PUBLIC PENSION OVERSIGHT BOARD

Kentucky Retirement Systems Administrative Subcommittee

Minutes of the 3rd Meeting
of the 2018 Interim

October 22, 2018

Call to Order and Roll Call

The 3rd meeting of the Kentucky Retirement Systems Administrative Subcommittee of the Public Pension Oversight Board was held on Monday, October 22, 2018, at 10:00 AM, in Room 154 of the Capitol Annex. Senator Wil Schroder, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Wil Schroder, Co-Chair; Representative Russell Webber, Co-Chair; Senators Jimmy Higdon and Dennis Parrett; Representatives DJ Johnson and Arnold Simpson; John Chilton, and James M. "Mac" Jefferson.

Guests: David Eager, Executive Director, Kentucky Retirement Systems.

LRC Staff: Jennifer Black Hans, Bo Cracraft, and Angela Rhodes.

Approval of Minutes

Representative Webber moved that the minutes of the September 24, 2018 meeting be approved. Representative Johnson seconded the motion, and the minutes were approved without objection.

Review of Administrative Issues and Fiscal Impact of KRS Restructuring

David Eager, Kentucky Retirement Systems (KRS), testified that after reviewing the administrative and financial impacts, KRS does not believe separating the County Employees Retirement System (CERS) from KRS is a good idea or would benefit the systems' 379,000 members. He discussed several key takeaways from their review and presentation. First, he noted that KRS runs efficiently and that running the two systems separately would cost more, while also causing transitional issues and disruptions. Next, Mr. Eager indicated that having a separate CERS Board to govern investments and actuarial assumptions would be less costly and disruptive than full separation, but stated that KRS was not recommending it. Lastly, he stated that the poorly funded position of the Kentucky Employee Retirement System (KERS) nonhazardous plan does not negatively impact the investment management of CERS funds.

Mr. Eager discussed KRS' administrative expenses and outlined some of the unique features of KRS that makes comparisons to other peer systems difficult. KRS' administrative expenses include investment related expenses and costs associated with administering health care plans, both items that many peers do not have to report. KRS staff administers a highly complex system, which includes multiple tiers, hazardous and nonhazardous plans, and 1,490 employers who are reporting payroll and have to be trained. KRS staff are members of the KERS nonhazardous plan, which has seen employer contribution rates increase dramatically from 5.89 percent in 2001 to 49.47 percent in 2018. Mr. Eager explained recent challenges faced by KRS, including high turnover and information technology upgrades.

Mr. Eager stated that KRS participated in the 2016 CEM Benchmarking study, which reported KRS administrative costs were $77 per active member and annuitant. This compared to a peer average of $112 per member and a median cost of $84 per member.

Mr. Eager reviewed total administrative expenses for the past five fiscal years and stated that expenses had averaged around $32 million per year. He also provided a summary of fees allocated between each system, which is determined by membership. He pointed out that as CERS membership has continued to grow, so has their share of administrative expenses. Lastly, he provided a breakdown of expenses by category for fiscal year 2018 and noted that salaries, pension contributions, and other staff related benefits accounted for just over $23 million of the $32.3 million total.

Mr. Eager presented two scenarios to demonstrate the separation or restructuring of the administration of CERS and discussed the implications and cost of both scenarios. Under the first scenario, CERS would have its own board to set actuarial assumptions and investment policies for the CERS plans, but the KRS board would oversee all other aspects and management of the plans. The second scenario would completely separate CERS from KERS and the State Police Retirement System (SPRS) over some period of time. Mr. Eager discussed several considerations under both scenarios, including additional governance, audit, actuarial, legal, consulting, personnel, financial, information technology, and member services that would need to be addressed and required. Mr. Eager summarized an estimate of the cost of separating CERS, which would include both one-time transitional costs of $2.5 to $4.7 million and additional on-going expenses of $2.3 to $3.2 million required for the separate trust. Lastly, Mr. Eager presented an estimated cost of additional staffing that could be required for the separate trust. He noted that in some areas, such as benefit counseling, additional staff members might not be needed, but estimated that additional management level and investment staff would likely be required and estimated a total cost of $2.7 million for salaries, pension contributions, and other employee benefits. In summary, Mr. Eager stated that the total combined estimated cost of separating CERS would range from $5.0 million to $6.0 million, which he believes is a conservative estimate.

Mr. Eager addressed several recent questions that have been asked of staff with regards to separation or administration of assets. In response to a question regarding the level of discussion that KRS staff has held with employee groups, Mr. Eager stated KRS staff had held many general discussion sessions, but that none had centered on CERS separation or SB 226.

Regarding the question about the fiscal advantages to outsourcing, Mr. Eager indicated that staff had, prior to the introduction of SB 226, had a very general discussion with employer groups. KRS staff had made their case as to duplication of services, but there had not been any further discussion since the stakeholders' recent presentation to the subcommittee.

In response to the question of what would happen to KRS staff after the five-year transition, Mr. Eager stated that he believed KRS would lose a lot of talent and history. Some KRS employees would likely be hired by CERS, retire, or find other employment during the transition.

In response to a claim made by employer groups that KRS' last experience study left out CERS data, Mr. Eager stated that the 2013 and 2015 studies did not leave out CERS data. He indicated that a copy of the experience study was available to the public on the KRS website.

In regard to a point made during a prior meeting that administrative expenses for KRS had increased 247 percent over the last 15 plus years, Mr. Eager confirmed that expenses had increased 247 percent since 2001, or at an annualized growth rate of five percent. Over the same time period, he noted that membership of KRS had grown at three percent per year and inflation was 2 percent, so net of membership growth and inflation, KRS' expenses were flat. On top of this, Mr. Eager noted that KRS pension cost had increased from 5.89 percent to 49.47 percent during that period.

In response to a question regarding if KRS commingles plan assets, Mr. Eager pointed out that it is against federal law to move assets from one trust to another to pay benefits. Mr. Eager did outline the process of making block investment trades and provided an example of how KRS staff might group investment transactions together to gain more attractive pricing if one or more plans desired to make a similar purchase or sale. However, he emphasized that once the transactions are completed, they are recorded by KRS' custodian in the underlying plan accounts and are not moved.

Regarding a question of whether the state would remain liable for the CERS share of the unfunded liability, Mr. Eager indicated that, if any single participating employer became insolvent, the responsibility would fall to the remaining group of participating CERS employers. However, KRS could not state with any certainty if the Commonwealth would be liable if CERS as a whole became insolvent. Such a decision would ultimately be left up to the courts to decide.

In response to a question about the Tennessee retirement system and how a "more" rather than "less" consolidated system differs from KRS, Mr. Eager stated that Tennessee consolidated seven systems that are all housed under the authority of the State Treasurer. The plans provide pension, disability, and death benefits, but do not administer health insurance. The system utilizes the services of several state agencies to administer the plans, and there is one investment group managing assets for all the plans. Mr. Eager pointed out that other states, such as South Carolina and Alabama, had similar structures.

Mr. Eager emphasized that KRS was a system that worked efficiently and expressed pride in how well KRS staff takes care of their 379,000 members. He shared several compliments from both employers and members, which commended the training and professionalism of KRS staff.

In response to a question from Senator Schroder regarding the impact on CERS from KERS and block purchasing, Mr. Eager indicated CERS was not negatively impacted. CERS and KERS have different portfolios and CERS has a higher return assumption at 6.25 percent versus 5.25 percent for KERS and SPRS. The CERS plan's portfolio was dictated based on liquidity and risk tolerance, which at 52 percent funded, is more risky than KERS, but still conservative compared to other plans. The plans are treated totally independent of each other and, if one was fully funded, its level of risk would likely change. CERS is not a healthy plan, but it is less sick than KERS and one that still requires a conservative portfolio.

In response to another question from Senator Schroder regarding why states like Tennessee and South Carolina consolidated their plans, Mr. Eager was unable to speak to specific reasons, but pointed out there is a movement to consolidate the investment management functions of plans, but not necessarily the boards. States like Wisconsin and Georgia have a common group managing the investment of pension and other state funds collectively.

In response to questions from Senator Parrett regarding the consolidation of all the states pension plans (KRS, the Teachers' Retirement System, and the Judicial Form Retirement System) together, Mr. Eager stated he would have to give more thought on the matter. At a very high level consolidation seems to make more sense than separation. He singled out the investment function of pension management and noted that consolidation would eliminate some of the duplicate staffing situations, and those savings could be used to fill empty positions or attract better talent.

In response to questions from Senator Higdon with regards to the number of benefit counselors KRS employees compared to other peers, Mr. Eager responded that he was not sure how KRS compared, but estimated that KRS had a greater number of counselors compared to other states due to the complexity and multiple tiers of benefits in the systems. As more KRS members join Tier 3 and active Tier 1 members retire over the next 8 to 10 years, the complexity will decrease.

In response to questions from Mr. Chilton regarding block trading and interplan transactions, Mr. Eager indicated there have been a few infrequent times where staff executed interplan transactions. Those cases involved public assets, and the pricing was based on the public market with no transaction costs. In response to follow-up questions regarding the recruiting of qualified board members, Mr. Eager agreed that a new board would present even more difficulty to identify and recruit qualified board members to govern the plans. In response to another question regarding members who have service in both KERS and CERS, Mr. Eager stated that about 10 percent of members fall into that category. And lastly, in response to a question from Mr. Chilton regarding whether proponents of separation had objections to the administrative function, as opposed to the actuarial and investment functions of KRS, Mr. Eager stated that would be a question for Kentucky League of Cities (KLC), Kentucky Association of Counties, and Kentucky School Boards Association.

In response to a question from Representative Johnson regarding the possibility that one plan could garner more attention or overshadow another, Mr. Eager acknowledged there could be a perception of that occurring given the poorly funded status and attention given to KERS. However, in reality, for all board members and staff, the main concern and focus falls to the membership, whether it is KERS, CERS, or SPRS. All are treated equally. In response to a follow-up question regarding CERS representation at the board level, Mr. Eager did not express an opinion either way.

In response to Senator Schroder's question to Mr. Eager and then staff regarding how the boards of states like Tennessee and South Carolina, who have consolidated their systems, are structured, Mr. Cracraft stated he did not have information on hand, but would follow up at a later date.

In response to a question from Representative Webber with regards to block trades, Mr. Eager stated that the decision to make the block transactions would be made by the investment committee and department. In response to a follow-up question, he indicated that he was not involved directly in the discussions, but believed that both KERS and CERS were represented in those decisions, and there was agreement.

In response to a question from Representative Simpson as to other plans who had recently separated pension plans, Mr. Eager stated that he is not aware of any other state systems separating.

In response to a question from Mr. Jefferson with regards to administrative expenses and if any are specifically accrued to a certain plan, Mr. Eager indicated all expenses incurred by KRS are combined into a single pool and shared across all the systems and allocated based on the head count.

In closing, Senator Schroder commented that KLC's actuarial administrative expense analysis, which was requested during the prior meeting, had been received and will be distributed to members.

With no further business, the meeting was adjourned. The next regularly scheduled meeting is Monday, November 26, 2018.