PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 2nd Meeting of the 2022 Interim

March 7, 2022

Call to Order and Roll Call

The 2nd meeting of the Public Pension Oversight Board was held on Monday, March 7, 2022, 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:

Members: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Robby Mills, Dennis Parrett, and Mike Wilson; Representatives Derrick Graham, Jerry T. Miller, James Tipton, Russell Webber, and Buddy Wheatley; Joseph Fawns, and Mike Harmon.

Guests: Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System; Alisa Bennett, Cathy Turcot, and Ed Koebel, Cavanaugh Macdonald Consulting, LLC; David Eager, Executive Director, Kentucky Public Pensions Authority; and Brad Gross, Legislative Research Commission.

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

Approval of Minutes

Representative Wheatley moved that the minutes of the February 23, 2022, meeting be approved. Senator Parrett seconded the motion, and the minutes were approved without objection.

Teachers' Retirement System Sick Leave Update

Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System (TRS) began his presentation by discussing the recent negative social media postings stating that TRS is the second largest shareholder of Sberbank, which is the largest Russian bank, and concerns that TRS is bankrupt. Mr. Barnes stated that the postings are false. TRS is not now, nor has it ever been the number two shareholder in Sberbank. TRS did own some shares in Sberbank through an outside manager from around 2017 until February 23, 2022, when they were sold with a slight investment gain. Mr. Barnes added that with international portfolios, investments will be in a lot of countries across the globe.

Mr. Barnes discussed TRS's funding sources, generally. He gave a brief overview of the funding sources for pension, health, and other benefits that pay for the normal cost and the unfunded liability. Those sources are the fixed statutory contribution rates, additional or supplemental funding through biennial budget requests, and special funding appropriations for prior benefit enhancements.

Mr. Barnes discussed the benefit enhancements for which the special funding appropriations are made – cost of living adjustments (COLAs) and sick leave funding. First, he discussed that, through a statute governing the Kentucky Department of Education, school districts may pay for unused sick leave at 30 percent of a teacher's daily rate of pay in a lump sum amount, which is distributed in the last year's salary for retirement calculation purposes. Contributions are received on the lump sum amount, but it is not enough to pay the full actuarial cost. The Commonwealth pays the additional actuarial costs. Second, he discussed the supplemental COLA of 1.5 percent that was given to retirees up until 2008.

Mr. Barnes stated that a policy decision was made in the late 1990s that, instead of paying for the full cost of sick leave and COLAs for each budget in a lump sum, those costs were paid on an amortized basis with interest. The Commonwealth is still making payments for these special funding appropriations. The COLAs will be paid in full by June 30, 2027. As for sick leave, legislation capped sick leave that could be used as salary credit at 300 days for individuals who become members on or after July 2008. More significantly, HB 258 passed during the 2021 Regular Session prevents teachers who become members on or after January 1, 2022, from using sick leave for retirement calculation purposes at all. So, eventually there will be a downward trend in sick leave costs. The special sick leave appropriations as calculated in the current version of the biennial budget are $39 million in fiscal year 2023 and $39 million in fiscal year 2024.

Mr. Barnes explained the composition of the actuarially determined employer contribution (ADEC), which pays for the normal cost, the unfunded liability, and other costs of benefits. However, these individual benefit costs are not separately line-itemed for the budget; they are just included as part of the ADEC. Part of the ADEC includes prefunding for sick leave for current, active teachers, which is 1.2 percent of payroll or approximately $47 million annually.

In response to a question from Senator Higdon regarding how long TRS has been paying for prefunded sick leave for active teachers, and why has he never heard of this before, Mr. Barnes stated that TRS's focus has been on the additional budget requests through the special appropriation and the "green box" dollars. Senator Higdon stated that the Public Pension Oversight Board (PPOB) was formed for openness, clarity, and education. With all the questions and actuarial information PPOB has received, Senator Higdon wanted to know why the Board was not made aware of the prefunded sick leave until now. Mr. Barnes stated that TRS wants to provide clear, transparent, and full information to the PPOB, and that the prefunded sick leave has not been a line item in the budget request like the Green Box dollars, but part of the ADEC. Mr. Barnes stated that he takes full responsibility, and that TRS strives to provide accurate information. Senator Higdon emphasized that the Board had advocated to legislative leadership to include in the budget funding to pay off the $479 million “green box” dollars for past sick leave. Had the Board been made aware of the approximately $538 million necessary to prefund sick leave for active teachers, it may very well have sought funding for that in the budget as well.

In response to a question from Representative DuPlessis regarding what the $39 million represents and how big the other dollar figure is, Mr. Barnes stated that the $39 million represents the special appropriation in each fiscal year of the budget for the sick leave in the green box dollars with no more borrowing over 20 years. The $479 million is the total cost of paying off the green box dollars as of June 30, 2022. In addition, built within the ADEC, there is prefunding for the liability of sick leave for active teachers, which is $47 million annually. In response to a follow-up question, Mr. Barnes stated that under statute, compensation for sick leave upon retirement is 30 percent of the current daily rate.

In response to a question from Representative DuPlessis regarding the Russian investments, Mr. Barnes stated that all investment decisions are made by the TRS Board of Trustees, and no decisions are made by PPOB, legislators, the Governor, and/or elected officials on behalf of TRS. Mr. Barnes addressed other international investments made by TRS, and other than Sberbank, they also have some indirect investments in Russian-based companies and other countries as well.

In response to questions from Representative Tipton, Mr. Barnes agreed that the Commonwealth was paying 7.5 percent interest on the $479 million amortized payment of the total unfunded portion of sick leave for retirees and the unfunded COLAs. Representative Tipton noted that HB 1 took a one-time general fund appropriation with the purpose of paying that total portion down to zero, so that in the future the only payment would be the annual cost. In response to a follow-up question, Ed Koebel stated that part of the normal cost for current active members is embedded into the normal cost portion of the contribution that makes up the ADEC, which is prefunding the whole lifetime of an active member by putting aside money to pay for those benefits for when the current active teachers retire. The portion that is in the green box dollars is being amortized over 20 years and is included into ADEC figures, but is separate from required increase requested each year. Cathy Turcot added that overall the money received is enough to fund the current benefits and past unfunded liabilities. In response to a follow-up question, Mr. Barnes stated that $534 million is the cost of prefunding sick leave with no more appropriations from the state budget. The ADEC is a little over $600 million, and the total appropriation is a little over $1.2 billion each fiscal year.

In response to questions from Representative Miller, Mr. Koebel stated that Cavanaugh Macdonald Consulting, LLC, is aware of all the numbers TRS has been quoting and that the 1.2 percent of payroll was developed by Cavanaugh Macdonald Consulting, LLC, based on the current active members and their portion of the sick leave prefunded every year in the normal cost. The $534 million is the present value of all the anticipated sick leave accruals for all current active members.

In response to questions from Senator Higdon, Mr. Barnes agreed that requested ADEC payment in 2016 was $500 million and the 2024 ADEC requested payment will be $756 million, adding that increases with the ADEC are due to experience studies and payroll growth. The prefunded active teacher sick leave does not have an interest payment included. In response to a follow-up question, Mr. Barnes stated that, even though it is not allowed, he would have to follow-up on whether or not vacation days are rolled over into sick leave in some districts.

Representative DuPlessis commented that he has been told that vacation days are rolled over into sick leave. In response to a question, Mr. Barnes stated that he would make sure and report back that year round employees are the only ones receiving annual leave.

In response to a question from Senator Higdon, Mr. Barnes stated that in August 2010, the Commonwealth repaid in full monies that were temporarily funded to the retiree's health insurance plan instead of the pension plan through amortized payments with interest and a bond of $479 million.

In response to a question from Representative DuPlessis, Mr. Barnes agreed that the Commonwealth is paying 30 percent of pay where teachers are paying 12.85 percent. Mr. Barnes also agreed that the Commonwealth has paid the required 13.1 percent every year for at least the last 30 to 40 years.

David Eager, Kentucky Public Pensions Authority (KPPA), discussed the Russian investments and stated that KPPA has about $32 million invested in two emerging market funds.

Auditor Harmon requested additional information from all the systems to the Board regarding any investment managers that are using an environmental, social, and governance approach to investing as opposed to adopting a strict fiduciary-duty approach for their members and the taxpayers. In response to a question from Auditor Harmon, Mr. Eager stated that when it comes to pension funds being shareholder proxies, the systems use a proxy voting service. Auditor Harmon also expressed his concern regarding how proxies are voted and, perhaps, the need to consider remaining neutral.

Annual Investment Review – Legislative Research Commission Staff

Brad Gross, Legislative Research Commission, discussed the annual investment review for the period ending fiscal year 2021. Mr. Gross began with the assets under management stating it was a good year with assets being up across all of the funds with pension funds up $8.4 billion collectively across the state-administered funds and $2.2 billion for the retiree health funds.

Mr. Gross discussed performance showing a comparison chart of the FY 2020 returns compared to FY 2021 returns, where nearly all asset classes in FY 2021 exceeded their assumed rate of return with a record setting year in regards to public pension. Mr. Gross reviewed a slide that provided trailing 1-, 3-, 5-, 10-, 20-year, and 30-year performances for each plan relative to its assumed rate of return and policy benchmark, as well as two peer groups. He referenced that the funds did provide some excess returns above the benchmarks. Mr. Gross then provided a chart that showed 25 years of fiscal year returns for each of the systems with FY 2021 being the highest year.

Mr. Gross began a discussion on asset allocation by noting that, historically, a plan's asset allocation decisions will drive 90 percent of its returns.

In response to a question from Representative Miller, Mr. Gross stated that the chart of the Kentucky system' asset allocations is in actual percentages and not targets.

Mr. Gross continued his discussion on asset allocation with peer comparisons on categories of equity, fixed income, alternatives, and cash. He noted that Kentucky Employees Retirement System (KERS) nonhazardous is below average allocation to equities and alternatives and above average allocation to fixed income and cash; County Employees Retirement System (CERS) nonhazardous more closely resembles average public pension plans; TRS is above average allocation to equities and below average allocation to alternatives; and Judicial Retirement Plan (JRP) is above average allocation to equities and no alternatives.

Mr. Gross provided a review of investment fees for the three retirement systems as of June 30, 2021. He discussed the total, management, and incentive fees and added that the fees are up. He noted that TRS has reported the incentive fees and/or carried interest in their 2020 and 2021 reports and that the Judicial Form Retirement System (JFRS) has the lowest fee structure.

Mr. Gross discussed the cash flow summary. There is a mix of negative/positive cash flow where KERS' continued higher contributions have led to positive cash flow in recent years having exceeded the 3-5 percent threshold for several years prior to 2019. CERS' negative cash flow has fallen within range of negative 3-5 percent since 2009. TRS' additional contributions have helped reduce negative cash flow back within range. JFRS is near or above the 5 percent threshold with both JRP and the Legislative Retirement Plan (LRP) near or above 100 percent funded.

In response to a question from Representative DuPlessis, Mr. Gross stated that with 4 percent negative cash flow and 54 percent funding, TRS' actuaries felt comfortable within that range. While a lower number would be better, particularly when funding is down, it is important to consider whether and how much more can raise the employer rate.

Mr. Gross continued with an update on pension performance as of December 31, 2021, with returns ranging from 3.41 to 9 percent on fiscal-year-to-date.

Mr. Gross discussed assumed rates of return and investment return assumption. The National Association of State Retirement Administrators (NASRA) collects data on public pension plans, including investment return assumptions. Since 2000, the median assumed rate of return among pension plans has dropped from 8 percent to 7 percent with a continuing downward trend. Within the investment return assumption comparison table provided by NASRA as of January 2022, KERS/State Police Retirement System were the lowest at 5.25 percent, CERS was below average at 6.25 percent, TRS close to the average at 7.10 percent, and JRP/LRP recently declined to 6.5 percent.

Mr. Gross provided an additional review data to meet statutory requirements. Staff has reviewed the following: total fund objectives, policies and oversight, and securities litigation and annual recoveries. He also discussed investment reviews that included asset class and total fund benchmarks as of June 30, 2021. Lastly, he discussed a review on allocation and targets, which included current asset allocation, targets, and allowable ranges as of June 30, 2021, for all systems. Of note, KPPA is out of range in liquidity and diversifying assets and, for the KERS nonhazardous fund, the cash allocation is growing.

Representative Miller commented that plans should be made to discuss whether the systems are struggling to maintain investments equal to their investment targets.

With no further business, the meeting was adjourned.