PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 6th Meeting of the 2022 Interim

August 22, 2022

Call to Order and Roll Call

The 6th meeting of the Public Pension Oversight Board was held on Monday, August 22, 2022, 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:

Members: Senator Jimmy Higdon, Co-Chair; Representative James Tipton, Co-Chair; Senators Michael J. Nemes, Dennis Parrett, Damon Thayer, and Mike Wilson; Representatives Ken Fleming, Derrick Graham, Jerry T. Miller, Jason Petrie, Phillip Pratt, Russell Webber, and Buddy Wheatley; Mike Harmon and Victor Maddox.

Guests: Beau Barnes, Deputy Executive Secretary and General Counsel, Teachers' Retirement System and Edward Koebel, Chief Executive Officer, Cavanaugh MacDonald Consulting, LLC; Bo Cracraft, Executive Director, Judicial Form Retirement System; and David Eager, Executive Director, Kentucky Public Pensions Authority.

LRC Staff: Brad Gross and Angela Rhodes.

Approval of Minutes

Senator Parrett moved that the minutes of the July 19, 2022, meeting be approved with a small change. Representative Tipton seconded the motion, and the minutes were approved without objection.

Sick Leave Update and Temporary Reemployment after Retirement Provisions/Investment and Cash Flow Update – Teachers' Retirement System

Mr. Barnes, Teachers' Retirement System (TRS), discussed some of the details of a July 1, 2022 letter from Cavanaugh Macdonald Consulting, LLC (Cavanaugh) regarding the cost of the sick leave program for members of TRS that was in response to a June 7, 2022 memorandum from the Public Pension Oversight Board.

Mr. Barnes went over some of the actuarial fundamentals to familiarize members with the actuarial goals for TRS in order to pay the normal cost and the unfunded liability. TRS receives a number of contributions in order to meet those goals: the fixed statutory employer contribution, fixed statutory employee/member contribution, and the actuarially determined employer contribution (ADEC). Until now, there was another funding contribution called Green Box dollars that reflected special appropriations that were a distinct line item request in each budget. Those Green Box dollars were going towards past benefit adjustments and liabilities, which most recently included only old supplemental cost of living adjustments above the normal 1.5 percent amount and sick leave salary credit. During the 2022 Regular Session, the General Assembly appropriated $479 million to pay off all of the Green Box dollars.

In response to a question from Senator Thayer, Mr. Barnes stated that the annual cost to taxpayers for sick leave enhancements after the payoff of the Green Box dollars is 1.2 percent or $47 million a year.

Mr. Barnes explained that sick leave salary credit will trend downward in the future. For teachers in Tier 3 (entry between 07/01/2008 and 12/31/2021), sick leave is capped at 300 days. For the new Tier 4 teacher, who began on or after January 1, 2022, there is no sick leave payment for salary credit that is incorporated into the defined benefit plan.

Mr. Barnes discussed details of the Cavanaugh July 2, 2022 letter. First, regarding TRS' budget request of $78 million total ($39 million per fiscal year) for the Green Box dollars, TRS requested this item prior to the budget appropriation to pay off the Green Box dollars. Therefore, Mr. Barnes confirmed that TRS did receive from the General Assembly more than what TRS needed now that the Green Box dollars are paid off. However, the monies could be applied to the overall unfunded liability. Second, there is no cost to the Commonwealth for the new TRS 4 members regarding sick leave salary credits.

In response to questions from Representative Petrie regarding if TRS had the authority to repurpose the $78 million ($39 million per fiscal year) that was appropriated for the specific purpose of the annual cost of the sick leave program, Mr. Barnes stated that TRS will apply the $78 million in appropriated monies toward the overall unfunded liability. Representative Petrie duly noted that, if the General Assembly appropriates money for a particular purpose, there is no statutory authority by which an agency may reappropriate or repurpose that money. Otherwise, there is no point for the General Assembly putting in details or purpose behind any appropriation made. The money was appropriated for a purpose, if the purpose is no longer necessary, there is no authority to reappropriate a decision passed by the General Assembly.

In response to questions from Senator Higdon, Mr. Barnes stated that the fiscal year payment toward the Green Box dollars of $39 million, which represented sick leave liability for retired teachers, has been funded by the Commonwealth since approximately the 1980s or 1990s. The normal cost and unfunded liability for active teachers' sick leave as salary credit, is part of the ADEC and has been funded by the Commonwealth since the 2000s. He added that TRS did not receive the full ADEC every year.

Mr. Koebel interjected, explaining that Cavanaugh did not start valuing sick leave within liabilities and normal cost until 2005. He explained how in a traditional defined benefit plan contributions are saved in a trust fund while the member is in active status so that enough money is available to fund the member's benefits when they retire. Sick leave used to increase a member's benefit is included in the normal cost. The total normal cost is about 16 percent of pay each year for a non-university active member with approximately 0.4 percent of that attributable to the cost of annual sick leave accruals or an annual cost of about $15.7 million in today's dollars. This will decline over time with the limit placed on Tier 3 and exclusion for Tier 4 teachers. The Green Box dollars were for retirees that began receiving their pension benefits well before 2005, when TRS was not putting aside money for their sick leave accruals during their active status. So, TRS needed the $39 million appropriation per year to pay down that liability. Now, they are left with the 1.2 percent of payroll going forward.

In response to a question from Senator Higdon regarding the calculation of the 1.2 percent of payroll total, Mr. Koebel stated that in 2021 TRS's trust fund was about $25 billion. The liability for all retirees and active members who have accrued a benefit is about $40 billion. So, there is a portion that is unfunded of about $17 billion from the last valuation. Another portion of the fund's total unfunded liability accrued to date is an estimated $407.6 million for pre-2005 active teachers' sick leave enhancements for which monies were not held back, which is amortized over many years (according to TRS' funding policy). In response to a follow-up from Senator Higdon, Mr. Koebel stated that an appropriation of $407.6 million from the General Assembly would pay off the unfunded liability for active teachers' sick leave, leaving only the normal cost, which is decreasing.

In response to a question from Representative Tipton, Mr. Barnes stated that all unfunded liabilities are targeted to be paid in 2040. In response to a follow-up regarding the different components to the ADEC, Mr. Koebel stated that the ADEC includes normal cost and liabilities all of which go to retirement benefits, which include pension, disability, and life insurance. Representative Tipton requested that in the future when the ADEC is requested, that the components like sick leave costs are categorized within the request.

In response to a question from Senator Higdon, Mr. Koebel stated that interest is being paid on the $408 million unfunded liability due to active teacher sick leave accruals. So, if paid over the full 20 year period, the total would be a little less than double the $408 million.

In response to a question from Senator Thayer, Mr. Barnes stated that sick day spiking is a statute within the Kentucky Department of Education's range of statutes enacted in the early 1980s, which says the school districts may compensate retiring teachers at 30 percent daily rate. All have chosen to do so. In response to a follow-up, Mr. Barnes stated that the unused sick days for pension enhancement is within the same statute and agreed it is outside the inviolable contract.

In response to questions from Senator Higdon, Mr. Barnes stated that TRS has not received an overpayment. The two streams of payment were going towards the ADEC (normal cost and unfunded liability) and the Green Box dollars (including unfunded liability for retiree sick leave), which totaled $787 million. With the payoff of the Green Box dollars, the General Assembly has eliminated $380 million of that sick leave unfunded liability, and TRS is down to $407 million for this specific benefit. In response to a follow-up, Mr. Barnes agreed that some school districts take unused personal days and convert them into sick leave days, much like state employees with 20 or more years of service with an excess of 60 annual leave days at the end of a calendar year is converted to sick leave. Senator Higdon asked that TRS look into the statutory authority for this rollover by these districts, and what the actuarial impact may be on TRS.

Mr. Barnes discussed the provisions and rules for retiring members who return to work (RTW) for a TRS employer. He stated these RTW provisions and rules are in place to allow school districts to address staffing needs by using retired teachers but do so in an actuarially sound manner and in compliance with federal law. RTW rules include making TRS contributions, limits on days and earnings, observing required breaks in service, and having no prearranged agreements. He also explained the critical shortage program, which is available to school districts only, has no earnings limit, but has a statutory cap on the number of critical shortage teachers per district.

Mr. Barnes discussed HB 1 from 2022 Regular Session. HB 1 made temporary adjustments to the RTW provisions for local school districts only to address staffing concerns by relaxing certain aspects of the RTW and critical shortage programs. The law sunsets June 30, 2024, when all rules revert to permanent provisions.

In response to a question from Representative Tipton, Mr. Barnes confirmed that within the RTW temporary provisions of HB 1, upon advice of their outside tax counsel, TRS will be reporting retirees to the IRS as a potential in-service distribution if they are under 59 ½ years of age and return with only a one month break in service. If members are over 59 ½ or they observe the traditional three or 12 month break in service, they will not be reported. In response to a follow-up question, Mr. Barnes stated that TRS's tax counsel is the Ice Miller law firm. He stated that while the firm may be the same for Kentucky Public Pensions Authority (KPPA), which does not report in-service distributions for hazardous retirees observing the statutory one month break in service, Ice Miller advised TRS that a one month break is different than the typical three month summer break for teachers.

Mr. Barnes continued by stating that with the teacher shortage, TRS has communicated to their members the temporary provisions will revert back to the permanent provisions June 30, 2024. He then communicated that both classified and certified positions are eligible; the break in service for the temporary rule is reduced to one month for all RTW positions and for school district critical shortage positions; and the critical shortage employer limits are increased from one percent of the active teachers per district to 10 percent.

Mr. Barnes discussed the critical shortage program positions. There are 622 critical shortage positions allowed statewide under the permanent program with 34 or 5.4 percent being used. In the temporary program, there are 5,423 allowed with 178 or 3.28 percent being used. It should be noted that 73 percent of school districts are not using the critical shortage program.

Mr. Barnes discussed what did not change for the RTW program, including that federal and state law continue to prohibit a prearranged agreement for retiring members to come back to work after retirement; retirees who RTW still have day and wage limits; reciprocity will affect retirees break in service; and retirees will have to drop retiree health insurance coverage from any system. As of June 30, 2022, TRS has 73,198 active members with 8,890 eligible to retire.

Mr. Barnes discussed investment performance for the pension fund for the June 30, 2022 quarter, which was -10.28 percent net, and discussed the gross and net performance for the fiscal-year-to-date, 1-, 3-, 5-, 10-, and 20-year trailing time periods, and the 30-year compounded gross return of 7.75 percent. The health insurance trust returns were -10.47 percent net for the quarter as of June 30, 2022, and a 10-year return of 7.24 percent net.

Mr. Barnes reviewed cash flow for the pension fund FYTD 2022 compared to FYTD 2021. He pointed out the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

In response to a question from Representative Tipton, Mr. Barnes stated that without the $479.2 million funding, the cash flow would have been -$429 million.

Mr. Barnes reviewed cash flow for the health fund FYTD 2022 compared to FYTD 2021. He pointed out the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

In response to a question from Senator Higdon, Mr. Barnes stated the health trust is funded at about 60 percent before the impact of the recent experience study. He continued by discussing the impact of the new assumptions and five year smoothing of returns. Finally, in response to a question regarding proxy voting, Mr. Barnes stated that TRS uses ISS for its proxy voting but all recommendations are reviewed internally.

In response to a comment from Auditor Harmon regarding proxy voting motivated by environmental, social, and governance (ESG) reasons, Mr. Barnes stated that TRS votes for what will increase the value of that company; TRS does not participate in ESG investing.

Investment and Cash Flow Update – Judicial Form Retirement System

Bo Cracraft, Judicial Form Retirement System, began his presentation reviewing the investment performance for the Judicial Retirement Plan and the Legislators' Retirement Plan. He discussed the gross and net performance for the fiscal-year-to-date, 3-, 5-, 10-, 20-year, and inception-to-date trailing time periods for the June 30, 2022 quarter.

Mr. Cracraft discussed the asset allocation for both plans. He reviewed the equity, fixed income, and cash allocations. The plans executed three rebalancing events during the course of the fiscal year to remain on target.

Lastly, Mr. Cracraft discussed cash flow for both plans for the FYTD 2022 compared to FYTD 2021. He reviewed the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

Investment and Cash Flow Update – Kentucky Public Pensions Authority

David Eager, KPPA, began his presentation stating that KPPA also uses Ice Miller as its tax counsel. He announced the hiring of and introduced Steve Willer, Chief Investment Officer, with 25 years' experience in the investment industry.

Mr. Eager discussed some KPPA highlights. The FY 2022 market losses were across the board. KPPA was down 5.73 percent and has met or exceeded their benchmarks in the 1-, 3-, 5-, and 10- year periods. Net cash flows were positive in all pension funds except the County Employees Retirement System nonhazardous fund. The $215 million budget appropriation to the State Police Retirement System reduced the contribution rate from 140.51 to 99.43 percent and increased the funded status from 30.7 to 51.1 percent. A number of asset allocations remained outside of their ranges.

Mr. Eager discussed the pension and insurance investment returns for all plans for the 1-, 3-, 5-, 10-, 20-, and 30- year trailing time periods for the June 30, 2022 quarter.

Mr. Eager provided charts on cash flow for all plans for the FYTD 2022 compared to FYTD 2021. He reviewed a few of the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

Mr. Eager discussed asset allocations for all plans. He reviewed the equity, fixed income, and inflation-protected asset classes, providing data for the asset classes that are outside of the range.

Mr. Willer provided further information on the allocation variances for the June 30, 2022 quarter. He reviewed the real estate, specialty credit, and other cash investment class variances.

Finally, Mr. Eager presented a chart of the Tier 3 interest credits for FY 2017 through FY 2022.

With no further business, the meeting was adjourned.