PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 8th Meeting of the 2021 Interim

October 19, 2021

Call to Order and Roll Call

The 8th meeting of the Public Pension Oversight Board was held on Tuesday, October 19, 2021, at 3:00 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 Robby Mills, Gerald A. Neal, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, Jason Petrie, James Tipton, and Buddy Wheatley; Joseph Fawns, Mike Harmon, and John Hicks.

<u>Guests:</u> Jennifer Black Hans, Legislative Research Commission; David Eager, Executive Director, Kentucky Public Pensions Authority; and Danny White and Janie Shaw, GRS Consulting.

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

Approval of Minutes

Representative Graham moved that the minutes of the September 21, 2021, meeting be approved. Senator Neal seconded the motion, and the minutes were approved without objection.

Senator Higdon recognized Mac Jefferson for the years of service he has provided to the Public Pension Oversight Board (PPOB) as his term on the board has expired.

Actuarial Audit Overview/Update – Legislative Research Commission Staff

Jennifer Black Hans, Staff, Legislative Research Commission (LRC) discussed the basics of an actuarial audit to be conducted by the PPOB. The PPOB has the statutory duty under KRS 7A.250, enacted in 2016, which requires an actuarial audit every five years to evaluate the reliability of each retirement system's actuarial assumptions and methods. The cost of the audit is to be paid by the state-administered retirement systems to the LRC.

Ms. Hans explained that an actuarial audit involves engaging an outside actuary or reviewing actuary to evaluate the work of the retirement system's consulting actuary. The audit reviews the actuarial assumptions, methods, process, and valuation results and determines if the findings are reasonable, consistent, and accurate.

Ms. Hans explained the levels of actuarial audits. There are three levels: a level 1, full scope audit; a level 2, limited scope audit; and a level 3 or basic audit. The determination of level depends on the scope of review pursued.

Previous actuarial audits of the state-administered retirement systems have generally been conducted by the systems every 10 years. Ms. Hans gave information on the last actuarial audits conducted for the Kentucky Retirement Systems (KRS) and the Teachers' Retirement System (TRS). KRS had a limited scope audit performed for the period of 2019-2020 on their June 30, 2019 actuarial valuation and their 2014-2018 Experience Study by the Segal Group at a cost of approximately $97,500. TRS had a full scope audit performed for the period of 2015 on their June 30, 2014 actuarial valuation by the Segal Group at a contracted price not to exceed $95,000.

Ms. Hans discussed the procedural steps for how the actuarial audit process should be conducted. However, this being the first actuarial audit under the authority of the Public Pension Oversight Board, the issuance of a Request for Information (RFI) is a reasonable starting point. An RFI is a part of the procurement process that is issued before other procurement steps, explains the task without a narrow scope of work, and is informational only. Responses to an RFI from interested firms contain no specific bids, but may provide: answers to questions, solutions to potential issues, necessary qualifications and experience, and estimates of the time, number of personnel, and costs required.

Ms. Hans discussed plans for the RFI and invited members to request additional information, if needed. The RFI will also include an introduction and background information, inquiries relating to the level of the audit (Level 1 or Level 2), organization of the three systems, level of independence, structure of audit process, necessary qualifications, and estimates of time, staff quantity, and cost.

In response to questions from Representative Miller, Ms. Hans stated that LRC tracks as closely as possible the level of transparency that is required by other state agencies during the procurement process. In response to a follow-up question regarding the past actuarial audits conducted by KRS and TRS, Ms. Hans confirmed that the boards of trustees for those systems had initiated the past audits on their own, as they are not required by law.

In response to a question from Representative Wheatley regarding whether there is an industry standard for handling conflicts of interest, Ms. Hans stated that LRC has asked for information on whether responding firms are a member of the American Academy of Actuaries, but she is not sure if the Academy has a specific conflict of interest provision. In response to a follow-up question, Ms. Hans stated the audit can provide opinions on how future actuarial valuations, including assumptions, methods, or processes should be conducted.

Senator Higdon commented that the PPOB will proceed with the RFI.

Discussion of Retiree COLAs

David Eager, Kentucky Public Pensions Authority (KPPA), along with Danny White and Janie Shaw, GRS Consulting (GRS) began the presentation with comments regarding the RFI. Mr. White commented that the process appears to be in order, but would make sure the time process is on target with the systems' own actuarial processes.

Mr. Eager began his presentation by stating he believes cost-of-living adjustments (COLAs) are being discussed throughout the country due to the higher investment returns, although even at a 25 percent return, Kentucky was at the lower end of those percentages. Additionally, looking at the systems' returns from a longer term window, KRS lost more investment return in 2009 than it was able to earn in 2021.

Mr. Eager provided a background on COLAs. There are two types of COLAs, automatic and ad hoc. An automatic COLA is predetermined and set as a formula or specific rate increase and continues with no action, unless taken away. An ad hoc COLA is granted periodically. States providing COLAs vary widely in the manner of how they are determined.

Mr. Eager discussed the history of COLAs starting from the 1960s through the last COLA for Kentucky retirees in 2012. Through the years, the COLAs were anywhere from .25 percent to 15 percent along with monthly dollar amounts of $1.00 to $2.50 a month per year of service in the 1980s and 1990s. Beginning in 1996, COLAs went from ad hoc to automatic, driven by the consumer price index for urban areas (CPI-U), and ranged between 1.5 percent and 3.4 percent. There have been no COLAs since 2012.

Mr. Eager discussed the statutes which provide that a 1.5 percent COLA will be granted in the future only if: the KRS board (now KRS and County Employee Retirement System boards) determines that assets of the respective systems are greater than 100 percent of the actuarial liabilities, and legislation authorizes the use of surplus funds for the COLA; or the General Assembly fully prefunds the COLA or directs the payment of funds in the year the COLA is provided. New COLAs are not part of the inviolable contract.

Mr. Eager provided a chart of the historical change in inflation from 2011 to 2021 year ending July 3. In 2021, there is uncertainty regarding inflation, with the CPI-U increasing above 5 percent, and thus a reason for the discussion on COLAs.

Mr. Eager discussed national trends in COLAs. Most states are moving away from CPI-driven formulas and moving towards caps and fixed-rate formulas. Now, more COLAs are tied to financial conditions, such as, funded status and investment performance. Mr. White commented that Wisconsin provides a dividend that is not guaranteed where they compare their investment performance to a benchmark. If the investment performance exceeds that particular amount, the surplus of the extra assets are then used to provide an increased dividend to retirees and then, if in a later year the investment return underperforms compared to the benchmark, the dividend is pulled back.

Mr. Eager discussed the funded status of the pensions as of June 30, 2020. He provided the status for actuarial accrued liability, actuarial value of assets, unfunded actuarial accrued liability, and funded ratio at June 30, 2020, for each of the systems. He also provided the fiscal year 2021 investment gain.

Mr. Eager discussed the cost of possible benefit increases for each of the systems. He described different benefit scenarios and the cost to each system. Starting with the proposal from the Kentucky Government Retirees (KGR) for a one-time 1.5 percent increase in retiree benefits payable for 5 years only, the total cost to all systems would be $171 million. Other COLA options presented range in cost from $188 million for a "13th check" option for one year to over $6 billion for a permanent, annual 1.5 percent COLA to current and future retirees.

In response to a question from Representative Tipton, Mr. Eager stated one of the benefit increases is a one-time check to retirees.

In response to a question from Auditor Harmon, Mr. Eager stated an age-determined COLA benefit could start around a predetermined age of approximately 62 or 65.

In response to a question from Senator Mills regarding whether the past COLAs were prepaid, Mr. Eager stated previous COLAs ended up impacting the contribution rate the following year, but were amortized for a long period of time. In response to a follow-up question, Mr. Eager stated that, according to the PFM calculation, the total cost of past COLAs represents 15 percent of the unfunded liability, which is about $2.4 billion with negative amortization.

Representative DuPlessis commented regarding Mr. Eager's information that it would appear financially best for the system not to give a COLA for the next 26 years until the unfunded liability is paid, but that would result in a total of 36 years between COLAs, which is possibly the life span of a member's retirement. In response to a question concerning options within the 26 years remaining on the amortization period, including adjusting for the payment cliff at the end, Mr. Eager responded that while KPPA is not making a policy recommendation on COLAs, they can provide several methods for financing COLAs, such as, a glide path and/or pension obligation bonds. Mr. White added that the glide path would have to wait another 10 to 15 years. As far as the COLAs, retirees in KRS do have some inflation protection with Social Security benefits. COLAs are expensive with the cost continuing to increase with more retirees at the same level of benefits. A 1 percent COLA will add about 7 to 8 percent to the value of a benefit. Mr. Eager added that a number of retirees continue to work for a supplemental income.

In response to a follow-up question from Representative DuPlessis regarding whether COLAs can be given to only those that are not of working age and/or disabled, Mr. Eager deferred the answer to LRC. Representative DuPlessis commented that he would appreciate ideas for a targeted COLA benefit for those who are no longer able to work as a result of disability and/or age.

In response to a question from Auditor Harmon, Mr. Eager and Mr. White explained the relationship between the glide path concepts in the context of level dollar funding with layered amortization.

Senator Higdon commented that additional discussion on COLAs would be necessary at a future date. In response to a question from Senator Higdon, Mr. White stated that GRS' opinion on using existing funds would be to make sure a COLA would be fully funded by being able to pay for the benefit in advance. Mr. Eager added funding a COLA is a policy matter for the legislature, but that as a fiduciary for the system he would not want money taken from the ARC to fund a COLA.

With no further business, the meeting was adjourned.