PUBLIC PENSION OVERSIGHT BOARD

Minutes

May 22, 2023

Call to Order and Roll Call
The 4th meeting of the Public Pension Oversight Board was held on May 22, 2023, at 1:00 PM in Room 154 of the Capitol Annex. Representative DJ Johnson, Chair, called the meeting to order, and the secretary called the roll.

Present were:
Members: Representative DJ Johnson, Co-Chair; Senator Jimmy Higdon, Co-Chair; Representative David Hale, Senator Danny Carroll, Senator Robby Mills, Senator Gerald A. Neal, Senator Michael J. Nemes, Senator Mike Wilson, Representative Tina Bojanowski, Representative Ken Fleming, Representative Derrick Graham, Representative Jason Petrie, Representative Phillip Pratt, Representative James Tipton, Representative Russell Webber, Mike Harmon, and Victor Maddox.

Guests: Ed Owens, Chief Executive Officer, County Employees Retirement System; Danny White and Janie Shaw, GRS Consulting; and David Lindberg, Wilshire.

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

Approval of Minutes
Representative Petrie moved that the minutes of the April 24, 2023, meeting be approved. Representative Fleming seconded the motion, and the minutes were approved without objection.

Review of CERS Actuarial Experience Study
Ed Owens, Chief Executive Officer of the County Employees Retirement System (CERS), discussed the CERS actuarial experience study and explained the process used by the CERS board of trustees to change the assumed rate of return from 6.25 percent to 6.50 percent at its May 9, 2023, meeting.

Mr. Owens discussed the implementation of the new assumed rate of return. The actuarial assumptions will be used to prepare the June 30, 2023, valuation, for presentation in November and approval and adoption by the CERS board in December 2023. This will include the contribution rates to be adopted by the CERS board for FY 2025. The contribution rates previously adopted by the CERS board for FY 2024 will remain unchanged.

Mr. Owens provided a chart of historical actuarial data compared to actual returns for the non-hazardous plan from 1990 to 2022.

Mr. Owens provided a pension and insurance contribution report for the period ending March 31, 2023, with comparative totals from the period ending March 31, 2022, for the non-hazardous and hazardous plans. The report included the cash inflows, outflows, investment gains or losses, and the total net plan assets across both time periods.

Mr. Owens gave a capital market return assumption update and provided forward-looking assumptions with a report from CERS investment consultant, Wilshire. The report provided CERS capital market assumptions as of December 31, 2022, and showed that the 10-, 20-, and 30-year forward-looking assumptions were extraordinarily positive for equity and fixed income.

David Lindberg, Wilshire, discussed the efficient frontier, which is an evaluation of the levels of return that can be accomplished with different levels of risk on a forward-looking basis focusing only on the assets. He provided a chart that plotted levels of expected return relative to the level of expected risk along the efficient frontier on a forward-looking basis over the next 10 years. The chart also reflected where the current CERS policy allocation fell on the axis and by how much you could adjust risk and achieve the same result.

Mr. Lindberg discussed a peer group analysis for the pension and insurance plans for the period ending March 31, 2023, for return, standard deviation, and Sharpe ratio for 1-, 3-, and 5-years. In both cases, the CERS plans demonstrated very strong risk-adjusted returns over a 5-year period.

Danny White, GRS Consulting, discussed the economic assumption recommendations, which included, price inflation, investment return, cash balance interest credit, individual salary increases, and payroll growth.

Janie Shaw, GRS Consulting, discussed the demographic assumption recommendations, which included, mortality, termination or withdrawal, disability incidence, and retirement. The most notable changes to these assumptions were the increases in the mortality and termination rates.

Mr. White discussed the investment return assumption. GRS recommended increasing the investment return assumption from 6.25 percent to 6.50 percent for all CERS funds (pension and insurance). The forward-looking investment return expectations by multiple investment consultants and the strength of CERS' funding policy were both factors in the recommendation.

Lastly, Mr. White presented an example of the fiscal impact of the assumption changes based on the 2022 actuarial valuation for the CERS hazardous and non-hazardous plans for both pension and insurance. He provided a chart showing how both proposed demographic assumptions and all proposed assumptions, including the discount rate, could impact the unfunded liability, funded ratio, and actuarially-determined contribution rates for each plan as compared to current percentages.

In response to a question from Mr. Harmon regarding a possible error on the historical performance report, Mr. Owens stated that the report was manually produced and that it looked like there was a small clerical error.

In response to a question from Representative Bojanowski, Mr. Owens stated that he believes the increase in the member contributions is due to an increased number of employees. In response to a follow-up question regarding mortality rates, Ms. Shaw stated that she could not speak to the higher mortality rates over the past 3 years being due to long COVID specifically, but that the mortality rate analysis was based on a 9-year period and that the majority of experts do foresee mortality rate improvement continuing in the future. Mr. White added that it is possible that long COVID has affected the mortality rates along with delayed treatment for other health issues during the pandemic.

Representative Tipton commented that he supported the CERS separation legislation but had reservations that the future CERS board of trustees would change the assumption rates. In response to whether the recommendation of the CERS board to change the investment return assumption was unanimous, Mr. Owens confirmed that the vote was 5 to 3 and agreed that he and the board members have a fiduciary responsibility to the retirees and members. Representative Tipton commented further, expressing his concern that the assumption change will reduce CERS funding by $102.82 million in employer contributions per year and advising of closely monitoring of the situation.

In response to a question from Representative Pratt regarding administrative expenses, Mr. Owens stated that the administrative budget for Kentucky Public Pensions Authority (KPPA) is somewhere between $48 and $50 million, and CERS is part of that total administrative budget. The administrative expenses for CERS are apportioned from the KPPA administrative budget based on a specified formula.

In response to a question from Senator Higdon, Mr. White stated that the recommendation to raise the investment return assumption was more strongly influenced by the CERS funding policy than by the funded ratio alone. In response to an additional comment, Mr. Owens stated that he will communicate the concerns about the increase in the investment return assumption to the CERS board, but their decision was made based upon a total review of the documentation, almost all of which was provided in CERS's presentation. He also referenced employee salary increases as one possible result of the savings from reducing the employer contribution rate.

In response to a question from Representative Johnson, Mr. Owens and Mr. White stated that with or without rate changes the anticipated date for being 100 percent funded is 2048. In response to a follow-up, Mr. Owens stated that CERS does have an actuarial committee, and they did not make a recommendation to the full board.

In response to a question from Senator Carroll, Mr. Owens stated that CERS would be willing to decrease the assumed rate of return if a recession were to occur within the next few years. In response to a follow-up regarding employee salary increases versus cost-of-living adjustments (COLA) for retirees, Mr. Owens stated that there are only two conditions under which CERS could issue a COLA: if the plan is 100 percent funded, or if CERS receives an indication from the General Assembly that they should. In response to another follow-up, Mr. Owens stated that he does not think the loss of $100 million a year from employer contributions will slow down the fund reaching 100 percent, adding that CERS reviews their rates annually, so the CERS board can make adjustments as necessary.

Representative Petrie commented that he is not sure there is benefit to the retirement participants in adjusting the assumption with $100 million not going into the balance. Whereas, if the assumptions remained, it may hasten the timetable for reaching 100 percent funding, which would seem to benefit the participants. Representative Petrie asked that the governing body seriously consider what actual advantage there is to the participants and the hastening of the full funding of that retirement system by leaving these assumptions steady as opposed to changing them and decreasing the amount of money going into the fund.

Representative Johnson commented that he reemphasizes Representative Petrie’s comments and that it has been a painful process to get the funds healthy. In response to a question regarding proxy voting, Mr. Owens acknowledged that CERS has reached an agreement with 11 of the 12 management funds and are currently in negotiations with the twelfth group due to a required material change in their agreement. If an agreement cannot be made with the final group, CERS will look to change services.

Employer Contribution Projections & Impact on State Budget

Brad Gross, Legislative Research Commission, began his presentation on employer contribution projections and the impact on the state budget from all 6 state administered retirement plans. All funds have a pension and retiree health fund and Teachers' Retirement System (TRS) has a life insurance fund.

Mr. Gross stated that the purpose of the review was to evaluate long-term trends and projections, understand individual system interaction within the budget, and approximate state General Fund costs for each of the applicable systems. He noted that the review provided projections that could always change.

Mr. Gross reviewed the actuarial statistical trends in the pension and retiree health liabilities and funding levels for each of the retirement systems for the years 2018 through 2022. To demonstrate the variability in costs, Mr. Gross discussed the improvement in the funding level for the retiree health funds across all systems. In particular, the unfunded liability for the Kentucky Employees Retirement System (KERS) non-hazardous retiree health fund decreased dramatically from 2021 to 2022 due to a decrease in the price of Medicare-eligible plans, which went from a $252 premium per person in 2021 to a $87 premium per person in 2022. On the pension side, the appropriation of $215 million from the General Fund to the State Police Retirement System (SPRS) for FY 2022 improved that system's funding level from 30.7 percent to 52.5 percent.

Mr. Gross provided a box plot demonstrating the total $42 billion in unfunded liability for pensions as divided among each system and in relation to their impact on the budget. He also discussed the combined unfunded liability of $0.6 billion for retiree health.

Mr. Gross provided a data overview of the employer cost projections through 2050. He explained that payment of the total employer costs are generated from the General Fund, federal funds, and other various sources. The percentages of costs paid by the General Fund vary by system. The Judicial Retirement Plan and Legislative Retirement Plan employer costs are fully paid by General Fund sources with the current cost projections through 2050 remaining at nearly zero. TRS determines or requests set state appropriations including: on behalf payments in the Kentucky Department of Education budget for the fixed statutory rate and additional direct appropriations above the fixed rate to meet the actuarially determined employer contribution (ADEC). For KERS, CERS, and SPRS, General Fund costs are based upon FY 2024 budgeted values, and, as a result of recent legislation, now include employer cost subsidies to quasi-governmental entities.

Mr. Gross discussed the employer costs for KERS non-hazardous and TRS. He stated that 95 percent of the General Fund's costs are from KERS non-hazardous and TRS. For KERS non-hazardous, he provided a chart projecting costs through 2050 and estimating potential General Fund costs.

Mr. Gross reviewed how the employer costs for TRS are composed of the statutory rate plus the direct payments which equal the General Fund payments. The increased cost of assumption changes resulting from the 2021 experience study were smoothed into the pension rate over a five-year period coinciding with positive 2021 investment returns. However, negative 2022 investment returns along with other factors has resulted in a growth in the contribution rate moving forward.

Mr. Gross discussed the TRS retiree health fund. He stated that the fund is receiving more than the actuarily determined contribution and is projected to be fully funded by 2030. However, there is not a mechanism to unwind the specific state funding once it reaches 100 percent funded, so TRS estimates the state's General Fund costs to continue.

Mr. Gross provided charts projecting the TRS pension-only employer costs and TRS employer costs for pension, life, and retiree costs through 2050.

Lastly, Mr. Gross provided a chart for the General Fund estimated costs for all systems with the projections through 2050.

In response to a question from Senator Higdon, Mr. Gross stated that, based upon current projections from the valuation, the employer costs for TRS will be over $2 billion by FY 2032.

In response to a question from Senator Mills, Mr. Gross stated that the funding level for TRS in 2000 was 96 percent.

Adjournment