began his presentation commenting on the COLA. He stated it has been a record year regarding investments and that COLAs are being discussed in several states. He agreed with Mr. Carroll that a 1.5 percent COLA would cost $33 million per year. However, the gains for this year are likely a one-time event and will be smoothed over multiple years. KPPA is prepared to give further information on this matter at a future meeting of the PPOB. Janie Shaw, GRS Consulting (GRS), added that this year's investment returns are not considered excess asset returns to be used to pay for benefits. Investment returns are inherently volatile, and one may expect some years to be higher/lower than the assumed return. As such, GRS's position, especially given the funded status, would be that any benefit enhancements be fully paid. Mr. Eager added that Mr. Carroll's proposal would be pre-funded.

In response to a question from Representative DuPlessis regarding how Wisconsin adjusts COLAs to share investment gains with their retirees as the market fluctuates up and down, Mr. Eager responded that he will gather the information for the next PPOB meeting.

In response to a question from Auditor Harmon regarding what the fully funded cost would be at the 1.5 percent, Ms. Shaw responded that it would roughly be in the $350 million range.

Mr. Eager proceeded with the budget request portion of his presentation. He noted that looking back from 2007 to 2021, for 14 out of 15 of those years, the pension cost to the state was either flat or increased. However, in fiscal year 2023, it will be going down.

Mr. Eager discussed the two cost components: normal cost and the unfunded liability amortization. Normal cost is the estimated cost for benefits earned by active members during the fiscal year calculated as a percent of payroll. The unfunded liability amortization is the cost to pay this year's portion of the unfunded liability (principal and interest). For most of the plans, the unfunded liability amortization is also calculated as a percent of payroll. For the Kentucky Employees Retirement System (KERS) nonhazardous plan, HB 8 provides that the payment be projected in dollars based on each employer's share of the unfunded liability as of the 2019 valuation.

Mr. Eager discussed the funded status for the pension assets and insurance assets as of June 30, 2020, if all Kentucky Retirement Systems and County Employees Retirement System (CERS) funds were combined. There were $12.7 billion in pension assets at a funded ratio of 33.6 percent for all combined pension funds and $5.7 billion in insurance assets at a funded ratio of 69.8 percent for all combined retiree health funds.

Mr. Eager discussed the normal cost rates for pension and insurance for fiscal year 2022. He provided the employer's normal cost rate for insurance for all three tiers for each plan. Mr. Eager also discussed the average normal costs, unfunded liability costs, and total normal and unfunded liability costs. For fiscal years 2023 and 2024, the total employer required contributions for the KERS hazardous plan is estimated at 31.62 percent of pay, down from 33.43 percent in FY 2022; for the State Police Retirement System is 141.77 percent of pay, down from 146.06 percent in FY 2022; for the CERS nonhazardous plan is 26.93 percent of pay, down slightly from 26.95 in FY 2022 with phase-in complete; and for the CERS hazardous plan the employer rate is 49.65 percent of pay, up from 44.33 percent in FY 2022 with one more year of the statutory phase-in. For the KERS nonhazardous plan, the executive branch estimated employer calculation for fiscal year 2023 is normal cost of 10.10 percent of pay plus a unfunded liability amortization payment of $766,971,308 from all fund sources, down from $784,690,828 in FY 2022. For FY 2023 for all employers, the total estimated unfunded liability amortization is $1,002,658,642 from all fund sources, down from $1,022,724,699 in FY 2022.

In response to a question from Representative Wheatley, Danny White, GRS, stated that it is reasonable to assume that the estimated amortization payment for the executive branch's share of the unfunded liability is expected to be the same or level dollar. The value is consistent with the $784 million for fiscal year 2022, and the reduction to $767 million is a result of market performance/investment. In response to a follow-up, Mr. White stated that as a result of statutory changes requiring a biennial budget, the FY 2023 will also apply to FY 2024.

Senator McDaniel commented that he wanted to caution that the systems are a ways off from being at a healthy funding level, and the General Assembly must maintain the commitment to fully fund and to possibly consider putting more money into the base funding.

Biennial Budget Request – Teachers' Retirement System

Beau Barnes, Teachers' Retirement System (TRS), began his presentation with estimates for the system's 2022-2024 biennial budget request, which is preliminary as of September 20, 2021. He noted that the fiscal year 2024 estimate is calculated as a result of the actuarial valuation for fiscal year 2021, which is not yet final.

In response to a question from Representative DuPlessis, Mr. Barnes confirmed that his presentation would include data that takes into consideration the recent TRS board decision to phase-in a new investment return assumption.

Mr. Barnes continued discussing the preliminary budget request for the fiscal year 2023 and 2024. He went over total annual expenditures in budget, additional actuarially determined employer contributions (ADEC), TRS budget actual/requested, fixed statutory contribution through SEEK funding in the Kentucky Department of Education (KDE) budget, and state expenditure for debt service. In particular, he noted increases to the ADEC as a result of changed assumptions from the experience study, including changes to the mortality tables, lowering payroll growth to 2.75 percent, and reducing the investment return assumption to 7.1 percent. He noted that TRS's actuary recommended smoothing in the employer contributions as a result of the investment return assumption over a five-year period. The total estimated TRS budget request for FY 2023 is $1.2503 billion and for FY 2024 is $1.3383.

In response to a question from Representative DuPlessis, Mr. Barnes stated the additional employer contributions required for FY 2024 are blended over a five year period as suggested by the actuary as it relates to the investment return assumption. Representative DuPlessis commented that 10 percent of the entire state general fund budget will be funding the $1.3 billion for educator pensions for FY 2024.

Mr. Barnes discussed the amortized payments for past expenditures for sick leave, supplemental COLAs, and non-single subsidies for health insurance, often referred to as "green box" dollars. He provided the annual payments for FY 2022 and the estimated balances as of June 30, 2022, for each category.

In response to a question from Senator Mills, Mr. Barnes stated that there would have been an additional increase for the additional employer contributions required for FY 2024 of approximately $150 to $200 million, if the numbers were not smoothed. In response to a follow-up, Mr. Barnes stated that when teachers retire, by KDE statute, they may be compensated with a lump sum payment by the school district for their unused sick leave at 30 percent of their daily rate. The district is not required to make the payment or pay the 30 percent, but all districts do pay. At that time, the lump sum payment is added to the retiring teacher's last year annual salary for retirement calculation purposes.

In response to a question from Representative DuPlessis, Mr. Barnes stated that the amortized payment schedule is changing as a result of the non-single subsidy and some of the supplemental COLA debt rolling off, which shows a reduction.

In response to a question from Senator Higdon, Mr. Barnes stated that the additional cost for sick leave is about $38 million a year for the actuarial cost to the state if paid in lump sum. However, it is not being paid in lump sum, so there is an interest of 7.5 percent being applied. In response to a follow-up regarding the annual increase in ADEC funding, Mr. Barnes stated that the increase from FY 2022 to FY 2023 is up about $50 million, and then from FY 2023 to FY 2024, with starting to implement assumption changes, there is an increase of about $77 million.

In response to a question from Representative DuPlessis, Mr. Barnes stated that the annual sick leave cost remains more stable with modest fluctuations from year to year. TRS staff has a history of the sick leave payments that it could provide to the PPOB.

In response to a question from Senator Mills, Mr. Barnes stated that the assumed rate of return, which is 7.5 percent but will now change to 7.1 percent, is also the interest that TRS may earn on the “green box” dollars.

Senator Higdon added that, at last month’s meeting, the PPOB was trying to find a cheaper interest rate for paying off the sick leave balance, and believes TRS can find a rate better than 7.1 percent.

Biennial Budget Request – Judicial Form Retirement System

Bo Cracraft, Judicial Form Retirement System (JFRS), began his presentation with a few organizational updates, including announcing two new board of trustee members, Scott Brinkman and Ben Allison. Mr. Allison introduced himself, describing his 27 years of investment experience and status as a Chartered Financial Analyst.

Mr. Cracraft continued by announcing that, at its April 2021 meeting, the board of trustees adopted the results of the October 2020 Pension Plan Experience. Changes from the study included minor adjustments to the timing to expect retirements and turnover and an update to mortality tables. The board also revised the current discount rates for the cash balance tier plans by adopting the same 6.5 percent rate as currently utilized for the legacy tier plans.

Mr. Cracraft discussed investment performance and stated that the returns have been good. Mr. LeLaurin added that JFRS’s investment manager, Hilliard Lyons, has merged with the company Baird Financial. Mr. LeLaurin discussed the investment performance as of June 30, 2021, for the Judicial Retirement Plan (JRP) and the Legislative Retirement Plan (LRP).

Lastly, Mr. Cracraft provided a cash flow slide for informational purposes, and then discussed the preliminary budget requests. For the LRP, the preliminary budget request is $0 as a result the change in the return assumption from 4 percent to 6.5 percent and the combination of the legacy and cash balance tiers for investment purposes. The preliminary budget request for the 2022-2024 biennium for JRP is $4.5 million or 14.7 percent of pay, reduced from approximately $7.15 million or 23.5 percent of pay for the 2020-2022 biennium.

Representative Miller commented that he is working on a bill request for assumption changes to bifurcate between demographic and financial. Mr. Cracraft stated that JFRS has no pro or con comment regarding such a legislative change. However, JFRS actuarial advisors has recommended reviewing its funding policy, which is statutory and different than other systems. In a follow-up question, Mr. LeLaurin stated JFRS does not fortify with international stocks, it invests in purely domestic stocks, but many of the companies it does invest in are global companies.

With no further business, the meeting was adjourned.